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"FOREIGN DIRECT INVESTMENT (FDI) DURING THE TRANSITION FROM A PLANNED TO A MARKET ECONOMY: THE CASE OF BULGARIA (1989-2001)"

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ABSTRACT

The main focus of this thesis is to provide an analysis of foreign direct investment inflows during the Bulgarian transition period from a planned to a market economy. The macroeconomic development, the legal framework, the privatisation deals and foreign participation in the Bulgarian banking system have been examined in the years 1989-2001 under the scope of FDI. Bulgaria has gone through significant changes in the years in question, initiated with the abolishment of communism in 1989 and the country's effort to become a market economy. FDI, on the other hand is an economic activity that assists countries in transition with a significant inflow of capital, technology and knowledge. The author analysed the reasons for the low FDI inflows in Bulgaria paying attention to the delayed transition, adverse initial conditions of the country, geographical distance from western countries, political instability and governmental inability and limited macroeconomic development. The analysis is also based on the consideration of Bulgarian historical elements, the legacy of the communist regime, the legal framework, the policies and reforms that have been used in the privatisation of state owned enterprises (SOEs) and in the banking system, and reference to the special role of Greek FDI outflows in Bulgaria has been made. Using a questionnaire survey we specified the most important incentives and barriers that an MNE considers when it decides to establish an FDI project in Bulgaria. The results were of great significance since we conclude that there is a "regionalisation" in the determination of FDI inflows in Bulgaria (dominant Greek investment interest). Moreover, with the help of a statistical analysis it was found that the sector that each MNE belongs to plays a decisive role in the determination of Bulgarian FDI inflows.

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Εγώ ειμί το φως του κόσμου.
Ο ακολουθών εμοί ου μη
περιπατήση εν τη σκοτία
αλλ' έξει το φως της ζωής.
"Ιησούς Χριστός"

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ABBREVIATIONS

ADP →	Agriculture Development Project
BANU →	Bulgarian Agrarian National Union
BCC →	Bank Consolidation Company
BCP →	Bulgarian Communist Party
BFIA →	Bulgarian Foreign Investment Agency
BFTB →	Bulgarian Foreign Trade Bank
BGL →	Bulgarian Leva
BNB →	Bulgarian National Bank
BNSI →	Bulgarian National Statistical Institute
BPA →	Bulgarian Privatisation Agency
BSP →	Bulgarian Socialist Party
BSTDB →	Black Sea Trade and Development Bank
CCFF →	Cereals Compensation Financial Facility
CCFF →	Compensatory and Contingency Financing Facility
CEE →	Central and Eastern Europe
CEECs →	Central and Eastern European Countries
CEFTA →	Central European Free Trade Association
CITUB →	Confederation of Independent Unions in Bulgaria
CIS →	Commonwealth of Independent States
CMEA →	Council for Mutual Economic Assistance
COMECON →	Council for Mutual Economic Assistance
CPI →	Consumer Price Index
CSFR →	Czech and Slovak Federal Republic
DEM →	Deutche Mark
EBRD →	European Bank for Reconstruction and Development
EC →	European Community
ECE →	Economic Commission for Europe
ECU →	European Currency Unit
EFTA →	European Free Trade Association
EIB →	European Investment Bank
EIU →	The Economist Intelligence Unit
EU →	European Union
FESAL →	Financial and Enterprise Sectoral Adjustment Loan
FBSE →	First Bulgarian Stock Exchange
FDI or DFI →	Foreign Direct Investment
FF →	Fatherland Front

FYROM →	Former Yugoslav Republic of Macedonia
GATT →	General Agreement on Tariffs and Trade
GDP →	Gross Domestic Product
GDR→	German Democratic Republic
GNA →	Grand National Assembly
IBI →	International Banking Institute
IDP →	Industrial Development Project
IIB →	International Investment Bank
IMF →	International Monetary Fund
LBCA →	Law on Banks and Credit Activity
LIBOR →	London Inter-Bank Offer Rate
LSNC →	Law on Settlement of Nonperforming Credits
MF →	Ministry of Finance
MRF →	Movement for Rights and Freedoms
MTT →	Ministry of Trade and Tourism
NA →	National Assembly
NATO →	North Atlantic Treaty Organisation
NCA →	National Chart of Accounts
NCBA →	National Chart of Bank Accounts
OECD →	Organisation for Economic Co-operation and Development
PETs →	Planned Economies in Transition
PHARE →	Poland/Hungary: Assistance for Reconstruction of the Economy. (Pologne/Hongrie: assistance a la restructuration economique)
PIEF →	Private Investment and Export Finance Project
SAL →	Structural Adjustment Loan
SBL →	State Budget Law
SDR →	Special Drawing Right
SFRD →	State Fund for Reconstruction and Development
SOE →	State-Owned Enterprises
SSB →	State Savings Bank
SSE →	Sofia Stock Exchange
STF →	Systemic Transformation Facility
UDF →	Union of Democratic Forces
UN →	United Nations
UNCTAD →	United Nations on Trade and Development
UNRRA →	United Nations Relief and Rehabilitation Administration
US →	United States

USA →	United States of America
USD →	United States Dollar
USSR →	Union of Soviet Socialist Republics
VAT →	Value Added Tax
WB →	World Bank
WIIW →	The Vienna Institute for International Economic Studies (Wiener Institut fur Internationale Wirtschaftsvergleiche)
WTO →	World Trade Organisation
ZUNK →	Bulgarian Abbreviation (**Z**akon za **U**rezhdane na **N**eobsluzhvani **K**rediti) of the Law on Settlement of Nonperforming Credits prior to 31 December 1990 (LSNC)
• Baltic Countries →	Estonia, Latvia, Lithuania
• CIS →	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldavia, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
• Visegrad Countries →	Czech and Slovak Republic, Poland, Hungary
• CMEA →	Bulgaria, Czechoslovakia, German Democratic Republic (GDR), Hungary, Poland, Romania, Soviet Union, Cuba, Mongolia, Vietnam

- **United Nations - 185 Member States** → 24 Oct. 1945 - (Bulgaria from 14 Dec. 1955, Greece from 25 Oct. 1945)

- **EUROPEAN UNION 15 MEMBERS** (from 1951-1957, Greece from 1979)→ Belgium, Denmark, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, Netherlands, Austria (1995), Portugal, Finland (1995), Sweden (1995), United Kingdom

- **Central and Eastern Europe Associate members with EU (10 Members)** → Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia

- **CEFTA – 7 Member Countries** → Bulgaria (from 1999), Czech Republic, Poland, Romania, Slovakia, Slovenia and Hungary

- **OECD - 29 Member Countries**

- **IMF - 182 countries**

- **NATO – 19 countries**

- **WTO → 134 members**

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INTRODUCTION

I. Importance of the study - Motivation of choosing Bulgaria as a case study

The fall of communism in Central and Eastern European countries gave rise to an intense interest to economists, entrepreneurs and multinational enterprises (MNEs) to analyse and exploit the potential of these markets. Bulgaria is one of these countries, which has not been studied yet. At the same time, it displays the following specific characteristics: geographical distance from the Western markets, cultural distance from the West, strong dependence on the ex -Soviet Union and its subsequent dissolution, strong dependence on the CMEA trade organisation and its collapse, adverse initial conditions (adverse macroeconomic indicators, external shocks that the Bulgarian economy has suffered from), political instability up to 1997 and inability of the governments in order to succeed in the whole transition process.

The aim of this thesis is to provide a detailed analysis of the macro-economic and financial development of Bulgaria to enable the reader to understand that its transition process and its steps towards stabilisation, liberalisation policies and structural reforms, need a sound and stable macroeconomic environment. In order for a country to attract significant foreign direct investment inflows, thus, during the transition period from a planned to a market economy there is a need for a country to attract Foreign Direct Investment (FDI) inflows to help its transition policy. **The foreign participation in the Bulgarian banking sector and the privatisation deals which are a significant part of foreign direct investment inflows** together with all the FDI projects, have been thoroughly discussed in the thesis in relation with the theoretical background for FDI. Actually, **the participation of an MNE in a privatisation program is an entry mode (an alternative of acquisition). All the privatisation deals are part of the total FDI deals, thus part of the total FDI inflows in one country.** The direct acquisition of a bank, the founding of a foreign branch or the acquisition of a state bank using a Bulgarian privatisation program and thus the foreign participation in the Bulgarian banking system are also a significant part of the total FDI inflows in Bulgaria. All the above can be proved by the Bulgarian official statistical data. Accordingly, 32% of the total FDI inflows in Bulgaria (end 2001) are flows derived from finalised privatisation deals with foreign participation (around 1.5 billion USD$ out of 4.5 billion USD$ - source: Bulgarian Foreign Investment Agency (BFIA)).

The author has chosen to discuss a former communist county in transition because, despite the substantial literature on FDI with particular emphasis on determining the reasons and the barriers for foreign direct investment, **this has not been the case for Bulgaria, a small country, isolated from western interest.** Also, the potential role of FDI in encouraging and supporting successful transition is well known. FDI in transition economies appears to be an effective tool for several reasons such as transfer of knowledge, increase of productivity, upgrading of managerial and labour force skills, improving the state balance, balancing the deficits, accelerating privatisation of state-owned enterprises and quick restructuring of them.

Economists and investors have dealt through the years with countries mainly from Latin America and Asia such as Argentine, Mexico, Chile, Korea, Malaysia, Hong Kong, Taiwan, Singapore, the Philippines, China, and a few others like the UK, the USA, Spain, Ireland, Portugal and Greece for their inward investment activities. After 1989 and the collapse of communism, Central and Eastern European countries have been an "attractive area" for business together with the Baltic States and the CIS. The interest is always on countries that open their borders, their economies, offer great opportunities, incentives and challenges for inward FDI. In the decade (1990-2000), the interest of foreign investors focused on the Central and Eastern European Economies. Bulgaria has been selected as a case study in analysing the above because of some unique characteristics:

- Bulgaria has received very little consideration in the available economic literature so far.
- Bulgaria had one of the worst initial conditions in the region.
- Bulgaria has received limited FDI inflows during its economic transition from a planned to a market economy.
- The geographical proximity of Bulgaria with Greece (researcher's home country) and the special role of the Greek investments during the transition.
- The legacy of the communist regime that created significant drawbacks, which were difficult for the Bulgarian governments to overcome.
- The strong dependence of Bulgaria on the CMEA and the USSR trade.

- The Bulgarian relations with the West, which were insignificant during the communist era.

- The physical distance of the Bulgarian market from the Western markets.

- The slow structural and privatisation progress and the inadequate macroeconomic stabilisation reform during the transition period.

- The choice of the shock therapy model of transition method and the Heterodox-Money-based stabilisation programme at the beginning of the transition period and the failure of both

- The significant political instability within the country (nine different Prime Ministers and four Presidents during the post-communist period 1989-2001.

- The fact that although Bulgaria had one of the most favourable and less complicated transition from the old communist regime to a post-communist regime with the so-called disguised reform, at the same time, it presented one of the worst market potentials and very unfavourable conditions for a successful economic reform and attraction of significant FDI inflows.

- Bulgaria has a fair chance of succeeding in the transition to market economy and to become a member of the European Union in the future (2004) if its government achieves political and economic stabilisation and development (Copenhagen Criteria).

- The geographical and strategic position of Bulgaria is of great significance; it is close enough to CIS and Greece, which is a member of EU and a crucial link in the European-Asiatic transportation.

- A stable Bulgaria in the European region could play a major role in the connection of Europe with Middle East, and Greece with the EU and Middle East. The results of the survey on this thesis will confirm that a considerable number of European multinational enterprises have considered this factor as the major reason to invest in Bulgaria.

In **centrally planned Eastern European economies,** the private ownership was severely limited and the economy was co-ordinated through bureaucratic plans. Prices were

administrated, fixed and changed rarely and natural resources were seriously under-priced. Macro-economic balance was sustained by direct control and foreign trade was dominated by a few monopolistic organisations. Autarkic trade patterns emphasised bilateral exchange among the members of the Council for Mutual Economic Assistance (CMEA). Passive, monopolistic state banks lacked the capability to evaluate creditworthiness. The risk was socialised and the government played the financial role, intermediating between enterprises and households through subsidies and transfer programs, therefore spending more than half of GDP.[1] Industry was "overbuilt", especially machine building and heavy industry. Medium-size and large state enterprises dominated output and employment. Before the collapse of this regime, wages exceeded the value of consumer goods, which were sold at fixed prices and goods were rationed, resulting in the development of **monetary overhang** in the form of excess household assets.

The **transformation** of centrally planned economies into market economies is a long and complex process. The early phases of this transformation involve a great degree of uncertainty and vulnerability. In the **transition period,** the economy is no longer centrally planned, but at the same time has not yet achieved the outcomes of a market economy. Therefore, the economy in this period can be labelled as "Previously Centrally Planned Economy".[2] The items in question in this transition are: the sequence of the reform, the optimal path, the measures for a successful transition and the delay between the time of the political decision to launch the program until the time of its actual application and implementation. The duration, intensity of reforms, choice of stabilisation policy, degree of external financing and political stability are significant factors for the outcomes of the transition.

This thesis is divided into the following five chapters. The **first** chapter presents the Bulgarian transition process together with its adverse initial conditions as well as criticism regarding the chosen transition of Bulgaria policies. Moreover, attention is given to its political instability during the transition and its strong dependence on the ex – Soviet Union and the CMEA trade organisation during the communist years. Finally, analysis of the Bulgarian banking system, before and after the transition, is also presented. In the **second** chapter, there is a literature review regarding FDI theories. In chapter **three** there is a presentation of a questionnaire survey based on Dunning's theory regarding the determination of incentives for doing business in Bulgaria and exploring the unfavourable conditions (barriers/obstacles) of discouraging establishing FDI projects in Bulgaria. FDI inflows in Bulgaria are also presented and there is a literature review regarding other

questionnaire surveys carried out by other researchers. A presentation of the questionnaire and the research methodology used along with the results from the survey are discussed. The **fourth** chapter focuses on all the privatisation deals in Bulgaria and the results of the questionnaire survey regarding privatisation are also revealed. The foreign participation in the banking system is also presented and analysed. Finally, results from the questionnaire survey regarding the foreign participation in the banking system are disclosed. The **fifth** chapter focuses on the special role of Greek investments in Bulgaria. The specific incentives and barriers for the Greek entrepreneurs which preferred to establish FDI projects in Bulgaria are also mentioned in this chapter. Finally, in the last part of this thesis, the conclusions are provided.

More specifically,

Chapter 1, "*The Transition from a Planned to a Market Economy and the Legacy of the Communist Regime which may Affect FDI Inflows in a Host Country: the case of Bulgaria: 1989-2001*". A quick review of the economic development of Bulgaria during the 20th century and prior to 1989, the legacy of the communist regime and the strong dependence of Bulgaria on the CMEA and the Soviet Union[3] trade are presented along with some other specific factors which led Bulgaria to have one of the worst initial conditions in the region, making the road for the transition to a market economy a hard task. An analysis is offered of the political instability in Bulgaria that created significant delay in the privatisation process, in the establishment and application of the new legal status and in the avoidance of the expansion of the nomenklatura, Mafia or/and other illegal actions.

Moreover, the means and outcomes of the transformation of centrally planned economies into market economies, the choice of a stabilisation policy, modes of transition and the speed of economic reforms in general and specifically for Bulgaria are also discussed. The process of transition contains elements of 1) macro-economic stabilisation or adjustment, together with monetary, credit, fiscal and income policy, 2) economic liberalisation of prices, trade, capital account, currency convertibility and exchange rates. The liberalisation provides competition opportunities and creates alternatives to the market and a more competitive environment for a successful integration into the world market, 3) systemic reform of institutions, market and bankruptcy mechanism and competition. Furthermore, institutional reform of financial sector, legal, accounting, tax, pension system and system of unemployment compensation, ownership, social safety net, restructuring and privatisation of the state-owned enterprises.

The development of the banking sector and the financial reform, in general, contain elements from both the institutional reform and liberalisation policy. In addition, the exchange rate policy also includes liberalisation of the rate, currency convertibility along with systemic reform of the foreign exchange market in Bulgaria. Therefore, the structural-systemic reform has been embodied in each of the following chapters in this thesis, whenever necessary.

Chapter 1, also analyses the macro-economic development in Bulgaria compared to other Central and East European countries, as well as the adverse initial conditions, causes and consequences of the three economic crises of the 1990s, the monetary policy, income policy, currency board, monetary overhang, re-allocation of capital and labour from industry toward services, and the economic obstacles and problems in choosing the road to the transition. It primarily analyses the liberalisation of foreign trade, exchange rates and prices. Bulgarian foreign trade partners, imports, exports, tariffs and its trade balance are studied. An important component of trade policy is the exchange rate, because a change in the level of the exchange rate immediately changes the competitiveness of exporters and importers and thus affects trade flows. There is also a presentation of the Bulgarian banking system and an analysis of statistical data, tables and graphs about GDP, output, employment & unemployment rates, balance of payments, debt, current account, budget balance, wages, unit labour cost, etc.

Chapter 2, "*Foreign Direct Investment as an entry mode*". In this chapter there is a literature review regarding the FDI theories.

Chapter 3, "*The Determinants of Foreign Direct Investment inflows in Bulgaria: 1989-2001"* presents a questionnaire survey. This survey was based on Dunning's theory which helped the author of this thesis to run and examine the questionnaire survey regarding the determination of incentives for doing business in Bulgaria and exploring the unfavourable conditions (barriers/obstacles) of discouraging establishment of FDI projects in Bulgaria.

Moreover, a questionnaire regarding the FDI inflows in Bulgaria has been constructed and its results critically analysed and discussed. This research, underpins the incentives and barriers that most influence the decision of multinationals in making investments or not in Bulgaria during its transition period. A complete and very extensive analysis of the questionnaire results, with the help of the statistical computerized package SPSS, has been made. All the statistical results and data together with tables and graphs have been presented in this chapter. Moreover, all the FDI laws and the Bulgarian legal framework

regarding foreign participation in the whole economic environment have been presented and analysed.

Chapter 4, *"Incentives for an increased Foreign Participation in the Bulgarian Privatisation Process and Banking System and the Role of Financial Intermediaries during the Privatisation Process"*. This chapter examined topics such as the privatisation and restructuring process in Bulgaria as part of foreign direct investment. Incentives and barriers regarding the whole privatisation process have been considered. Moreover, topics such as financial reform in general, cleaning up of the balances of the banks, their debt cancellation and the problem of bad loans have been discussed. The role of financial institutions and commercial banks in the privatisation process (if any) together with the stock market development, legal framework and the presence of foreign banks in Bulgaria are also examined.

Criticism is made of the slow privatisation process in Bulgaria, and its choice of different methods of privatisation. In addition, there is a discussion about the development of small and medium enterprises, property rights, and corporate governance, ownership and private sector development. All the privatisation laws are presented together with graphs and examples of all the privatisation and FDI deals and the progress from the beginning until the end of 2001 are presented in this chapter.

Case studies with foreign MNEs that participated in the privatisation process, together with all the BCC deals taking part in the Bulgarian privatisation of the banking system, are found in this chapter.

Chapter 5, *"The Determinants of Greek FDI and the Role of the Greek Investments in the Bulgarian Transition to a Market Economy"*. Strong emphasis is placed on Greek investments due to the fact that Greece appears to be a unique case among the other foreign investors in Bulgaria. Greece ranks first in the number of foreign direct investments in Bulgaria among the members of EU. Greece is a neighbour country with cultural and geographic proximity with Bulgaria and already had played an important role in the economic development of Bulgaria. At the end of 2002, Greece appeared to be in the 1st place in volume of investing dollars. All the specific incentives and barriers for the Greek entrepreneurs who invested in Bulgaria are also presented and discussed.

Conclusion sets out the *"Final Conclusions"* of the overall thesis

II. Research Methodology

The first step of the research was to present and examine all the theoretical issues found in the thesis as accurately as possible. A careful study of the sources provided the author with a comprehensive understanding of the different theories which have been presented. Moreover, it was a primary goal to consider Bulgarian FDI inflows during its transition period and the practical use of the country in each theoretical issue in order to understand the country case study, which has been chosen.

Then the author carried out an extensive literature review regarding the topic of the transition from a planned to a market economy. The author came to realise that there are tremendous gaps in the theory of transition and there is no finalised theory describing the path of transition (shock therapy or gradualism). The issues if privatisation must take place before restructuring or the opposite, if the fixed or flexible exchange rates are better, if there is a need for a quick or slow privatisation, if the mass privatisation programs are necessary, etc. are also examined.

Furthermore, the author studied most of the FDI theories presented in the International Business area together with the entry modes in order to gain the necessary background for constructing the questionnaire and completing the statistical analysis of this survey.

The second step was the accumulation and constant updating of the official data concerning Bulgaria and other related countries (CEE countries), from official sources like the International Monetary Fund (IMF), OECD, UNCTAD – UN, EBRD, Bulgarian Foreign Investment Agency (BFIA), World Bank, the Bulgarian Government, the Bulgarian Privatisation Agency, etc. This was accomplished mainly through their internet wed sites, but also through mail and E-mail correspondence with competent authorities and personal contacts.

The third step was the analysis of more regional studies and works such as papers, books, newspapers and surveys published in the Bulgarian, Greek and English language. At this point the author did a significant survey of the Bulgarian legal framework, which has been analysed and presented in the thesis in order to discuss the possible absence of western investment interest and to connect this absence with the inadequate Bulgarian laws on FDI and privatisation.

The fourth step was the empirical research. The initial stage in the research process was the identification of what might determine the research question. Hence, the research was based on the issue of what the determinants, incentives and barriers of FDI are for a small economy such as Bulgaria.

III. Construction of the questionnaire

A questionnaire was designed to extract valuable information regarding the determination of FDI in Bulgaria during the post-communist period 1989-1999. Its purpose was to identify the kind and the type of incentives and entry barriers for inward foreign direct investment that the foreign firms have considered in order to establish whether they should make an investment or not in Bulgaria. For the purpose of this empirical research, a data set was collected from a primary source (using an own-design questionnaire and personal interviews were made in order to gain in-depth qualitative information).

The questionnaire used in the research study consisted of three parts. In the first part, the questions provided necessary background information on certain issues that were considered important in characterising the sample population. In the second part, one question included seven groups of sub-questions with related factors that were considered to be of major importance and allowed the managers of the enterprises to select the most appropriate for their case. These groups of sub-questions were initially selected based on Dunning's theory, but necessary amendments were made during the research period of eighteen months (the research was started in January 1998, six months were needed for the construction of the questionnaire, studying the theories and deciding the way of contacting the companies and creating the sample. Twelve months were needed for the interviews and the statistical analysis of the results of the questionnaires). Similarly, part three contained only one question with a group of factors that describe the barriers discouraging the firms to invest in Bulgaria. More specifically, in the first part there are questions searching for some general characteristics of the company, such as the sector that the company belongs to, the year of investment, the amount of investment, the home country of an MNE, entry mode etc. In the second part there is the theoretical part of the questionnaire survey. In this second part, seven groups of hunters (seekers) have been created: Locational hunters (historical links, cultural closeness or distance, geographical proximity, stability, climate etc.), factor hunters or natural resource hunters (access to low cost of acquiring natural resources and raw materials - p. 13 "the eclectic paradigm of international production: a restatement and some possible extensions", John H. Dunning, Journal of International Business Studies, Spring 1988), market hunters (size of the market, prospects for market

growth, increasing market share), strategic market hunters (follow the competition, follow the clients, a way to survive, acquiring of assets, international pressures, globalisation etc.), efficiency hunters (economies of scale, of scope, risk diversification), exploiting the ownership advantages (brand name, know-how, past experience, existing business links etc.), hunter of financial aspects (favourable investment law framework, subsidies, tax exemptions). In the third part, there are twenty entry barriers (instability, bureaucracy, corruption, unstable legal system, etc.) The construction of the questionnaire was based on the Dunning's theory [the eclectic theory (OLI – eclectic paradigm of international production)]. According to Dunning we have: Locational (L) (natural resources availability and cost, investment incentives, characteristics of the country – language, culture...), Internalisation (I) (avoid costs, control supplies, avoid or exploit government intervention), and Ownership advantages (O) (intangible asset advantages, product innovations, know how, multinationality). Dunning has also define natural resource seeking (vertical integration, availability, cost), market seeking (market size and characteristics, investment incentives, p.82 Multinational Enterprises and the Global Economy, John, H. Dunning, 1993, chapter 4), efficiency seeking (economies of scale and scope, risk reduction through product diversification – p.13 "The eclectic paradigm of international production: a restatement and some possible extensions", John H. Dunning, Journal of International Business Studies, Spring 1988) and strategic asset seeking (gain new product lines or markets, economies of synergy, economies of common governance, improved competitive or strategic advantage, reduce or spread risks- p.82 Multinational Enterprises and the Global Economy, John, H. Dunning, 1993, chapter 4). At this point it is worth saying that the researcher spent a lot of time explaining to all the interviewers the questionnaire's questions and the questionnaires were completed with the presence of the researcher.

IV. Statistical analysis

The statistical analysis has employed the Descriptive Statistics methods, as well as the Inferential Statistics methods. More specifically, tabular and graphical methods were used to summarise the collected qualitative data and provided us the first insights about the research variables. Then, the chi-square test was used to investigate the statistical association between the variables. The author used the Chi-Square Test of Independence or test of association. The objective was to determine whether the variables are independent or not. The descriptive nature of the variables allowed such approach. For statistical validity, in order to be able to run the chi-square tests, there is a need to have at least five observations per cell. Thus, it was suggested to categorise the variable in the following

way. For the implementation of the test the following was needed: Using specific descriptions, the population of the companies must be divided into classes. In other words, the 64 companies were classified according to their type/kind of business into three classes (taking under consideration from the theory the importance and the similarity of the different sectors):

1: Productive, Textile and Industry

2: Services and Banks

3: Trade and Food

In more details, the 1st group of sector: (POWER INDUSTRY, NON-FERROUS METALLURGY, METALWORKING INDUSTRY, ELECTRICAL INDUSTRY, NON-METALLIC MINERALS AND BUILDING MATERIAL, CHEMICAL AND PHARMACEUTICAL INDUSTRY, WOODWORKING INDUSTRY, GLASS INDUSTRY, CEMENT INDUSTRY, TEXTILE INDUSTRY, LEATHER AND FOOTWEAR (CLOTHING) INDUSTRY, PAPER PRODUCTION AND PROCESSING (Productive-Industrial companies – thus HEAVY – LIGHT INDUSTRY, productive +industry + textiles).

The 2nd group of sector: Banking – Finance – Telecommunications – Hotels (Tourism) - Banks – Transport (thus SERVICES).

The 3rd group of sector: FOOD PROCESSING INDUSTRY, CATERING AND TRADE, consumer products– retail sector (thus FOOD + TRADE) (the categorisation is based on the statistical data used by Bulgarian Foreign Investment Agency).

After collecting and examining the results for the questionnaire survey, it was decided to move one more step forward in his empirical research and to run a statistical analysis. His purpose was not only to determine the general incentives and barriers for the Bulgarian FDI inflows during the period in question, but also to determine IF the ranking of the incentives and barriers is different when dividing the 64 MNEs into 3 groups of sectors (considering 3 groups according to the sector that each MNE belongs to).

Another grouping was made which regarded the country of origin of the investor of interest. We examined if the specific ranking regarding the general determination of incentives and barriers for the case of Bulgarian FDI inflows, changes when considering only the neighbor origin MNEs, thus the Greek ones against the foreign MNEs (other than neighbour MNEs to the host country of Bulgaria). We have done this in order to conclude if there is a "Regionalisation" in the trend of FDI inflows in Bulgaria.

1: Neighbour countries such as GREECE (Greek origin of MNEs or MNEs with Greek interest)
2: MNEs from EUROPE and OTHER COUNTRIES

Contingency or cross tabulation tables were produced to allow a subjective impression of the data. Each one of the contingency table is a simple array used to present the results of a classification of a sample. In such a table the classes of the first part of variables are the row headings and those of the other variables are the column headings.

According to the test, in the null hypothesis (Ho) the variables are independent (there is no association between the variables) and in the alternative hypothesis (H1) the variables are dependent (there is association between the variables). The analysis is based on the p-value. If the p-value is less than 0.01 (strongly significant) and less than 0.05 and 0.1 (significant), then there seems to be enough evidence against the null hypothesis of no association and it can be concluded that there is enough evidence to support the alternative hypothesis. If the p-value is more than 0.1, it cannot be rejected the null hypothesis of no association cannot be rejected in favour of the alternative hypothesis of a significant association between the variables of interest within the sample.

The statistical analysis establishes possible relations between the variables for the 64 questioned companies. The nature of the relation between the variables, if any, was investigated with the chi-square statistic, which is regarded the most suitable for this kind of data. Instead of using a statistic method like correlation coefficients, which requires data collected in a continuous form, the chi-square test allows for making inferences to the population of interest, in this case foreign investors in Bulgaria, by making use of the categorical data. The results are valid in most of the cases at 0.01, 0.05 and 0.1 levels of significance and the inferences about the population were based on the results of the p-value. There are reported to be some 110 foreign enterprises in Bulgaria, according to the official catalogue obtained from the Bulgarian Foreign Investment Agency (BFIA) mid 1998, which have invested over 1,000,000 · US dollars. For the purpose of this questionnaire research, this author used an extended catalogue of 131 foreign investors in Bulgaria, which was comprised from the official BFIA catalogue mentioned above, and another 21 investors mainly of Greek origin, whose data was collected from a one to one interview (5 companies, which were excluded from the old BFIA catalogue in mid 1998, have been included in the new BFIA catalogue, end 2000). These 21 other investors did

not form part of the BFIA official published data of foreign investment in Bulgaria due to the expected inefficient data collection in such a hard task.

V. Chi – Square Method

The Chi Square Method is a non-parametric test of statistical significance for bivariate tabular analysis (also known as crossbreaks). Any appropriately performed test of statistical significance informs you of the degree of confidence you can have in accepting or rejecting a hypothesis. Typically, the hypothesis tested with chi square is whether or not two different samples (of people, texts, whatever) are different enough in some characteristic so we can generalize from our samples that the populations from which our samples are drawn are also different in the behavior or characteristic.

A non-parametric test, like the Chi Square, is a rough estimate of confidence; it accepts weaker, less accurate data as input than parametric tests do (like t-tests and analysis of variance, for example) and therefore has less status in the pantheon of statistical tests. Nonetheless, its limitations are also its strengths because Chi Square is more 'forgiving' in the data it will accept. It can be used in a wide variety of research contexts.

When expected frequencies are large, there is no problem with the assumption of normal distribution, but the smaller the expected frequencies, the less valid are the results of the chi-square test. Therefore, if you have cells in your bivariate table which show very low raw observed frequencies (5 or below), your expected frequencies may also be too low for chi square to be appropriately used. In addition, because some of the mathematical formulas used in chi square use division, no cell in your table can have an observed raw frequency of 0.

The following **minimum frequency thresholds** should be obeyed:

- for a 1 X 2 or 2 X 2 Table, expected frequencies in each cell should be at least 5;
- for a 2 X 3 Table, expected frequencies should be at least 2;
- for a 2 X 4 or 3 X 3 or larger table, if all expected frequencies but one are at least 5 and if the one small cell is at least 1, chi-square is still a good approximation.

Then the test requires that the data be grouped. The actual number of observations in each group is compared to the expected number of observations and the test statistic is calculated as a function of this difference. The number of groups and how group membership is defined will affect the power of the test (i.e., how sensitive it is to detecting

departures from the null hypothesis). Power will not only be affected by the number of groups and how they are defined, but also by the sample size and shape of the null and underlying (true) distributions[4].

VI. Procedure – Difficulties

The first step towards accomplishment of the empirical research was the selection of the appropriate set of companies that had already invested in Bulgaria. For this purpose, a statistical significant sample was selected. From an official list that had been collected from the Bulgarian Foreign Investment Agency (BFIA), a list with 110 foreign companies was found (as of 30 June 1998). This list contained the enterprises that according to the BFIA have invested over 1,000,000 million US dollars in Bulgaria until mid June 1998. The total invested capital from these enterprises amounted to around 70% of the total volume of foreign investments in Bulgaria at that time. Sixty-four foreign companies have participated, answered and been interviewed in this important research. The level of participation was very high, the sample statistically significant and according to the researcher's belief there is no other work in the field with such a magnitude of sample for a country such as Bulgaria.

Prior to commencing this research, literature review of theories of FDI together with methodologies, techniques and previous empirical studies on determining factors influencing FDI decisions were studied and presented. Moreover, elements and conclusions from previous questionnaires' analyses for Central and Eastern European countries also appear in this thesis. In addition, the results are compared with similar works.

Although it was a time consuming process, the researcher found it very useful and important to ask questions about the background of the participating companies in the questionnaire. Important information, such as the amount of investment, kind of business, direction of products, future expectations, etc. was gathered. Sometimes, the interview schedule was made up of some open questions, which allowed the interviewer to develop these questions in order to expand and explain the interviewee's responses further. Notes were taken during the interviews so as to facilitate the analysis of the research process. The quality of data and information obtained was very reliable due to the fact that all the managers had been informed that their names and their companies' names would not appear in the statistical analysis. It was primary data source and it was direct from the

companies' managers. The ultimate aim was to combine a theoretical thesis with real empirical research.

In conclusion, the whole research process was a completely new and valuable learning experience, within the researcher's expectations. Initially, it was uncertain if financial sources to complete such a difficult research would be found. The research needed eighteen months to be completed. The researcher visited Bulgaria at least seven times, stayed there almost six months in total, took approximately 100 interviews from foreign companies that had invested in Bulgaria and spend a large sum of money and valuable time collecting the results (the whole research lasted 18 months).

Various unexpected problems were encountered and many new situations were experienced thought out the research and the results found were important. It is obvious that much of the research process should be allocated to the fieldwork. A specific example is the research timetable, which was created at the beginning. It was impossible to keep to the initial schedule, as the whole process took longer than expected and planned (the author notes that after the completion of the questionnaire analysis (end 1999), he was bedridden under medical treatment for a period of over a year due to health problems).

The researcher did not encounter any problems in finding sources of data about the transition to a market economy. There is ample literature on this topic, as well as about foreign direct investment theories. Moreover, as already mentioned, for the empirical part of the thesis a lot of similar work appears in journals, but not for Bulgaria. Furthermore, the extensive list of the people (see acknowledgements) that helped in this thesis provided the author with articles, publications and secondary data for all the Central and Eastern European Economies and thus prevented the encounter of any major obstacles in their collection. In addition, visits and interviews in Bulgaria, the already available published articles, and the data collected from the official Bulgarian agencies and organisations (all in the English language) have significantly increased the researcher's knowledge about the Bulgarian economic environment throughout the years.

Finally, it should be mentioned that during the research, a diary was kept, proved useful in checking upon the progress made. The researcher was able to refer back to it to retrieve important information whenever necessary. Of course it was not the first time, this method was followed since it had been used by the researcher (in his dissertation of MPhil in

International Finance at the University of Glasgow and in his two bachelor degrees BA in Business Administration and BA in Law both completed in Greece).

VII. Describing the Survey

The survey lasted 18 months (time period January 98 – June 99), but most of the questionnaires were completed in the period Jan '99-June '99. The total invested amount for the 110 foreign companies was 1,283,419,173 USD$ and for the extra 21 companies (extended catalogue) was 47,6 million USDS. The statistical sample with 64 companies consisted of a total investment amount equal to 863 million USD$, which was 64.7% of the total investments of these 131 companies or 50.7% of the total Bulgarian FDI inflows (BFIA catalogue, Foreign Direct Investments over 1 million USD$ (as of 30 June 1998)).

Only 9 out of the 64 participating countries in the questionnaire had made their first investment after January 1998 and the remaining 55 companies until the end of 1997. Most of the 64 companies had undertaken additional investment projects in Bulgaria throughout the previous years. The questionnaire survey was run before the benefits of the introduction of currency appeared in the Bulgarian macroeconomic environment. Thus it was expected that the macroeconomic instability, political instability, and low progress in the transition appeared were as significant barriers for the investors (from the questionnaire results).

During the completion of the questionnaire research, the problem of limited answers to the questionnaire arose. To overcome this problem, other ways rather than the post for distributing the questionnaires were selected. The combination of interviews, faxes, phone calls and visiting companies' websites, was the most appropriate way for the successful completion of this research. More specifically, the usual way of replying questionnaires [Table A], the post way, in any research study, failed (i.e. only 4.7% of the companies replied in this way). Hence, it seems that the best replying rate came from one to one interviews (35,9% of the total response rate, followed by e-mail or www with 29.7%). The fax and telephone methods had success in about 30% cases together. Due to the above bad response rate by post and the possibility of a failure to collect the sufficient data, a multiple approach of the target group was decided by applying some pressure with various methods of contacting and getting their attention.

In the first six months, the author completed the questionnaire design and made decisions

on the source of data, literature review, theory study, other published articles – empirical studies, methodology (statistical analysis, target group, sample size, way of approaching the target group, financial sources for completing the study, scheduling timetable etc.)

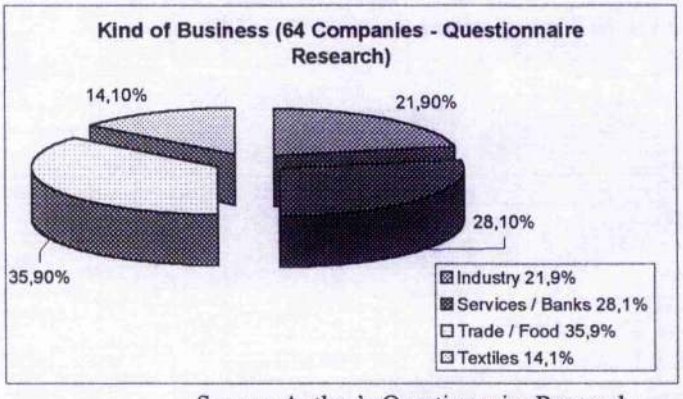
Among the 64 companies 37 were of Greek origin. The reason that 37 companies seem to be of Greek origin is because firstly we have considered the offshore companies with approved Greek interest as Greek (i.e. Cyprus or Luxembourg based offshore companies). Secondly, we have also considered as Greek investments the joint ventures or consortiums with approved significant Greek participation (i.e. Alico/CEH that bought Postbank, the management and 43% of the total shares belong to the Greek Eurobank and the remaining shares to the American Insurance Group (AIG) and its subsidiary ALICO). Eight out of the 37 above-mentioned companies were of this type.

The BFIA table helped the author to decide the minimum amount invested by each company in order to be considered in the analysis, having as a result a sufficient number of observations in the population for the purpose of this study.

However, it is possible that the author was not able to find all the investments over one million dollars, possibly due to the lack of formal government statistics. Thus, if the author has not included in this study a number of important investments (over one million dollars), this should be taken as a statistical error and should be added to the statistical error caused by the non-replied questionnaires. Thusly, some misleading results are unavoidable.

Since the researcher of this questionnaire is of Greek origin, the high rate of responses and the high percentage of Greek answers in the final results were expected.

Figure A: Composition of Sector for Sixty-Four Interviewed Multinationals



Source: Author's Questionnaire Research

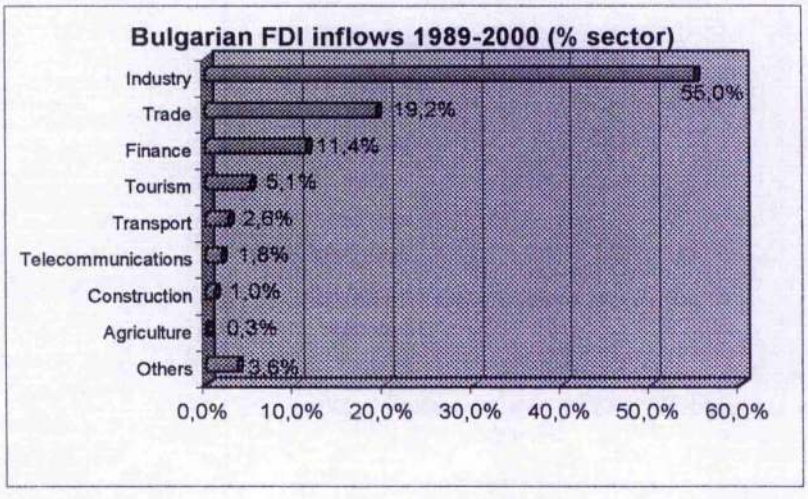
According to the existing literature, there has been no other statistically analysed research

for Bulgaria with such a magnitude (64 companies have been interviewed and answered a questionnaire) and statistical significant sample, in order to identify the incentives and barriers for the FDI decisions in Bulgaria. Other surveys tried to determine incentives and barriers for more than one country simultaneously with less than 64 MNEs as a sample for one specific country.

The response size was 64 out of 131, and it formed the sample size. Literature has shown that this response rate in the subject area is extremely large and according to statistics a sample size (response rate) of 10% of the population of interest is regarded big enough to allow secure inferences about the population of interest. Our response rate was 48.9% of the updated catalogue. The sample is very representative since it comprises companies that have invested a very significant amount of US $ for the economic figures of Bulgaria. The invested volume of the 131 companies adds to around 70% of the total foreign invested capital in Bulgaria (Total FDI inflows in Bulgaria: 1.7 billion US$ in mid 1998).

The sample of the questionnaire analysis is **also representative** because the answers (see Figures A and B). Moreover, in our sample the answers collected and analyzed, belonged almost proportionally to the sectors of industry, services and trade. In our questionnaire survey the services sector accounts 28% and the official FDI inflows in Bulgaria in the same sector were 18% (Finance 11,4% + Tourism 5,1% + Telecommunications 1,8% =18.3%). Trade in our questionnaire survey accounts 36% and the official FDI inflows in Bulgaria in the same sector were 19,2%. Finally, the answers from the industrial sector were 22% and textiles 14% (total 36%) and at the same time the official FDI inflows in Bulgaria in the industrial sector were 55% of the total.

Figure B: Bulgarian FDI Inflows 1989-2000 (% sector)



Source: BFIA Catalogue

Table A: Questionnaire Survey Properties

Way of Completing	Frequency (No of companies)	Percentage (%)
Fax	9	14.1
Telephone	10	15.6
By Post	3	4.7
E-mail, www	19	29.7
Interview	23	35.9
Total	64	100

		Frequency	Percent
Valid	until end 1997	55	85,9
	1998	9	14,1
	Total	64	100,0
Total		64	100,0

which year MNEs have made the initial investment

Average of MNEs FDI inflows (from the questionnaire research) –

AVERAGE=14.412

		Frequency	Percent
Valid	less than mean volume of investment	51	79,7
	greater than mean volume of investment	13	20,3
	Total	64	100,0

		Frequency	Percent
Valid	GREEK	37	57,8
	EUROPEAN	22	34,4
	OTHER	5	7,8
	Total	64	100,0
Total		64	100,0

Home location of MNEs (origin)

		Frequency	Percent
Valid	INDUSTRY	14	21,9
	SERVICES/BANKS	18	28,1
	TRADE/FOOD	23	35,9
	TEXTILES	9	14,1
	Total	64	100,0

Kind of Business – the sector that an MNE belongs to

		Frequency	Percent
Valid	no additional investment	14	21,9
	additional investment	50	78,1
	Total	64	100,0

additional investments in the future

Source: Author's Questionnaire Research

VIII. Statistical problems

"Even in established market economies ***standard statistical data*** *provide only an incomplete description of economic reality, but in countries in transition data deficiencies and biases are much more serious".*[5]

Under central planning, the output of state enterprises was often exaggerated, whereas during the transition, there are strong tax incentives for the output of the private sector to be underreported by large margins, conventional statistics fail to reflect the sharp improvement in the quality of goods and the satisfaction of the demand in the transition period, relative to the previous situation with enormous output and unsatisfied demand. Reported unemployment data and fiscal deficits during the communist period were problematic and cross-borders transactions are poorly reported. Regarding the foreign direct investment inflows comparisons have been made with three different sources of data have been considered (it is important to be noticed that the late 2000 data from all the resources more or less has been converged).

One source of data is a database, which was retrieved from IMF, OECD, UNCTAD, UN, WIIW ETC., the second one is the Bulgarian balance of payments, which is used by all the international organisations and the third one is the Foreign Investment Agency in Bulgaria – together with the Bulgarian NSI-, in which the data are derived from the companies' information. Moreover, tables for comparing the inflows of FDI in different countries are presented in the whole thesis.

However, there is a problem in making comparisons using these data, due to the fact that four elements are included in FDI and thus, for example many countries exclude one of the components of FDI, usually the re-investments of the foreign companies. Besides, the comparisons are also inaccurate because each country follows a different method of calculating FDI. Thus, one country has followed the USA model, which defines as FDI the acquisition of at least 10% of the total shares of a company, whilst another country has followed the German model, which defines as FDI the acquisition of at least 25% of the total shares. Investments below these percentages are considered as portfolio investment.

On the other hand, as it was mentioned before, extensive help from several organisations has been received. They willingly provided statistical data for Central and East European countries and especially for Bulgaria. Therefore, the serious obstacle mentioned in other studies regarding the lack of available and necessary data has been overcome. The author was given the chance to compare statistical data from thirteen (13) different sources of data (OECD, EBRD, IMF, UN, UNCTAD, EIU, BNB, BNSI, BFIA, BPA, WB, Plan Econ. Reports, WIIW publications – see abbreviations) and discuss all of them. There was scepticism about the reliability of Bulgarian statistics – especially for the ex-transition years – a situation shared by other Central and East European countries as well. The economic survey of Europe in 1989/1990 published by the United Nation Economic Commission for Europe argued that the initial estimates of Bulgaria's growth in NMP for 1988 were reduced by almost four percentage points in early 1990. Moreover, a deliberate distortion of the statistics has to be pointed out. Singh & Park (1985) have discussed and suggested that the overall growth in real Bulgarian NMP over the 1970s should be revised downwards to 5,4% per annum due to problems in the official treatment of the trade sector's contribution to total NMP. They claimed that the estimates of growth rates in GDP are subject to even greater uncertainty, since there are few data on the performance of the non-material sectors of the economy.

Many times throughout the years of our research these statistical problems were experienced. Different editions of the same source of reference provide different figures

for the same variable. However, the latest publications with updated data from different sources agree more or less to the estimates of all the economic data not only about the Bulgarian economy, but also for all Central Eastern European economies.

IX. ENDNOTES

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CHAPTER ONE

1.1 Introduction

The legacy of the communist regime in Bulgaria created unfavourable conditions of the transition to a market economy. In 1989 Bulgaria was an industrialised country, which produced low quality products that were distributed to the CMEA countries and the USSR. The collapse of both of them also created a lack of foreign trade partners. Therefore, finding new partners as well as making changes in the composition and in the geographical distribution of the producing commodities was also necessary. Moreover, energy lacks due to the strong dependence on the Soviet Union imports and its energy crisis in 1990 and the segmentation of the USSR further aggravate the situation.

The transition to a market economy needs new policies to be applied. The whole package of the transition process includes stabilisation programme, structural reform and liberalisation of trade, prices and exchange rates. One of the worst initial economic conditions due to the legacy of the communist regime that existed in Bulgaria led the country lagging in economic development and thus, attracting limited FDI inflows.

The political instability and the inability or unwillingness for governmental decisions and changes during the post-communist period, led to a delay in structural reform, privatisation progress and restructuring of state-owned enterprises. The legacy of the communist regime in Bulgaria created unfavourable conditions for the transition to a market economy. In 1989, Bulgaria was an industrialised country, which produced low quality products, which were distributed to the CMEA countries and the USSR. The collapse of both, created a lack of foreign trade partners, therefore, finding new partners as well as making changes in the composition and the geographical distribution of the producing commodities, was necessary. The transition to a market economy was not easy. The unfavourable initial economic conditions, due to the legacy of the communist regime, led the country to a lag in economic development. A general transformation of the economic policies, laws and regulations of the country was needed. A transition process includes stabilisation programmes, structural reform and liberalisation of trade, prices and exchange rates, privatisation and restructuring of the state-owned enterprises. Because of the difficulties and the delay of the Bulgarian transition, FDI inflows were limited in the first years.

In this chapter we will try to outline the means and outcomes of transformation of centrally planned economies into market economies, the choice of stabilisation policy, modes of

transition and the speed of economic reforms in general and specifically for Bulgaria. The process of transition contains elements of **macro-economic stabilisation** or adjustment, together with monetary, credit, fiscal and income policy, economic liberalisation of prices, trade, capital account, currency convertibility and exchange rates. The **liberalisation** provides competition opportunities and creates alternatives to the market and a more competitive environment for a successful integration into the world market, systemic reform of institutions, market and bankruptcy mechanism and competition. Furthermore, **institutional reform** of financial sector, legal, accounting, tax, pension system and system of unemployment compensation, ownership, social safety net, restructuring and privatisation of state-owned enterprises (SOEs). The **development of the banking sector** and the financial reform, in general, contains elements from both the institutional reform and liberalisation policy. In addition, exchange rate policy also includes liberalisation of the rate, currency convertibility and also systemic reform of the foreign exchange market in Bulgaria. Therefore, the structural-systemic reform has been embodied in each of the following chapters in this thesis, whenever necessary.

This chapter, also analyses the macro-economic development for Bulgaria compared to other Central and East European countries, as well as, its initial conditions, causes and consequences of the three economic crises, the monetary policy, the income policy, the currency board, the monetary overhang, the re-allocation of capital and labour from industry toward services, and the economic obstacles and problems in choosing the road to the transition. It primarily, analyses the liberalisation of foreign trade, exchange rates and prices. Bulgarian foreign trade partners, imports, exports, tariffs and its trade balance have been studied. An important component of trade policy is the exchange rate, because a change in the level of the exchange rate immediately changes the competitiveness of exporters and importers and thus affects trade flows. There is also an extensive presentation and analysis of statistical data, tables and graphs about GDP, output, employment & unemployment rates, balance of payments, debt, current account, budget balance, wages, unit labour cost, etc.

1.2 Bulgarian Transition to a market economy

Bulgaria is one of the smallest of Central and Eastern European countries. Its' monetary unit is the lev[1]. The territory of the Republic of Bulgaria is divided into 278 municipalities and 9 regions.[2] Bulgaria today has practically no illiteracy, the labour-force is highly qualified and educated and more than 50% of the employees have secondary and higher education. This was a result of the struggle for improving their lives and a strong tradition

of cherishing education. In the decades of socialism, notable advances in education and health care were made. Bell (1997)[3] mentioned that *"Bulgaria ranked among the most advanced nations in terms of the proportion of its eligible population that received secondary and higher education"*. The country's dependence on the USSR and the CMEA caused its heavy industrialization, and led the country's industry to pay attention to quantity rather than quality of the products. Because of the country's specialization on certain products its workers were highly skilled in certain sectors. This positive aspect is diminished in front of the negative aspects of the lack of variety and quality of goods, the lack of environmental concern, lack of management and good governance motivation, quantity rather than profit orientation, governmental subsidies that turned to bad loans, bureaucracy, low productivity, low motivation, and many other aspects, which are discussed throughout the thesis.

1.3 The transition to Communism

The end of the 2nd World War found Bulgaria in a difficult economic situation build through years of being in the wrong side of the wars. Bulgaria's contact with the ex-Soviet Union at the end of the war strengthened the growing interest of Bulgarians in communism.

1.3.1 The first years of the transition– the Soviet Union influence

Close to the end of 2nd World War (1944) Bulgaria found itself in an awkward political position. Bulgaria in the beginning of the war sided up with Germany, but at the end of the war, when the defeat of the Germans was close and the monstrosities of the Nazis started to show, Bulgaria wanted to join the forces of the opposing side. This attempt seemed really dangerous with the German troops all over Bulgarian ground. At the end, the Soviet Union cut the 'Gordian Bond' and declared war on Bulgaria on September 8, 1944. Not surprisingly, the Soviet troops were rather welcome from the Bulgarian people.

There were a lot of steps in order for Bulgaria to be a truly Communist state. Communism was growing in the Bulgarian people since 1943, when the Fatherland Frond (FF) was formed. FF was the mass organization of the Bulgarian Communist Party (BCP), which had a long history in Bulgaria, and was formed by Communists, Socialists and other factions[4]. In September 1946, Bulgaria was declared a Republic by a referendum on the monarchy, which ended the dynasty that had twice taken the country to war along side with Germany. The transformation of the political system was completed in December 1947

with the 'Dimitrov constitution' that declared Bulgaria as a 'People's Republic'. It was drafted in the ex-USSR and it was of a typical Soviet style; promising all freedoms to the people, accepting Marxism-Leninism as the ruling ideology for all parties, and stating the leading role of the communist party. The one-party system was imposed at the end of 1947.

Until 1990, when free elections were held and the Communist party lost its constitutionally guaranteed exclusive power, the party controlled the government and all aspects of national life. The government controlled all functions of the economy, from the agricultural trade, which worked through co-operative farms, to the financial sector. The Bulgarian economy was a centrally planned and managed one, where the government determined the allocation of resources and output at all the levels of production. The nationalisation of the industry was quickly and easily accomplished, foreign trade was made a government monopoly and the state integrated into a system with alliances and agreements with Stalin's Soviet Union and other Eastern European countries. The FF resumed its former name, the Bulgarian Communist Party (BCP) on December 1948. They created a socialist economy and social structure based on the Soviet model. In fact every "... *aspect of national life seemed to be refashioned on the Soviet model: education, culture, economy, architecture and military. To keep the Bulgarians on the correct line there were ever more Soviet advisors attached to every arm of government.*" [Crampton (1997, p.194)][5] The intent to turn the economy from the agricultural to the heavy industrial sector was made obvious in 1949, when the first five-year plan came into operation. The plans from 1948 to 1960 followed the strategy of extensive growth by means of high accumulation and step-by-step the machine building and the chemical industry became the dominant industrial branches and dictated the industrial growth rate.

1.3.2 Bulgaria under Todor Zhivkov –strong dependence on the Soviet Union (1954-1989)

During the Communist period, Bulgaria was under the influence of the Union of Soviet Socialist Republics (USSR), still, it made efforts to improve its relations with Greece, USA and Yugoslavia. Even after Stalin's death, Bulgaria followed the revised Soviet attitude adopted by Stalin's successors in the Kremlin. In March 1954, Todor Zhivkov[6], became the new BCP leader and Bulgarian Prime Minister. He was the longest serving communist leader in Eastern Europe. Zhivkov "*always stressed fidelity to the Soviet Union, going as far as to ask the USSR to admit Bulgaria as the sixteenth Soviet Republic*". [Bell 1997, p.357][7] During most of the Communist period, under the leadership of Todor Zhivkov,

Bulgaria was one of the most restrictive societies among the former Soviet satellites. Remarks like the one he made on September 1973 show his eagerness to be one with the Soviet Union: "*Bulgaria and the Soviet Union would act as single body, breathing with the same lungs and nourished by the same bloodstream*". [Crampton 1997, p199][8]

In 1958, Bulgaria announced the completion of the collectivisation of agriculture. The end of this process was considered the end of the period of transition to the centrally planned economy, and marked the end of the economic revolution era. During these first years of the mass mobilisation of efforts and the political enthusiasm, Bulgaria experienced significant growth. At the end of the 1950s, the new economic system began to show signs of failure, a fact that was demonstrated by the increasing failure to meet with the five-year-plan targets. On 1964, the unsatisfactory economic performance led to the first of a series of reforms towards the improvement of the system. The reforms introduced management systems in some enterprises (consumer goods' producers) and also a system where wages, premiums and enterprise funds were formed according to profits. The reforms extended in investments, shifting the responsibility from the state budget to bank credit, and to price regulations by introducing three types of prices - pegged, flexible and free. By 1967, this system was extended on the two-thirds of the industrial enterprises. The reforms continued in the 1970s, focusing especially on the further integration of the existing enterprises, with the purpose of reducing their number so as to make supervision over their activities easier. The result of these actions was the fact that the output concentration in Bulgarian enterprises was higher than that in Western Europe.

During the 1980s, the Bulgarian state made several efforts, through institutional reforms to reduce the state-owned industrial property, but still most of it, remained under state ownership. As Bulgaria reaches the end of the communist era (1986-1989), there were more efforts to put all management functions at a firm level and reduce the plan targets controlled by ministries. There was also an effort to improve product quality in order to meet with the CMEA export requirements.

During the communist period Bulgaria was a "*typical - Little- Stalin*" communist country. Bulgarian economy was highly centralized and planned and was mainly based on heavy industry. From the social point of view the industrialization raised living standards, but it also resulted in internal immigration towards towns, and created pollution in many areas. Bulgaria was heavily depended economically on the Soviet Union, being a member of the Council for Mutual Economic Assistance (CMEA/COMECON)[9] and the Warsaw Pact, and remained for a long time USSR's most dependable allies. In return, the USSR granted

Bulgaria with substantial financial aid, during the 1970s, which was used for industrialisation and also energy imports, mainly oil, in low prices. Bulgaria produced low-quality manufactured goods and exported them to CMEA and high-quality agricultural products in Scandinavia, North America and the Far East and imported other goods, especially oil from Soviet Union at low prices. CMEA schemes and agreements had a beneficial effect on the Bulgarian economy. Bulgaria's low-quality manufactured goods were exported to the CMEA countries and its high-quality agricultural products in Scandinavia, North America and the Far East. These trade actions brought a relative stability and gradual economic improvement during 1960s and 1970s, owing to the Eastern countries and especially to ex-Soviet Union.

1.3.3 The Retaliation Period Against Turkish Minority; an obstacle for Turkish FDI outflows in Bulgaria

Bulgaria, through the years, had varying relationship with its neighbouring countries. Turkey was a country, which was never in friendly terms with Bulgaria. Besides the obvious hostility developed by the 500 years of Turkish occupation, and the bad blood remaining from the Balkan Wars, there was another, more recent point of friction among the two countries; the Pomaks and the Muslims of Bulgaria. The fact that the Bulgarians with Turkish roots were not wanted in Bulgaria was plainly demonstrated by Prime Minister, Chervenkov, when in 1952, has encouraged the emigration of 250,000 Turks. This happened in a time, when Bulgaria was one of the most restrictive Eastern societies, and a little before, it was the year 1953, when a government decision stated that anyone who left the country illegally could be sentenced with the death penalty and their families might be taken to concentration camps. On that particular incident, Turkey[10] agreed to take only 162,000 before they closed their borders.[11]

The pressures on the Turkish population were intensified after the 1971 programme for the creation of a unified socialist nation. In the early 1970's Pomaks were required to adopt Slav names, or be punished and by 1974-75, Turkish schools and Turkish language newspapers and journals were shut down.[12] Another 130,000 Turks left Bulgaria between 1968-1978.[13]

"*There are no Turks in Bulgaria*" Zhivkov stated in the mid-1980's supporting the idea of a unified socialist nation. In 1984-85, there was another attempt to assimilate the 800,000 Bulgarian ethnic Turks by obliging them to take Bulgarian or Slav names. However, the governmental attitude was not against Turks. Zhivkov based the governments' persistence

on the fact that "*the most of the ethnic Turks were really Bulgarians who had been forcibly converted to Islam and a Turkish identity during the Ottoman period*" [Bell (1997), p.359]. He was, in fact referring to Pomaks who had been *Islamicised* and *Turkified* under the Ottoman rule. Another reason was a demographic trend that appeared in the 1980s showing a bigger birth rate for Turks. That created the fear that the 10 per cent of Turkish population in Bulgaria would increase following the example of northern Cyprus. This precision led a part of the Turkish minority to go on hunger strike on the August of 1989 and that forced Zhivkov to announce that ethnic Turks once again were free to leave from Bulgaria if "*they preferred capitalist Turkey to socialist Bulgaria*". After that 344,000[14] ethnic Turks left Bulgaria, until Turkish authorities closed their borders since this massive emigration created problems to Turkey. This event led to the international isolation of Zhivkov and gave the opportunity to Petur Mladenov, the minister for foreign affairs and the leader of a cabal, to act against Zhivkov, and become, with the acceptance of Russia, the new Prime Minister after the resignation of Zhivkov on 10th, November 1989. Within four months about 42% of the people, which emigrated had returned to Bulgaria.[15]

Thus, although the existence of Turkish minority in Bulgaria is an incentive for significant FDI inflows there, on the other hand the unfavourable bilateral relations in the past were a barrier, especially at the beginning of the Bulgarian transition. From table 1b we can argue that Turkey appeared only in the 12th place with limited invested volume. However, the existence of minority and the geographical proximity have been proved strong enough in order over 6300 Turkish companies to be registered in Bulgaria (table 1a). The significant number of Turkish companies and the limited amount of FDI flows can be explained from the fact that most of the Turkish registered companies are not active in the Bulgarian economic environment, together with the event that Turkish entrepreneurs use offshore enterprises in order to invest in Bulgaria and that most of those thousand of companies prefer to invest in Bulgaria for exploring the Turkish minority and thus to produce significant value added activities with insignificant FDI outflows.

Table 1a: DISTRIBUTION OF FOREIGN INVESTORS IN BULGARIA BY REGIONS (most important) (NUMBER)

№	COUNTRY OF INVESTOR	BOURGAS	VARNA	PLOVDIV	SOFIA CITY	STARA ZAGORA	HASKOVO	TOTAL BY COUNTRIES
1.	TURKEY	400	205	1153	1203	152	586	6366
2.	RUSSIAN FEDERATION	350	743	302	1225	88	59	4004
3.	GREECE	60	52	547	1575	43	96	3746
4.	CHINA	4	12	51	2733	1	2	2878
5.	SYRIA	43	136	216	1747	31	3	2399
6.	ARMENIA	378	323	564	356	34	39	2254
7.	ITALY	56	69	360	895	30	7	1867
8.	FYROM	6	9	38	232	10	4	1606
9.	UKRAINE	163	255	123	490	23	26	1578

№	COUNTRY OF INVESTOR	BOURGAS	VARNA	PLOVDIV	SOFIA CITY	STARA ZAGORA	HASKOVO	TOTAL BY COUNTRIES
10.	GERMANY	89	146	115	757	31	15	1554

Source: BFIA August 2002

Table 1b: FOREIGN DIRECT INVESTMENT INFLOWS IN BULGARIA BY EACH COUNTRY BY YEARS in USD$

Nr.	Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Jan-June 2002	Total by countries
1	GREECE	0.2	5.1	3	29.8	14.6	16.1	3.3	14.9	241.1	213.6	78.2	619.9
2	GERMANY	0.1	56.6	111	16.2	53.1	31.4	55.7	101	72.3	65.1	23.0	586.2
3	ITALY	0	0.2	5.2	2.3	1.2	0.4	2.1	23	339.7	77.3	13.9	465.3
4	BELGIUM	0	0.1	0.3	10	0.8	264	31.2	66.2	39.8	3.1	0.6	416.5
5	AUSTRIA	13	1	14.7	1.4	12.1	12.5	46.9	23.4	88.8	137.4	8.6	359.8
6	USA	0	10.5	16.2	16.1	20.7	46.6	38.6	49.8	37.1	41.4	8.4	285.4
7	CYPRUS	0.3	1.2	0.4	1.4	7.5	20.6	109	109	-11.3	29.1	6.1	273.3
8	RUSSIA	0.3	1.4	2.3	15.1	14.4	2	14.8	104	50.8	0.5	0.1	205.4
9	NETHERLANDS	0.1	0.5	37.9	0.9	46.3	10.8	41.3	28	17.4	21.6	-6.3	198.5
10	UK	6.2	5.6	2.4	13.7	7.3	15.8	58.9	48	22.6	15.5	-0.8	195.2
11	TURKEY	0	9.8	1.3	13.7	7.3	9.9	23.8	39.4	19.5	3.8	7.5	136.0

Source: Bulgarian Foreign Investment Agency 2003,

1.4. Bulgaria in the Post-Communist Period

The Bulgarian communist regime did not collapse in a climate of violence and revolution, as in Yugoslavia or Romania. It was the so-called **"disguised" transition** to democracy brought from within the communist party as a response to the public feeling and the obvious fact that the virtues of communisms were becoming obsolete in the world order of the times. Petur Mladenov, then the minister of foreign affairs, and Dobri Dzhurov, minister of defence, forced the resignation of Zhivkov. It was the 10th of November 1989; one day after East Germany opened the Berlin Wall, that the BCP accepted Zhivkov's resignation. After the fall of the communist regime Bulgaria faced great political instability, changing eight prime ministers in seven years (as shown in table 1c).

Table 1c: Bulgarian Governments (1990-2002)

Bulgarian Prime Ministers			Bulgarian Presidents
1. ANDREI LOUKANOV	8 February 1990 - 19 December 1990	BCP	1. Mladenov (BCP) from November 1989 until 7/7/1990
2. DIMITUR POPOV	20 December 1990 – 7 November 1991	Independent, coalition government	
3. FILIP DIMITROV	8 November 1991 – 29 December 1992	UDF	2. Zhelev (UDF) from August 1990 – May 1996
4. LYUBEN BEROV	30 December 1992 – 17 October 1994 (Professor of economic history)	BSP	
5. RENATA INDZHOVA	17 October 1994 – 24 January 1995	Caretaker government	
6. ZHAN VIDENOV	25 January 1995 – 11 February 1997	BSP	3. Stoyanov (agreed as a president from all parties) from 1/6/1996 – nowadays

7. STEFAN SOFIANSKI	12 February 1997 – 20 May 1997	Caretaker government	
8. IVAN KOSTOV	21 May 1997 – June 2001	UDF	
9. Simeon Saxe-Coburg-Gotha	PRIME MINISTER June, 17 2001 - …, National Movement Simeon II – 42,73 per cent	(Exiled King Simeon II)	4. Georgi Parvanov (BSP) 53.3%, Nov. 2001 [44-year old academic, who has the reputation of a conciliator and moderniser]

Source: Bitzenis' investigation – various sources

Nevertheless, it is not only the changes in governments alone, which led to the delay in the stabilisation, liberalisation and structural reform, and consequently to the delay of the smooth transition to a market economy. Bulgaria lagged behind most of the rest of Central and Eastern Europe in economic reform due to several reasons such as the **adverse initial conditions** and the inability or unwillingness of the politicians to introduce adequate reforms.

Table 2: Direction of Bulgarian Trade (1945-1998)

DIRECTION/SOURCE / YEARS	USSR (OR RUSSIA AFTER 1990)	OTHER EASTERN EUROPEAN COUNTRIES *[Cuba's percentage is also added (1960-1983)]*	TOTAL EASTERN EUROPEAN/ CMEA (OR FORMER CMEA)	WESTERN COUNTRIES/ OTHER	
EXPORTS					
1945	95	3	98	2	
1950	54	37	91	9	
1960	53.8	30.2	84.2	15.8	
1965	52.1	27.2	79.6	20.4	
1970	53.8	25.5	79.7	20.3	
1975	54.6	25.4	80	20	
1980	49.9	23.5	70.8	29.2	
1983	58.5	20.6	76.4	23.6	
1990	64	12.1	76.1	(EU) 5.6	(other) 18.4
1991	49.8	5.2	55	17.4	27.6
1992	17.1	5.1	22.2	31.5	46.3
1998	5.5	4.2	9.7	49.7	40.7
IMPORTS					
1945	80	13	93	7	
1950	50	36	86	14	
1960	52.6	32.7	84	16	
1965	50	24.3	74.2	25.8	
1970	52.2	24	76.1	23.9	
1975	50.7	21.3	72.5	27.5	
1980	57.3	21.6	78.9	21.1	
1983	58.5	21.8	80.2	19.8	
1990	56.5	11.6	68.1	(EU)	(other)

				11.5	20.4
1991	43.2	3.2	45.4	26.4	27.2
1992	22.7	5.3	28	35.5	36.4
1998	20.1	5.2	25.3	45.2	29.5

Sources: WIIW database, EIU various reports

Furthermore, Bulgaria's grave economic dependence upon the USSR [see table 2], the collapse of the COMECON, which caused the most damage in Bulgaria comparing to other transition economies, the unification of Germany and **many other reasons**, led Bulgaria to face more obstacles in its economic development. On the other hand, though, the already existing industry set up by the USSR financial aid, along with Bulgaria's highly skilled and relatively cheap industry workers, gives one strong incentive among the others for foreign investors.

1.5 The Transition from Communism to Democracy

A successful transition process may be treated as a tool for the economic development of a country. However, transition "... *in not only an intermediate goal contributing to economic development. It may also be regarded as an ultimate objective in itself. The market economy, in contrast to central planning, gives, in principle, the individual the right to basic choices over aspects of his or her life: occupation and place of work, where to live, what to consume, what risks to take or avoid, and so on.*" [EBRD (1994)[16]]

There is a distinct difference between transition from a planned to a market economy and transition from a communist regime to a democracy, which should be also considered. In other words, after the Central and East European countries faced the collapse of the communist regime and they moved to democracy, they adopted monetary, income, fiscal stabilisation policies and institutional reforms in order to establish in their economic environment all the elements of a functioning market economy. Thus, it is necessary to discuss shortly the transition to democracy and the need of having a "strict or severe government", which would not sacrifice the successful implementation of its reform policy for the sake of popularity. The opposite was the case in Bulgaria, hence the long delay in adopting adequate structural reforms, successful and effective privatisation and stabilisation policies.

A very important factor in studying the transition process is the way the initial dismissal of the communist regime occurred. Regimes 'fall' in many different ways, for example "*the transition of power was smooth and peaceful in Poland and Hungary, which had a tradition of dialogue and negotiations; it was peaceful but painful in East Germany,*

Czechoslovakia and Bulgaria; and it was painful and violent in Romania which was on the verge of civil war by Christmas 1989". [Berglund et al. (1994) [17]] We can define six general models with regard to the way that the transition to democracy was achieved:

1) **Violent reform:** the old regime is overthrown by a violent uprising and is replaced by the forces of the opposition (e.g. Romania)
2) **Quiet reform:** the old regime is faced with a peaceful yet determined opposition and eventually hands over power to the latter (e.g. Czechoslovakia)
3) **Compromise reform:** the communist regime gives in to the demand for democratisation by joining the democratic opposition. This can be either the result of pressure upon the former (e.g. Poland), or a conscious political decision for a gradual reform on the part of the old regime (e.g. Hungary)
4) **Diplomacy reform:** the transition is achieved through political intervention of an external power. This model refers exclusively to the GDR where the collapse of the old regime and the subsequent reunion with West Germany was demanded by the latter (e.g. GDR)
5) **Mixed reform:** the old regime, (Yugoslavian case), being the most liberal compared to other ex-communist countries during the pre-transition period, remained in power, promised transition reforms, but failed to change the situation. Only after 1999, many years after the totalitarian dictatorship of Milosevic, when the country suffered a lot from the NATO war and its embargo, a democratic regime finally has been established in the country, starting from the beginning the reforms and the actual transition to a market economy (e.g. Yugoslavia (FRY))
6) **Disguised reform:** the old regime anticipates the inevitable changes and in attempt to stay in power "disguises" itself as a democratic socialist party (e.g. Bulgaria).

Bulgaria's regime was transformed, by a 'disguised reform'. The ruling elite in Bulgaria lacked pressure from a strong opposition and they moved to the political opening only when the Soviet Union made a political intervention. Then the communist party renamed itself to Socialist party, scheduled and won the first elections.

1.6 The Transition from Planned to Market Economy

The **transition** from a centralized economy to a market oriented economy is, in essence, the introduction of the private involvement in the productive sectors of the economy and the reduction of the state to the role of the legislator and facilitator of economic activity rather than the guiding force of the market. In **centrally planned markets** the decision-making is the obligation and privilege of the state. Centralised markets are usually

dominated by a social aspect of welfare, which allows the government to manipulate output, pricing, employment, etc. in ways that fit the socialistic profile of the market. Since the market forces do not guide the economic activities, they are biased and inaccurate in their valuation and estimation by market-oriented standards.

In socialist countries the income is distributed in a somewhat fair way, and the education and health levels are considerably high compared to countries with similar per capita income, due to the social safety net provided by the state. Still the economic results are usually artificial, since the state is not an entrepreneur so it is not profit-oriented, or efficiency oriented, thus the state-owned enterprises (SOEs) are more of a static mechanism of maintaining production rather than a dynamic economic force aiming at development and improvement.

The static nature of a direct government planning also affected the **technological gap** between the country and the developed world. When the decision for the transition is made, the whole structure of the country is proven inadequate to face free market, especially the citizens, which are not prepared to face the economic adversity and uncertainty that goes along with the free market structure, being protected for so long by the social safety net.

In the turning point of the transition the countries in question **lack essential elements of facilitating a free market structure**. There is no regulation, clearly, defining the individual property rights, which are essential in the development of a private sector. The institutional and legal infrastructure has been adjusted to the needs of a centralised market, so the country lacks commercial legislations and market oriented taxation systems, and sometimes there is no domestic price system in countries belonging to organizations like the Council for Mutual Economic Assistance (CMEA). The Banking system is hardly market oriented; the financial markets non-exist, and there are no open labour markets.

The **social aspect** of the transition to a market economy is complicated and difficult to manage. The first issue is that citizens have trivial private property, since the vast majority of property belongs to the state. This trivial property together with the low per capita income, which was deteriorated by high inflation, resulted to the fact that people faced poverty, and thus restricted from access to certain goods, which safety net provided them with during the communist years (EBRD, 1997)[18]. People with small savings cannot participate in any privatisation plan or in establishment of new private companies, until

some restitution or mass privatisation plan is issued, so they are also negative to foreign investors in fear of unemployment and foreign control. The state, in this point, should not stall the changes or avoid decisions, which are "hard" on the people, in order to satisfy political purposes. Instead they should take rapid measures for restructuring of the whole country, and quick and fair re-distribution of state property to the people in order to avoid worst circumstances. Another social issue that arises is the power of the infamous nomenklatura, members of the former communist party, state officials and politicians, which maintain a degree of power and they are not willing to let it go. Nomenklatura, in the lack of efficient control of the changes, manage to create corruption, fraud and underline criminality in the state agencies and in all the transactions, aiming in benefiting of the whole procedure of privatisation and of other profit opportunities, exchanging their political power for economic prosperity. Those people affect the state and cause delays in the structural reform and inequality in any distribution of state wealth, increasing the wealth distances of the people. Another socio-structural problem is the increased interference of bureaucracy in the economic activity. This is not only a matter of structure or regulations, but also a matter of mentality of state officials, which needs to be changed.

The **macroeconomic** point of view is equally **disappointing**. The typical initial conditions of internal finances is the accumulation of bad loans to the state banks and the state itself from loss-making state companies, which had to remain operational, because of the socialistic policy (unemployment avoidance), but failed to become efficient due to many reasons. In turn, the external finances are also loaded with debts to international organizations and other countries. In order to finance the transition and restructuring of the state and firms, the state keeps increasing the external loans, and the companies the internal. The country faces high fiscal deficits, because authorities cannot balance the revenues and expenditures, due to several reasons such as the tax arrears, low productivity, increase of barter trade and increase of shadow economy.

The issue of the **exchange rate regime** is as significant as it is controversial in the first stages of the transition. The fact that countries, which used the exact opposite regimes, fixed exchange rate with the currency of a developed country or floating exchange rate, have reached success, implies that the choice of the regime is not as important as the efficient handling of the money supply and other important element by the state. The fixed exchange rate regime (pegging and other techniques) is safer, working as a 'monetary anchor' for the first steps. On contrary, if the country undertakes a flexible exchange rate regime may be denominated in no time, causing monetary crisis. Still it is essential for the

country's development and economic independence to be able to replace the fixed for a floating exchange rate regime (World Economic Outlook, 2000)[19].

1.7 The Steps needed for a successful transition process to a market economy

An efficient transition takes place in four steps (see table 3), each contributing, independently and inter-dependently, in transforming of the country in question.

Table 3: Four Steps for the Transition to Market Economy

MACROECONOMIC STABILISATION	LIBERALISATION	STRUCTURAL or Institutional REFORM	PRIVATISATION & RESTRUCTURING
Monetary Policy Decrease the monetary overhang, control of the money supply	**Prices**, increase of the **competition**, increase of the prices of products, stop the subsidies	**Legislation** Extensive introduction of new laws and rules for a new market environment	Clear (Well defined) **Property Rights**, demonopolization
Exchange Rate Policy Fixed Exchange rate as an anchor for stabilization		**Commercialization** of state-owned enterprises	**Restitution** and settlement of claims
Wage Policy Workers need new social safety net, unemployment benefits, increase of wages, increase of unemployment rate	Open **Trade** Rules New trade partners, new trade agreements, stop subsidies, new competitive products, increase competition, differentiation of the products, increased quality of the products, no trade barriers, elimination of quotas and tariffs	New worker environment, giving power to the worker's councils, new accounting rules, protection of consumers, steps for improvement of the infrastructure, protection of environment	Introduction of **privatization** and **liquidation** laws
Credit Policy, Interest Rate Policy, Low interest rates to be competitive the environment		Adoption of commercial code, privatization rules, competition rules	**Stop Monopolies** Increase of the competition
Financial Policy Decrease **foreign debt**, decrease all the **deficits**, balance the state budget, revenues from privatization deals	**Openness of the economy** Entry access for foreign investors, worker mobility, establishment of **relations** with foreign organizations	Two-tier Banking system, Bankruptcy laws, clearing bad debts, stop subsidies, hard budget constraints, new banking rules	Small scale privatization, incentives for creation of new firms, increasing **private sector**, increasing services' sector
Income Policy Strict income policy as a nominal anchor for stabilization, decreases in subsidies	Establishing of new companies, Liberal Market Rules, competitive environment	New market rules and introduction of FDI laws and incentives for foreign participation	Elimination of governmental intervention Free movements for the private sector, elimination of the bureaucracy
Taxation Policy Revenues from VAT, taxation of revenues of the profits of the new private sector or from the privatized state-owned	**Currency** Convertibility Free move of the currency with foreign, easier foreign transaction, attract investments, capital	Introduction of rules for financial intermediaries and stock market exchange, creation of commercial banks, foreign branches, foreign	Introducing **hard budget constraints, corporate governance,** new bankruptcy laws

firms	mobility	banks	
Fiscal Policy Decrease governmental expenditures, increase revenues		New tax system, new social security system	Settlement of **Bad loans**
Inflation Policy Decrease the inflation rate, keep low inflation rates			

The first step is the **macro-economic stabilisation program**, which should be adopted in order to reduce the inflation and money-overhang followed by severe efforts to decrease the huge debt burden. There are two determinants for the stabilization process, each of which including two different stabilisation strategies; the orthodox and heterodox approach combined with the money based and exchange rate based stabilisation strategy. The **orthodox** approach is based on elimination of the budget deficit with strict fiscal policy (fiscal anchor) and simultaneously a monetary policy (monetary anchor) is used. In **heterodox** stabilisation approach, income policy is used together with monetary and fiscal policy, as an extra tool for rapid and synchronized cut of inflation. Thus, there is direct intervention into wages and prices (income anchor). The "... *heterodox approach argues that budget adjustments and tight monetary policy alone are insufficient to stop high inflation...in* [the] *...contrary...wage and price controls may be superfluous...*[The]... *price controls may be difficult to enforce beyond a very small group of commodities... controls might be anticipated, controls may be addictive, giving policymakers the idea that inflation can be stopped without any other pain...*[Those]... *controls can introduce a great deal of rigidity in the relative price structure of the economy...controls may prove hard to phase out".* [Jeffrey Sachs, (1993)[20]]. In **money based** stabilisation policy, the central bank chooses the money stock or the net domestic assets as its main policy target. In contrary, in **exchange rate based** stabilisation, the exchange rate serves as the main nominal anchor. Therefore, a country has to choose from Heterodox or Orthodox stabilisation policy setting the option of having the exchange rate as an extra nominal anchor or using the money based stabilisation program. However, if a country chooses the heterodox exchange rate based stabilisation program, but after a short or long time removes the wage and price measures, then the program becomes an orthodox exchange rate stabilisation program.

Bulgaria has chosen the heterodox money based stabilisation programme. Miguel A. Kiguel et al. (1991)[21], have argued that "*The effectiveness of alternative stabilisation strategies largely depends on a country's inflationary history...hyperinflation cannot be*

stopped always and everywhere in the same way." It should be pointed out *"that the money based stabilisations apply an inadequate therapy in the wrong way: monetary targeting is inadequate because of an unstable demand of money, and it is applied in the wrong way, as it has been designed as a medium-term concept and not as a strategy for short-term macro-economic fine-tuning"*. [Peter Bofinger (1996)[22]] Most of the Central and Eastern countries followed the heterodox stabilisation programme (Bulgaria, Romania, Czechoslovakia, Poland and Hungary). Only Russia, Ukraine and Kazakhstan (according to Bofinger, 1996), followed the orthodox program. Bulgaria and Romania, having limited foreign reserves, have chosen a money-based approach, but all the others have selected the exchange rate based stabilisation program. The Bulgarian economy was suffering of economic and political instability from 1989-1997 when on July 1997 the introduction of the currency board, finally brought "peace". The excuse of lack of currency reserves, the inability of each government to draw loans from the western countries or institutions, or the foreign countries' or institutions' unwillingness to help, brought on Bulgaria three major economic crises in eight years of the transition period. Those crises weakened economically the Bulgarian people resulting to the per capita consumption being so low, which discouraged any significant FDI inflows.

The second step of the transition is the **liberalization** of economic activity (prices, trade, currency convertibility etc.), which of course should be supported by institutional restructuring. This structural reform provides an efficient system of laws regulating the economic activity and redefining the role of the state. This also includes the restructuring and privatisation of the bulk of the state assets, which constitute a large percentage of the total assets of the country. The sudden exposure to market forces is due to cause instability in the economy, and complemented by the trivial experience of people and the mediocre economic legacy of the past, it may lead to severe economic crises. In order to avoid the crises the state needs to establish policies of macroeconomic stabilization. The typical symptoms of the 'transition shock' are the drastic increase of inflation, reduction of total output levels, increase in the unemployment rate, increase in prices, and of course a severe social impact and citizens' negative reactions due to their bad economic condition.

The third step is **the reduction of size of public sector by the quick privatisation and restructuring of state-owned enterprises,** which is essential to be supported by the introduction of new corporate governance and property rights. Although privatisation, restructuring, imposition of hard budget constraints and elimination of subsidies will create large unemployment rates and decreasing the quality of living standards they are all

necessary for the transition to a market economy.

In the fourth step, **new laws must be issued in order to establish market institutions** (corporate law, accounting system, tax system, pension fund system etc.) and unlimited and unrestricted private ownership/property, must be legally established. New laws should be also issued regarding banking system structure, bank rehabilitation, privatisation of banks, foreign banks participation[23], payment system, and methods for dealing with bad loans as well as bankruptcy and liquidation laws must be enforced. New social policy is needed and social expenditures such as unemployment benefits, lessons for finding new jobs and increasing employee's skills, must be introduced. Hard budget constraints must also be introduced, together with generous elimination of subsidies from the government to the state-owned enterprises in order for the governmental expenditures to be lowered. The tax system should be reformed in order to encourage individuals and companies. A financial reform is also necessary to support any other activity. The creation of a stock exchange market will facilitate the privatisation process, and it should be met by other currency reforms like the introduction of unlimited currency convertibility. Moreover, all the deficits must be balanced, the overvalued domestic currency must be devalued and generally there is a need for introduction of adequate institutional reforms.

A successful transition does not only come from within the country, since outside assistance is essential, either in the form of guidance or directly in the form of financial or other support. The countries in transition obtain **assistance on technical aspects** by the international institutions, mainly the IMF and the World Bank, which guide their way into the set up of a functional market economy. They get assistance in organizing legislation, in deciding on monetary policies and tools, in issuing new tax and treasury systems, in improving the management of administration and public expenditure. The help of international institutions also reflect in the financial sector, in restructuring of the banking system and creation of financial markets. Also with the help of the IMF, inaccurate statistical systems used in the past, are upgraded, so that dependability of the data can be trusted for evaluation of the country's progress (World Economic Outlook, 2000).[24]

The **international organizations** also provide the country in transition with **financial help** in order for the country to meet certain stabilization goals, and to be able to repay the old and new debts. The steps, required by the IMF assistance plans, shared by transition countries are a large-scale liberalization of trade, prices and exchange rates regimes, de-monopolization of large state owned enterprises, rapid privatisation, development of the

SMEs, social net provision in the budget, and adjustment of the taxation systems. Each plan provides additional steps, which are appropriate for separate countries. International organizations are willing to embrace reformed countries. Some of the countries, which undertook the way of the transition to a market economy, have already joined the OECD, WTO and NATO and a few Central and Eastern European countries have hopes of entering to the European Union (EBRD, 1997)[25].

1.8 Which is the optimal path for a successful economic reform

The **sequence, path** or **pace** of adaptation of each policy is very important in the transition process. The concepts of gradualism and gradual changes that in the long-term lead to a market economy, and the concept of shock-therapy or big-bang and the rapid changes, which are refined in time, are the two approaches that can be used, either pure, or mixed in different aspects of the transition. There is no optimal path for a successful economic reform. In the absence of an optimal model, each country must drawn the lessons about its policy approach in the beginning phase of the road to a market economy, by practical guidance rules and the history of transition experiences.

In a paper, the World Bank, 2002, pointed out that

> *"The relationship between the speed of reform and economic growth has been the subject of controversy. Some economists argued for advancing reforms in all areas as fast as possible; others criticized such a strategy as imposing un-necessarily high cost. The most interesting part of the debate focuses on the sequencing of policies—on the relative speed of different types of reform. Advocates of moving fast in areas amenable to rapid reform argue that the synergies among different components--for example, privatization together with liberalization of prices and trade—may generate enough gains and winners to maintain the reform momentum. The need to take advantage of windows of opportunity is also cited as important in that decision. By contrast, advocates of slower reform point out that going ahead with reforms that can be implemented quickly—"stroke of the pen" reforms— without waiting for those that take more time, such as the creation of institutions that support markets, significantly reduces the benefits of these reforms. The loss could be so severe as to generate output losses and also lead to the creation of interest groups opposing those reforms requiring more time[26]."*[p. 16]

Technically is impossible to have at once all the changes of elements, which lead to a market economy. In order for the 'big bang' to be a successful policy, the country should already have the bases for the restructure (political stability, legal framework base and experience, competent government, eagerness and support from the citizens, sufficient per-capita income so that citizens may endure the changes). The changes must be induced in such sequence that will provide bases for the changes to come. For example how could a government liberalize the exchange rate regime, when the foreign currency reserves of the

country were non-existent, or how can a government achieve a quick and successful privatisation process when the country lacked a sound banking system, financial intermediaries, and a stock exchange market? How can a country attract significant FDI inflows, when state monopolies in basic goods (gas, electricity etc.) are yet to be abandoned? So, in the cases that a reform in one matter is highly depended in the success of a reform in another, it should be treated gradually. However, this argument is very different from the policy of continuously postponing changes such as privatisation and restructuring of state-owned enterprises and introduction of new legal system.

The government must focus on what is important and not on what is urgent. For the government it is impossible to protect the entire population from the burden of the transition process and the imposition of strict measures. Dornbusch (1991)[27] in a paper argued that:

> *"Radical change is the only realistic option... gradualism opens the door to an unstructured free-for-all: consumers will go to the black market, firms will produce for the black market. Households will turn to DM and dollars and thus provoke hyperinflation. Workers will privatise firms spontaneously... Gradualism may seem a low risk strategy in that day-to-day events seem under control. But the realistic answer is immediate, radical reform, not the mirage of a phased-in move to a market economy. Temporary collapse may be inevitable one way or the other, but in the context of radical reform it may at least be the seed for reconstruction...[The]... transition needs to be accomplished extremely fast because the ice is melting, the distance to go is far, and the task is overwhelming. The illusion that transition could be managed over many years is just that. The pace will be determined by the market, which is already operating on the back stage. Countries that move fast will draw resources from abroad and stand a better chance to retain scarce human capital and political reserves: countries that drag their feet risk falling into deep poverty, where even the unsatisfactory living standards of the past decade can no longer be maintained because the organisation of the economy has vanished... A gradualist solution is appropriate when a market economy is in place and the issue is how to improve the use of resources at the margin... [This]... is not the case of Central and Eastern economies, therefore, radical and rapid reform is the right medicine...the acceptance of property is essential...if private property is not accepted the train cannot leave"*

The rapid changes are favoured by most countries, but have been sometimes criticized by theorists. **Stanley Fischer et al.** [2000, p.1] mentioned that *"the faster is the speed of reforms, the quicker is the recovery and the higher is growth"* [28]. By observation of countries in transition, some concluded that the shock-therapy approach leads to drastic increases in the level of poverty and income inequality. Especially in the case of privatisation of state owned firms the rushed moves have often led to the disorganization of valuable operational enterprises, a fact assisting the drop of the output level. Others object,

pointing to the fact that the output would drop any way and that the output was manipulated before the transition, therefore it was not so high. They also claim that the level of poverty and income inequality is higher in the countries following the gradualist method, which is a method that provides more space for the satisfaction of personal interests and corruption (World Economic Outlook, 2000).[29] Issues of speed and sequencing have also played an important role in debates on privatisation policies and restructuring. *"The question that arises is whether a country should privatise before or after restructuring or should both proceed simultaneously. Another question is whether there is a need for sequencing in privatisation or not and if so what principles should underline it"* [Bitzenis, A. 2002, p.6].

Although early analysts have seen Bulgaria as a country, which undertook a 'big bang' transition, the eleven years of the Bulgarian transition studied by this author indicates otherwise. The instant price liberalization of more than 70% of the commodities in 1989 was the only sign to point toward a 'big bang' strategy. On the other hand there was a delay in the liberalization of prices in remaining commodities, preservation of the big state monopolies, late introduction of bankruptcy laws and hard budget constraints as well as accumulation of bad loans and inability to stop the inflation before the introduction of the currency board, which them all resulted to the reinforcement of the nomenklatura, development of wild privatisation, and in overall a very slow progress of the privatisation and restructuring process. Bitzenis, A. 2002[30] argued *"The developments in Bulgarian privatisation are not only far from a 'big bang' path, but also arise doubts on whether it falls under gradualism. It can be argued that political constraints impose a gradual approach to restructuring, which has implications on the speed and sequencing of privatisation"*.

1.9 The Road to a Market Economy: the case of Bulgaria 1989-2001

Although all countries in transition have the same final goal, which is the creation of a market economy, the results of their efforts are different. This is because of different strategies, policies, and paths, which are followed, and different adverse initial economic conditions and many other external facts, which each country has faced or started with. Bulgaria lagged behind most of the other countries in the CEE region, mainly because of its adverse initial economic conditions, the geographical distance from the west, the legacy of the communist regime, and the external shocks and the political instability, which has been suffered from. A few inefficient actions of the regarding governments in Bulgaria were the introduction of a flexible exchange rate regime in the early years of transition or

the late introduction of the currency board (only in July 1997), the very slow privatisation process (graph 1), etc. Besides the political aspect, the adverse behaviour of people regarding privatisation together with the inadequate legal framework with its constant changes, or even, the total absence of appropriate laws at the beginning of transition, them all, strengthened the nomenklatura, and thus bribery and corruption, and discouraged the inflow of significant amounts of FDI. The increase of nomenklatura's power further delayed the privatisation process, created social problems, income inequality, caused discontent to the citizens and reduction of per capita income, decreases of governmental revenues, increase of illegal actions, and most important created an unstable economic environment, which also discouraged foreign investors. Moreover, the restitution problem and the unclear property rights in the beginning of the transition in Bulgaria, and the bureaucracy, are only some of many other reasons, which did not help the whole transition process. The Bulgarian economic policy until 1997 has intensified the problem and kept Bulgaria far away from development, which other countries in the region enjoy, countries such as Hungary, Poland, the Czech and the Slovak Republic and Slovenia. After the introduction of the currency board the newly elected government of 1997, with the assistance of IMF, managed in less than 4 years to achieve some stabilization of the economy, with one-digit inflation rate (tables 4a, 4b), drastic acceleration of the privatization process, (expected to be concluded by the end of 2003), improvement of investment environment, which made Bulgaria more attractive to foreign investors.

Table 4a: Bulgarian Inflation rate 1990-2000

Bulgarian Inflation Rate according to BNB, various Annual Reports													
	MONTH	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
YEARLY	1989												
72,5	1990	2,3	2,3	2,3	2,3	2,3	4,1	3,5	10,9	4,5	4,1	4,9	10,4
474,1	1991	13,6	123	50,5	2,5	0,8	5,9	8,4	7,5	3,8	3,3	5	4,9
79,3	1992	4,8	5,8	3,8	3,2	11,9	5,8	2,8	1,2	3,4	6,2	6,7	4,6
63,96	1993	6,9	4,7	5,6	3,9	5,3	4,1	1	2,6	3,8	4,2	4,6	3,9
121,95	1994	3,8	4,6	7,5	21,7	7,9	4,1	0,6	5,2	11	6,9	5,5	5
33,04	1995	3,9	3,8	3,4	1	1,9	0,5	1,5	0,5	4,8	2,5	2,6	2,6
311,4	1996	2,3	1,9	1,7	2,9	12,5	20,3	23,3	17,1	18,8	16,7	9,7	26,9
578,9	1997	43,5	243	12,3	-0,7	5,7	0,8	3,7	5,5	3,6	0,5	0,5	1,5
2,71	1998	1,98	1,74	-0,1	0,11	0,46	-1,9	-1,5	-0,9	3,02	-0,3	-0,94	-0,7
5,65	1999	1,6	-0,6	-1	-0,6	-0,7	-0,5	3,2	1	1,5	1	0,6	0,7
	2000	3,1	0,6	-0,6	-0,9	0,2	0.1	0.5	3.0	2.4	1.2	-0.2	1.4

Source: BNB various annual reports

Table 4b: Consumer prices in Central & Eastern Europe, 1990-2000, (Annual average, percentage change over preceding year)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Albania	..	35.5	193.1	85.0	21.5	8.0	12.7	33.1	20.3	- 0.1	–
Bosnia and Herzegovina	594.0	116.2	64 218.3	38 825.1	553.5	- 12.1	- 21.2	11.8	4.9	- 0.6	1.7
Bulgaria	23.8	338.5	91.3	72.9	96.2	62.1	123.1	1 082.6	22.2	0.4	10.0

Croatia [a]	609.5	123.0	663.6	1 516.6	97.5	2.0	3.6	3.7	5.9	4.3	6.4
Czech Republic	9.9	56.7	11.1	20.8	10.0	9.1	8.9	8.4	10.6	2.1	3.9
Hungary	28.9	35.0	23.0	22.6	19.1	28.5	23.6	18.4	14.2	10.1	9.9
Poland	585.8	70.3	45.3	36.9	33.2	28.1	19.8	15.1	11.7	7.4	10.2
Romania	5.1	170.2	210.7	256.2	137.1	32.2	38.8	154.9	59.3	45.9	45.7
Slovakia	10.4	61.2	10.2	23.1	13.4	10.0	6.1	6.1	6.7	10.5	12.0
Slovenia	551.6	115.0	207.3	31.7	21.0	13.5	9.9	8.4	8.1	6.3	9.0
FYROM [a]	608.4	114.9	1 505.5	353.1	121.0	16.9	4.1	3.8	1.1	- 1.4	10.1
Yugoslavia	580.0	122.0	8 926.0	2.2E+14	7.9E+10	71.8	90.5	23.2	30.4	44.1	77.9

Source: UN/ECE Common Database, derived from national statistics.

Note: From 1992 onwards indices derived from monthly data except for Armenia, Georgia, Hungary, Slovenia, Yugoslavia (from 1993); Turkmenistan (from 1995); Uzbekistan (from 1996). [a] Retail prices.

Comment: From the above table, it is obvious that the achievement of the Bulgarian government to decrease inflation from over 1000% in 1997 in a one digit – inflation rate at the end of 1999 is more than remarkable.

There is also political stability since the previous Bulgarian government has not changed from the beginning of 1997 up to the middle of 2001. Compared to previous years in the last five years, Bulgaria achieved significant grow for the economy in general and now Bulgaria may hope for the country's admittance in the European Union when Bulgaria will satisfy the Copenhagen criteria. Bulgaria has already signed an association agreement with the EU, which constantly guides and supervises the country in its effort for full membership. In the latest report from the EU commission (November 2001), Bulgaria is close to being a functioning market economy. Provided it continues implementing reforms and intensifies the effort to remove persistent difficulties, it should be able to cope with competitive pressure and market forces within the Union in the medium term.

1.10 Bulgarian adverse initial conditions

Economists, governments and academic scholars during the transition period tried to explain the economic outcomes and the differences in magnitude of sequence of the transition policies. They also tried to explore the various characteristics of countries, which had at the beginning of transition, the external or internal shocks derived from the breakdown of the central planning system, the dissolution of the Soviet Union, the wars and civil strives, and the variation of policies, which the countries of the CEE region adopted in order to succeed in the transition to a market economy. A question that has been derived from the above analysis is "if the initial conditions affect overall performance of those countries and the consequent success in order to become a functioning market economy". Actually, there are several characteristics, which may affect country's economic performance, not only at the start of the transition to a market economy but also at any stage of adaptation of a specific program or measure, which may also encourage or discourage the country's transition policy to a market economy. For example, countries with little experience as independent nation states had more difficulties in creating efficient political institutions and on the other hand, the legacy of the communist regime and the

external economic shocks delayed the economic recovery. Moreover, the various financial crises of the 1990s in Mexico, East Asia, and particularly in Russia, also contributed to delaying or interrupting the recovery of output. Furthermore, repressed inflation, high black market exchange rates, and the war and civil strife in Armenia, Azerbaijan, and Tajikistan in 1992–94, in Georgia and Moldova in 1992, and in Croatia and FYROM in 1991–94 which them all took a major toll on lives, infrastructure, and the state, undermining the political consensus on reforms needed for successful transition, etc. [World Bank 2002, pp. 11-15]

It is argued that the Bulgarian macro-economic development is behind compared to other countries in Central and Eastern European region, because (a) no other country in the region has faced severe exogenous shocks (collapse of the CMEA, UN's embargo against Iraq and former Yugoslavia, Kosovo war) (b) no other state in the CMEA had developed a trade specialization that was so vulnerable to the collapse of the trading bloc, (c) Bulgaria started with one of the worst foreign debt/GDP ratios in the region (d) its adverse economic initial conditions were extremely unbearable and (d) because of geographical distance from the West.[31] More specifically, Bulgaria reached the point of being between the least competent Central and East European countries in attracting foreign investment (table 5) and one of the slower in transition progress for a series of reasons.

Table 5: Inflows of foreign direct investment in Central & Eastern Europe, the Baltic states and the CIS, 1990-2000, (Million dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Eastern Europe [b]	479	2 332	3 124	4 165	3 575	9 230	7 974	9 399	15 268	18 615	21 502*
Albania [c]	–	–	20	58	53	70	90	48	45	41	100*
Bosnia and Herzegovina	..	..	..	..	–	–	–	–	100	90	117
Bulgaria [c]	4	56	42	40	105	90	109	505	537	819	975
Croatia	–	–	16	120	117	115	506	530	898	1 408	1 000*
Czech Republic	132	513	1 004	654	869	2 562	1 428	1 300	3 718[d]	6 324[d]	4 595
Hungary	311	1 459	1 471	2 339	1 146	4 453	2 275	2 173	2 036	1 970	1 957
Poland (cash basis) [c]	10	117	284	580	542	1 132	2 768	3 077	5 129	6 471	9 461
Romania	–	40	77	94	341	419	263	1 215	2 031	1 041	998
Slovakia	18	82	100	168	250	202	330	161	508	330	2 075
Slovenia	4	65	111	113	128	177	194	375	248	181	181
FYROM [c]	–	–	–	–	24	9	11	16	118	30	160*
Yugoslavia	..	..	..	..	..	..	–	740	113	112	–*
Baltic states	..	..	119	238	460	454	685	1 142	1 863	1 139	1 148
Estonia	..	..	82	162	215	202	151	267	581	305	398
Latvia	..	..	29	45	214	180	382	521	357	347	400*
Lithuania	..	..	8	30	31	73	152	355	926	486	350*
CIS	..	..	1 777	1 875	1 770	4 064	5 288	8 842	6 726	6 886*	5 363*
Armenia [c]	..	..	–	1	8	25	18	52	221	122	140*
Azerbaijan [c]	..	..	–	60	22	330	627	1 115	1 023	510	-30*
Belarus	..	..	7	18	11	15	73	200	149	444	90
Georgia [c]	..	..	–	–	8	6	40	203	265	82	100*
Kazakhstan [e]	..	..	100	228	635	964	1 137	1 321	1 144	1 632	1 099*
Kyrgyzstan [c]	..	..	–	10	38	96	47	83	109	36	20*
Republic of Moldova	..	25	17	14	12	67	24	75	81	34	120*
Russian Federation [c]	–	100	1 454	1 211	690	2 065	2 579	4 865	2 762	3 309	3 000*
Tajikistan [c]	..	..	9	9	12	20	25	30	24	21*	24*
Turkmenistan [c]	–	–	11	79	103	233	108	108	64	80*	100*

Ukraine	..	..	170	198	159	267	521	623	743	496	600*
Uzbekistan [c]	..	..	9	48	73	-24	90	167	140	121	100*
Total above [b]	..	..	5 020	6 278	5 806	13 748	13 947	19 383	23 857	26 640*	28 013*

Source: National balance of payments statistics; IMF.

Note: [a] Inflows into the reporting country., [b] Excluding Bosnia and Herzegovina and Yugoslavia., [c] Net of residents' investments abroad. Bulgaria, 1990-1994; Poland, 1990-1992., [d] The Czech data for 1998-1999 have recently been revised to incorporate inter-company loans, increasing FDI inflows from $2,720 and $5,108 million, respectively. Both figures also reflect reinvested profits, which is not the case for the preceding years., [e] Drawings less repayments.

The adverse initial conditions may be divided into the following four groups:

- Bulgarian adverse economic conditions, which were strong enough to underpin the delay in the whole transition process
- the legacy of the communist regime, which provided Bulgaria with elements that worsened the whole situation
- political instability together with political inability or unwillingness of various Bulgarian governments to adopt adequate policies, which may lead to a successful transition
- various external shocks, which also burden the way on becoming a marking economy

More specifically, adverse economic initial conditions were:

- Its foreign debt in the beginning of the transition (about 12 billion $ in 1992) most of which was denominated in US dollars. The Bulgarian ratio of external debt over GDP in 1991 was the worst in the region, with 157.4, when the following country, Hungary, had 67.8 ratio. The continuous depreciation of the domestic currency, at the early years of the transition, made the situation even worst. (table 6)

Table 6: EXTERNAL DEBT/ GDP % in EEC countries (1991-93)

EXTERNAL DEBT/ GDP %			
COUNTRIES	1991	1992	1993
CZECH REPUBLIC	26,4	23,7	24,7
HUNGARY	67,8	57,6	63,7
POLAND	61,5	56,4	54,9
SLOVAK REPUBLIC			28,1
SLOVENIA	14,7	13,9	14,8
BULGARIA	**157,4**	**145,6**	**128,3**
ROMANIA	7,4	16,6	16,1
CROATIA	16,4	26,7	22,8

SOURCE: EBRD

- Bulgarian current account deficit in 1990 was the worst in the region after Romanian, with almost 1.7 billion dollars deficit. In 1991 the Bulgarian ratio of current account/GDP was still the worst in the region with a negative ratio of –5.4%. (table 7)

Table 7: CURRENT ACCOUNT in % of GDP in EEC (1991-93)

CURRENT ACCOUNT in % of GDP			
COUNTRIES	1991	1992	1993
CZECH REPUBLIC	1,2	-1	0,3
HUNGARY	0,8	0,9	-9
POLAND	-2,6	1,1	-0,7
SLOVENIA	1	7,4	1,5
BULGARIA	**-5,4**	-9,3	-12,8
ROMANIA	-4,1	-8	-4,5
CROATIA	-3,2	8	5,5

SOURCE: EBRD

Comment: Bulgaria begun its transition with the biggest external debt /GDP ratio compared to the rest of the CEE countries.

- Low foreign exchange reserves and large enough monetary overhang led Bulgaria to choose the heterodox stabilisation policy with nearly 70% liberalization of prices, but having a flexible exchange rate regime led to an unstable macroeconomic environment. After July 1997 the introduction of the currency board and the fixed exchange rate with the German DM, led Bulgaria to an economic development that proved that the decision, which was taken at the beginning of the transition, was "wrong" and the delay of the introduction of a fixed exchange rate regime.

However, the external shocks were more unbearable, and Bulgaria managed to overcome most of their subsequent outcome only after 1999.

- The collapse of the CMEA on which Bulgaria heavily depended[32]
- The unification of Germany and the loss of the GDR as a trade partner
- USSR's energy crisis (after 1988[33]) and the termination of the USSR subsidies and exports of energy sources and commodities in preferential prices, together with the subsequent political fragmentation that followed the USSR's collapse, had a devastating effect on Bulgarian economy since Bulgaria's trade and energy supplies depended heavily upon the former super-power.[34]
- The Gulf crisis cost approximately $2.5 billion US dollars; Iraq was one of Bulgaria's largest debtor through trade relations (with 1.239 billion USD in 1989[35] and another 0.7 billion USD on 1990 from Iraq's non-repayment of debt) and, thus, the agreement of repayment of the loan with the delivery of 600,000 tons of oil was devastatingly postponed due to the UN embargo (this cost Bulgaria $565 million USD - the cost of replacing of Iraq contracted oil at higher prices)[36]. Bulgaria has also lost (except East Germany) another significant trade partner, Iraq.
- The embargo of Yugoslavia that cost in total approximately $8 billion (1,833 million dollars from the impact on balance of payments and another $6,2 billion in

the period July 1992-September 1994) and provoked real problems to the Bulgarian trade (tables 8 & 9) because of the loss of Yugoslavia as a trade partner. Moreover, the ex-Yugoslavian road, rail and river routes were the cheapest, nearest and maybe the only way to reach the West for exporting its products (a fall in the trade with neighboring countries, sharply increases in transaction costs).[37] The rail and road routes through the former Yugoslavia were indeed some of the leader arteries for Bulgarian trade and the alternatives, through Romania, Black Sea were slow and overcrowded.

Table 8: Merchandise exports of Central & Eastern Europe, 1980, 1988-2000, (Billion dollars)

	1980	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Eastern Europe	56.367	65.020	63.850	61.733	57.241	59.333	62.675	72.937	94.777	100.206	107.428	119.174	117.769	132.926*
Albania	0.320	0.230	0.302	0.231	0.101	0.072	0.123	0.139	0.202	0.213	0.137	0.207	0.265	0.239*
Bulgaria	7.160	7.554	**6.651**	5.232	**3.433**	3.992	3.769	3.935	5.345	4.890	4.940	4.194	4.006	4.808
Czechoslovakia	10.475	12.381	11.988	10.728	11.319									
Czech Republic	..	..	..	..	..	8.767	14.463	15.882	21.273	22.180	22.779	26.351	26.242	28.979
Slovakia	..	..	..	..	..	3.500	5.458	6.714	8.585	8.822	9.640	10.775	10.277	11.905
Hungary	8.609	9.999	9.673	9.731	10.226	10.681	8.921	10.701	12.867	15.704	19.100	23.005	25.015	28.092
Poland	13.071	14.573	14.665	18.291	14.912	13.187	14.202	17.240	22.887	24.440	25.756	28.229	27.404	31.651
Romania	9.217	8.971	8.076	4.570	4.266	4.363	4.892	6.151	7.910	8.085	8.431	8.302	8.504	10.367
Yugoslavia (SFR)	7.514	11.311	12.496	12.950	12.984	14.772								
Bosnia and Herzegovina	..	1.550	2.100	1.850	..	..	..	..	0.024	0.058	0.193	0.352	0.518	0.675
Croatia	..	2.300	2.600	4.020	3.310	4.353	3.709	4.260	4.633	4.512	4.171	4.541	4.303	4.432
Slovenia	1.836	3.278	3.408	4.118	3.874	6.681	6.083	6.828	8.316	8.310	8.369	9.050	8.546	8.731
FYROM	..	..	0.654	1.113	1.095	1.199	1.055	1.086	1.204	1.147	1.237	1.311	1.191	1.326*
Yugoslavia	..	4.298	4.461	4.651	4.704	2.539	..	..	1.531	1.846	2.677	2.858	1.498	1.723

Source: UN/ECE secretariat, based on national statistical publications and direct communications from national statistical offices.

Note: Trade flows reported include the "new trade" among members of the dissolved federal states: former Czechoslovakia (from 1993), the former SFR of Yugoslavia (from 1992). Data excluding the "new trade" were shown in earlier issues of this publication. Changes in the method of recording trade are reflected from 1993 in data for the Czech Republic (inclusion of OPT transactions, etc.), from 1996 in Hungary (inclusion of trade flows of free trade zones) and from 1997 in Slovakia (inclusion of OPT transactions, etc.).

Comment: In less than two years from the beginning of transition (1989-91) Bulgaria, Romania and Albania lost half of their exports. Although the others recovered in 2000, Bulgaria did not.

Table 9: Merchandise imports of Central & Eastern Europe, 1980, 1988-2000, (Billion dollars)

	1980	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Eastern Europe	65.443	60.158	61.185	63.408	61.610	68.388	76.285	86.128	117.026	135.887	146.195	159.491	155.434	172.589*
Albania	0.320	0.280	0.385	0.381	0.409	0.524	0.421	0.549	0.650	0.913	0.620	0.795	0.885	1.009*
Bulgaria	6.321	8.131	**7.325**	5.584	**2.700**	4.530	5.120	4.272	5.638	5.074	4.932	4.957	5.515	6.487
Czechoslovakia	10.619	12.180	11.772	11.808	10.962									
Czech Republic	..	..	..	..	..	10.368	14.617	17.427	25.265	27.919	27.563	28.789	28.073	32.244
Slovakia	..	..	..	..	..	3.889	6.332	6.634	8.777	11.112	11.622	13.006	11.265	12.671
Hungary	9.188	9.372	8.863	8.797	11.449	11.123	12.648	14.554	15.466	18.144	21.234	25.706	28.017	32.080
Poland	14.705	12.987	12.941	12.619	15.531	16.141	18.758	21.566	29.043	37.137	42.314	47.054	45.901	48.940
Romania	11.061	5.361	5.834	6.889	5.793	6.260	6.522	7.109	10.278	11.435	11.280	11.838	10.394	13.055
Yugoslavia (SFR)	13.229	11.847	14.064	17.330	14.765									
Bosnia and Herzegovina	..	1.300	1.850	1.750	..	..	..	..	0.524	1.204	1.555	2.120	2.431	2.290
Croatia	..	2.900	3.750	5.133	3.811	4.346	4.166	5.229	7.510	7.788	9.104	8.383	7.799	7.923
Slovenia	2.463	2.914	3.216	4.727	4.131	6.141	6.501	7.304	9.492	9.421	9.367	10.098	10.083	10.115
FYROM	..	..	0.934	1.531	1.274	1.206	1.199	1.484	1.719	1.627	1.779	1.915	1.776	2.066*
Yugoslavia	..	4.915	5.383	6.701	5.548	3.859	..	..	2.665	4.113	4.826	4.830	3.296	3.711

Source: UN/ECE secretariat, based on national statistical publications and direct communications from national statistical offices.

Comment: In 1991,Bulgaria's imports have deteriorated to 1/3 compared with the 1989 volume, while, at the same time, all other countries retained (more or less) constant their volume of imports. The decrease of imports was not indicative of an increase in the local production, but in loss of trade partners.

- Apart from the front-line states (Albania, FYROM and Yugoslavia), Bulgaria is probably the country most affected by the war in Kosovo. Before the war, some 50% of Bulgarian exports were being transported through Yugoslavia. The

magnitude of the damage in the Yugoslavian infrastructure indicates that the problem for Bulgaria will remain for long time (tables 6 & 7)

- The economic crises of Mexico, East Asia and the former USSR, which discouraged investors from investing in Eastern Emerging Markets.

The legacy of the communist regime provided the Bulgarian environment with negative characteristics, which need time, sacrifices and hard efforts in order their subsequent outcomes to be overcome (such as the negative attitude against consumption, labor, entrepreneurship, not profit oriented enterprises and the low level of productivity, not efficiency oriented behavior, absence of private sector, pursuing profitability and efficiency)

- lack of regulations, adequate legal framework, financial intermediaries, stock market exchange, which are essential elements that facilitating a free market structure
- macroeconomic instability due to the burden fiscal deficits, low productivity, external and internal loans (bad loans), increased shadow economy, heavily industrialized GDP, low quality of produced products together with the lack of finding new trade partners, inability to balance the state budgets, monetary overhang, and depressed inflation
- The very low per capita income and living standards (one of the lowest compared to many other Central and Eastern European countries) and the growing poverty, led the Bulgarian governments to be sceptical and a few times to postpone the tightened policies in the early years of transition.
- The insufficient quality and variety of products, which were unable to offset the lost trade partners with others from West and the limitation of natural resources.
- There were quite a large number of illegal actions during the transition process from illegal organizations (mafia and nomenklatura), which made the business environment unwelcoming.
- The magnitude of the restitution problem and the significant delay in re-privatisation of the property, created a subsequent delay in the privatisation process.

Furthermore, politicians and governments have been proved unable to adopt adequate transition policies in order Bulgaria to become a fully functioning market economy before the end of 2002.

- The three economic crises, two in the same year, led the Bulgarian people to a significant loss of their money savings, and perhaps brought them to one of the lowest per capita consumption level. This was an entry barrier for most of the

foreign companies that was in the procedure of examining and ranking the possible countries of the region as future host countries for establishing their investments.

- There was a significant delay in the liberalization of prices in products that remained Bulgarian monopolies in sectors such as energy, gas, petroleum, telecommunications, railways, television, etc.
- There is also a noticeably low progress in the development and increase of the private sector. In 1991 only 19% belonged to the private sector, one of the worse ratios in the region only larger from the Czech republic, Slovenia, and Slovakia. In 1999, the Bulgarian ratio was lower than that of the counties which began with a worst initial ratio by almost 15%. The delay occurred not only because of the slow privatisation progress, but also due to the slow creation and establishment of new small enterprises. (table 10)

Table 10: Private Sector Share in % of GDP for CEE countries (1991-1999)

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999
Country	Private sector share (% of GDP)								
Bulgaria	19	26	35	39	48	53	59	65	62
Croatia	25	35	41	56	51	49	50	48	55
Czech	17	28	45	56	64	62	62	70	75
Hungary	30	44	52	55	60	70	75	80	85
Poland	42	45	54	56	60	78	79	78	81
Romania	24	26	32	35	40	60	58	60	62
Slovak	15	22	25	44	60	77	75	83	83
Slovenia	16	20	25	30	48	45	50	55	55

Source: EBRD various reports, EIU (Economist Intelligence Unit)
IMF Staff Country Report no. 99/26 April 1999

- The 'favourable introduction of the laws' in the early years of the Bulgarian transition for the "nomenklatura" and the governmental support they received, created an unfavourable business environment with no significant economic development, low FDI inflows, soft budget constraints, slow and inadequate restructuring, inefficiency of the state-owned enterprises, accumulation of new debts and low privatisation process of the SOEs.
- In order to overcome the negative conditions at the beginning of the reform, Bulgaria borrowed in convertible currencies from private commercial banks.[38] This only worsened the situation, as the national currency was devaluated.
- The effort of Bulgaria to get the higher proceeds possible for the larger and more significant state companies, led the government to decide on restructuring before privatization and this led to a slower privatisation process, and to a lack of significant cases – offers to foreign investors.
- The lack of transparency in the privatization progress, the inexperience in valuation of SOEs, the bureaucracy, the complex criteria of selecting the buyers,

corruption, the late introduction of bankruptcy laws and hard budget constraints as well as the accumulation of bad loans and the large debt of most of the SOEs, which the Bulgarian state did not restructure rapidly and effectively.

- The inability to stop the inflation before the introduction of the currency board.
- The inadequate legal framework and it constant changes.

Internal shortcomings like the delay of reforming, slow process of privatisation, inadequate restructuring of public enterprises and a series of weak governments in the post-communist period did not help much Bulgaria's economic development. The weaker Bulgarian geographic, historic and cultural links with Western Europe have been also proved "lethal" for its transition to a market economy. Moreover, incentives regarding Bulgaria[39], such as the low labour cost, which support the transition and may lead to the attraction of significant FDI inflows have been lost. More specifically, Bulgaria, Romania and Russia are the countries with the lowest level of wages in the CEE region, but the Bulgarian competitiveness in terms of cheap skilled, semi-skilled and unskilled labour force may be threatened more in the near future, since the depreciation of the rouble in Russia (end of 1998), led wages below those in Bulgaria (table 11).

Table 11: Average Gross Monthly Wages In Current Dollars

	Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Bulgaria	**1999**	**119**	**114**	**119**	**116**	**122**	**116**	**117**	**121**	**130**	**119**	**118**	**121**
	2000	**111**	**110**	**119**	**113**	**123**	**123**	**117**	**112**	**122**	**107**	**118**	**136**
	2001	**122**	**120**	**123**	130	130	128	N/A	N/A	N/A	N/A	N/A	N/A
Croatia	2000	631	608	605	572	580	602	590	588	558	561	579	593
	2001	627	579	598	587	619	585	N/A	N/A	N/A	N/A	N/A	N/A
Czech Republic*	2000	341	335	354	333	348	366	357	345	323	335	400	377
	2001	364	339	359	354	384	370	369	N/A	N/A	N/A	N/A	N/A
Hungary	2000	319	299	307	303	299	315	314	289	277	284	327	392
	2001	335	317	325	331	332	351	342	350	354	N/A	N/A	N/A
Poland	2000	459	465	487	488	442	466	471	471	242	450	474	545
	2001	503	507	529	542	543	541	525	516	N/A	N/A	N/A	N/A
Romania	2000	123	122	130	144	131	133	132	130	127	127	133	155
	2001	138	127	136	155	147	148	151	149	N/A	N/A	N/A	N/A
Russia*	**1999**	**51.9**	**52.3**	**58.9**	**57.5**	**60.1**	**66.4**	**66.5**	**65.3**	**66.9**	**66.7**	**67.9**	**85.1**
	2000	**64**	**64**	**71**	**71**	**74**	**81**	**83**	**82**	**85**	**87**	**90**	**108**
	2001	**96**	**93**	**103**	**104**	**105**	**113**	111	115	116	N/A	N/A	N/A
Slovakia*	2000	262	248	270	263	260	279	270	257	240	246	284	277
	2001	284	277	266	245	262	258	270	272	N/A	N/A	N/A	N/A
Slovenia	2000	916	887	881	855	835	869	870	846	806	807	868	904
	2001	918	883	877	855	852	823	N/A	N/A	N/A	N/A	N/A	N/A
Ukraine	2000	33	34	38	38	39	42	44	46	46	47	47	55
	2001	47	49	52	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Source: PlanEcon. Report *=Industry

Thus, as Bulgaria and Russia share a few common export goods such as metals and chemicals, and Russia has already attracted limited foreign investments in respect to its population, the competition will probably create problems not only on Bulgarian

exports, but also in the inflows of FDI. However, the signs of the time period 1997-2000 arise much hope for the future.

1.11 The conditions of the Banking System in a Centralised Economy

Under central planning the financial systems were not involved in control and monitoring of state-owned enterprises. In the old system the commercial banks played the passive role of the administrator and controller of money. The government and its central plan, determined each time which enterprise should receive financing and which bank should ask for credit. This leads to a high degree of centralisation and a subsequent simplification of the banking activities. Actually, there was an abolishment of the main banking activities, and the banks learn to live without competition, pursuing profits and short or long run goals.

Under this regime, commercial banks used the passive role in their activities and performed the role of governmental agencies. They act in an environment where there was lack of competition, inadequate legal regulations, inefficient payment system and an absence in regulating and adopting bankruptcy and liquidation laws. It is not surprising the delay in the Bulgarian banking privatisation process, the low level of managerial skills, the weak corporate governance, and the bad loans burden of the state owned enterprises, which restrained the banking sector and the financial intermediaries from playing an important role in the privatisation process during the transition period and especially up to the end of 1997. [Bitzenis A., 2003a].

The financial institutions in the Central and Eastern Europe have neither the experience nor the capability to perform well the intermediation functions of a market economy. It is obvious, that the establishment of a modern and efficient financial system is one of the main elements of the economic transformation. In the short run, it is an extra instrument for managing monetary policy, and thus controlling inflation or even hyperinflation phenomena. In the medium or in the long term, it is also a tool for improving the allocation of resources. In 1993, Thorne has pointed out that,[40] *"If banks behave efficiently, they will try to diversify their loan portfolio by lending to new good customers and limiting their lending to the old borrowers that have accumulated arrears with banks and account for most of banks' non-performing loans"*. All the Central and Eastern European (CEE) economies had a choice of different strategies for reforming their financial systems. It is again the desirable and feasible pace of reforming the system; big bang or gradualism, and the additional problem of resolving the well-known issue of bad debts (non-performing

debts). In 1996, Bristow has mentioned that[41] "*It was not that bank managers were stupid, inefficient or venal, but that the planning system did not require loans to perform, provided no incentives for enterprises to service their debt and provided no incentives for the banks to enforce debt-service by their customers. When the planning system is removed, the banks find themselves standing naked in a gale. Their balance sheets contain a high volume of loans which are not being serviced...*".

In centrally planned economies, state enterprises relied on relative price controls and direct and indirect subsidies. At the early years of transition, loss-making state-enterprises have managed to continue financing their losses from the banking system because stopping this behaviour was a hard governmental decision with social implications. The fear of an increase in the unemployment rate, the lack of bankruptcy and liquidation law, the slow process of restructuring and privatisation of the enterprises and banks, led to a postpone of dealing with the problem. In 1994, Dittus argued that[42] "*Such loans had been, in effect, a substitute for fiscal subsidies. The termination of this lending would push many enterprises into bankruptcy and perhaps liquidation, leading to job losses*". Fiscal policy is also a major concern for an effective transition process. Large government deficits and rapid inflation led the government to find ways of raising the revenues and reducing the expenditures. Thus, in order to eliminate these deficits through reducing expenditures governments moved to distortions of the subsidies to the state-owned enterprises.

In order to understand the difficulties of passing from the monopolised banking system into a banking system under market economy, the reader will be provided with a quick historical preview of the Bulgarian banking system. As mentioned above in order to attract foreign investors it is necessary to have a stable, liberal legal framework and banking system, which operates under the market economy's mechanisms. Under the communist regime, the policy of generous subsidies to state-owned enterprises and the gathering of bad loans to the state banks, led Bulgarian banks to a one way situation, facing big problems in their development and together with the slow introduction of necessary laws, it brought a general delay in the creation of a sound banking system and the limited foreign participation until the introduction of the currency board (mid 1997). The currency board led Bulgaria to a relative economic development and significant FDI inflows. The political instability or inability (unwillingness) and the political cost of the introduction of strict measures (cut of subsidies and imposition of hard budget constraints) resulted to the delay in the privatisation of state-owned banks, entering of foreign banks and the creation of new private banks. Since economic stability and development, competitive environment,

adequate legal framework and good banking system are significant incentives for FDI, and for the success of the transition from a planned to a market economy, the total delay had a much higher cost in the long run than the cost of a rapid restructuring, which would have a heavy social impact in the short run, but very good results in the long run.

1.12 The History of the Bulgarian Banking System

1.12.1 Banking Activities in pre-communist period

Although Bulgaria was among the first countries to start the transition [table 12 by the EBRD] it ended up being among the last CEE countries to start organised western-style banking activities.

Table 12:Selected Characteristics of Transition Countries

Transition Country/ Group[1]	Year the Transition began[2]	Starting Date of the Stabilization Program [2]	1999 EBRD Average Transition Indicator [3]	[5]Exchange rate regime adopted[6]	[5]Exchange regime end 1998[6]	Price liberalization[9]
EU accession countries (excluding Baltics)	1991	Mar-91	3.3	...	...	...
Bulgaria	1991	Feb-91[7]	2.9	Flexible	Fixed[8]	Instant 70%
Czech Republic	1991	Jan-91	3.4	Fixed	Flexible	Instant 85% Nov-91 95%
Hungary	1990	Mar-90	3.7	Fixed	Flexible	Gradual
Poland	1990	Jan-90	3.5	Fixed	Flexible	Instant 90%
Romania	1991	Oct-93[7]	2.8	Flexible	Flexible	Gradual 80% (4 stages)
Slovak Republic	1991	Jan-91	3.3	Fixed	Flexible	...
Slovenia	1990	Feb-92	3.3	Flexible	Flexible	...
Other southeastern European countries	1990	Jun-93	2.5	...	...	...
Albania	1991	Aug-92	2.5	Flexible	Flexible	...
Bosnia & Herzegovina[4]	...	...	1.8	...	...	...
Croatia	1990	Oct-93	3	Fixed	Flexible	...
FYROM	1990	Jan-94	2.8	Fixed	Flexible	...

Source: European Bank for Reconstruction and Development; *Transition Report 1999;* IMF staff estimates unless otherwise noted.

[1] Data for country groups are simple averages of group member data. [2] From Fischer and Sahay, "The Transition Economies After Ten Years," IMF Working Paper 00/30 (Washington: International Monetary Fund, 2000). [3] Indicator of progress in structural reforms; see the Appendix.

[4] For Bosnia and Herzegovina, inflation over the period 1991–99 for the Federation is used for "Average Inflation 1989–99" and 1999 GDP per capita in U.S. dollars is used for "PPP GDP per capita 1999."

[5] International Monetary Fund, International Financial Statistics, World Economic Outlook, IMF staff estimates

[6] Fixed regimes are those that have a currency board, pegged, (explicitly or implicitly) at a fixed rate or have a narrow crawling band. Flexible regimes include those that are free or managed floating.

[7] The date of the first stabilization attempt. [8] Currency board in Bulgaria adapted in July 1997.

[9] survey 1991-1992 UN, chapter 3, "Eastern Europe", p.40

After the liberation of Bulgaria from the Ottoman Empire in 1879, the Bulgarian National Bank (BNB) was founded. The idea of establishing a National Bank was initially

supported by the provisional Russian administration, which prepared the Statute of the Bank, which was approved by Prince DonDoukov on 25th, January 1879 (see table 13). The bank was actually established on 23rd, May 1879 after the replacement of the Russian administration by a Bulgarian one.[43] The Banks of General Use that existed before the liberation were restored and renamed to Agrarian Banks. The BNB and the Agrarian Banks, the two state credit institutions, constituted the foundations of the Bulgarian banking system. The Bulgarian people yearned to fill the gap of a modern banking system, according to the standards of those times, resulting by the Ottoman rule, and that is self-proven by the immediate establishment of BNB after the liberation.

At that time, the nature of the BNB in the first years of operations was purely of a commercial deposit bank, financing trade in the urban areas, since Bulgaria lacked banks to finance the emerging local industries and trade. Another function of the BNB was to use the temporary surplus in the budget for short-term loans, since it was also the free cashier of the state budget. The BNB kept time and demand deposits, and opened current accounts of some larger companies, but was not authorised to issue banknotes yet.[44]

Table 13: Establishment of Bulgarian Banks up to 1989

1879	1896	1903	1905	1906	1926-28
BNB	POST SAVINGS BANK	BULGARIAN AGRARIAN BANK	BALKAN, GENERAL, CREDIT	35 JOINT STOCK BANKS	129 JOINT STOCK BANKS
1926-28	1934	1947	1964	1969	1981
82 JOINT STOCK BANKS	34 JOINT STOCK BANKS	BNB, Bulgarian Investment Bank until 1967 POST CREDIT until BANK(1951)	FOREIGN TRADE BANK (BFTB)	Bulgarian Industrial Bank, AGRICULTURAL & TRADE BANK, SSB	MINERAL BANK
1987	1989				
7 sectoral banks	59 commercial banks				

Source: BNB various annual reports

One of the first restrictions of the BNB was not to lend any loans to the government for purposes of independent and efficient operation. Still, during the war years (1912-1918), the BNB was actually forced to finance the main bulk of the military spending at the expense of printing large amounts of new banknotes. Violating all principles of issuing operations, the government debt to the bank increased from 8 million levs (end of 1912), to 881 million levs (end of 1918).

The autonomy of the BNB was substantially increased by the 1926-28 Law, which also widened the functions of the BNB as the regulating agent of currency circulation. The private banking also developed at a high speed. In 1929-1933, the first years of the Great

Depression, the number of private banks grew up to 129, but after the crisis, it diminished to 82. Later, from the middle of 1934 up to the end of the Second World War, there were only 34 joint-stock banks in Bulgaria.[45]

The World War II, (before the coup on 9th of September, 1944) had a heavy negative impact in the development of BNB, since it was placed under extreme conditions and was, once again, forced to finance the military spending of the government through new banknote issue.

1.12.2 Banking Activities in communist period – the USSR influence and monopolisation

At the end of the World War II the Bulgarian banking system suffered a complete reorganization as the new social system was establishing. In 1947 all industrial enterprises, mines and private banks were nationalized. [46] On December 27, 1947 Bulgaria entered a new era in the country's banking system, as a result of the Banking Law presented on that day. According to that law the National Bank of Bulgaria (BNB) was the institution that would handle all government funds and nationalized enterprises and the Bulgarian Investment Bank would handle the long-term lending. The Post Credit Bank, although in retail banking (households services), was the only other banking institution preserved. This new legislation was based on a model imported from the USSR, serving the requirements of a centrally planned economy and was quite effective in nationalizing the Bulgarian banking system.[47]

The banking system of Bulgaria in the years from 1948-1981 consisted of three separate institutions, each handling deferent sectors of the Bulgarian economy.

- **The Bulgarian National Bank (BNB)** was responsible for monitoring the financial aspects and payments of enterprises, as well as receiving their deposits. This institution was also responsible for extending credit in the domestic currency and financing government investments.
- **The Bulgarian Foreign Trade Bank (BFTB)** was responsible for foreign exchange operations.
- **The State Saving Bank (SSB)** was handling the needs of the Bulgarian citizens; receiving saving deposits and financing the household sector.

Only the BNB and the SSB had a network of branch-offices around the country, while the remaining bank exercised its functions and serviced its clients through the branch-offices

of the BNB.

From 1981 until 1989, certain changes in the system made a way for the reformations that occurred in 1989. The first one, was the introduction of the Mineral Bank, in 1981, an institution created to allocate credit resources to new small and medium size enterprises. The second change, in 1987, was the formation of seven "sectoral" banks that provided loans in any currency.[48]

Table 14: Main activities of the Bulgarian banks during the communist era

YEAR	BANKS	FUNCTIONS
1951	The Post Credit bank was closed	Its functions passed to the State Savings Bank
1964	The Bulgarian Foreign Trade Bank was founded	Serviced all foreign currency operations and financial relations with the rest of the world
1967	The Bulgarian Investment Bank was closed	Its functions were transferred to the Bulgarian National Bank and the State and Savings Bank
1969	Establishment of specialised banks; the Bulgarian Industrial Bank, the Bulgarian Agricultural and Trade Bank.	They existed only until the end of the following year.
1981	"Mineralbank" was founded, transformed the next year into the Bank for Economical Projects	"Mineralbank" operated on the basis of semi-market principles.
1987	Establishment of seven new commercial banks; Economic Bank, Biochim Bank, Balkan Bank, Construction Bank, Elektronika Bank, Agrocooperative Bank, and Transport Bank operating in the same field as the Bank for Economical Projects "Mineralbank"	The purpose of the reform was to decentralise the banking activities. Functioning as investment banks, each bank was specialised in servicing a concrete industrial branch they had no branch-offices in the country and were servised by the branch-offices of the Bulgarian National Bank on commission basis.

Sources: BNB various[49] reports[50]

1.12.3 Banking Activities in the early years of the post-communist period

After four decades of central planning, the need for updating the banking system was intense for the Bulgarian economy, since the years that the main target of the system was the movement of credit from the state budget towards depended public enterprises, resulted in crucial delays in the system. This reflected on the functions and operations of the banks especially those that dealt with the foreign transactions, by restraining any initiatives they might develop, to compete in the international banking market, which was continuously renewed.

In that difficult economic environment, the Bulgarian banking system attempted a radical transformation in 1989; in order to avoid inefficiencies created by an obsolete system and to support their initial tries to create a market economy. The years before the collapse of the communist regime created a lot of drawbacks in the Bulgarian banking system that a significant delay in the transformation was partially expected, but the delay in taking governmental decisions, introducing a legal framework, and facilitating the quick

privatisation and restructuring of state banks was more than could be justified.

The banking system model of government monopoly was effective in a centrally planned economy, but was absolutely inapplicable for a market economy. The adoption of Decree No.56 in 1989 on Economic Activity, allowing the establishment of private businesses, was the first step for the whole private sector, including private banks. The other important step was the introduction of the "Rules for the Banks" by Ordinance 19, which distinguished the functions of the BNB as a central bank and the activities of the commercial banks, already in existence in Bulgaria. The introduction of those laws led to the establishment of 59 new commercial banks in 1989[51] initially being owned by the BNB, (they were BNB branches transformed to commercial banks), having 100% state capital and being allowed to function as universal banks. In 1989, the institutions composing the Bulgarian banking system were the BNB, the BFTB, the SSB, the Mineralbank, the seven sectoral banks, and the 59 commercial banks. The effectiveness of the structure formed after the last reorganisation was questioned since it was too scattered, the number of banks was too high (69 banks in 1991), and their capital too small (more 50% had ownership capital up to USD 500,000 and an average volume of credit investments for the year up to USD12 million). Their size restricted their capability to fully participate in the financing of large-scale projects. Since there was no clear concept of the optimum size and capacity of a commercial bank under the 1991 conditions, and the future banking structure was far from final, the BNB Board, in order to prevent the establishment of other inefficient banks, suspended the issuing of new licenses for banking activities. The only licences issued were for opening new banks with substantial foreign capital interest, or with a capacity to play a key role in the restructuring of the economy.

Table 15: Macroeconomic indicators, non performing loans and fiscal costs

	HUNGARY	POLAND	CZECHO-SLOVAKIA	BULGARIA	ROMANIA
Ratio of enterprises' bank credit to GDP %					
In end of 1990	25.8	15.6	60.5	78.8	38.6
In June 1991	24	18.4	62.4	47.8	44.6
Real Interest Rates					
In end of 1990	1.9	-44.4	-32.6	-35.5	-96.8
In 3rd quarter of 1991	8.1	15.6	2.3	-71.9	-31.7
Annual Rate of inflation %					
In end of 1990	33.4	250	16.6	64	150.1
In June 1991	36	79.9	71.3	554.6	224.9
Estimated ratio of nonperforming to total loans in 1991 %	50	40	55	44.2	36.6

Estimated fiscal cost of removing all bank nonperforming loans (in % of GDP)	5.4	6.5	5.6	17.7	22.9

Source: Thorne (1993), p. 977, Countries' official statistics and Thorne's estimates. For Czechoslovakia the real interest rate if for the first quarter of 1992. For the fiscal cost of removing the nonperforming loans Thorne has used the nominal lending rate as a proxy for swapping governmental bonds for nonperforming loans or providing a governmental guarantee on these loans. The total enterprises' loans, as a share of GDP, were less than 20% in Hungary and Poland and about 50% in Bulgaria and Romania.

In an article, Thorne[52] has presented a table [table 15], which among other things presents the number of private banks in CEE countries in 1989. At that time, Poland had 9 private banks, Hungary 4, Czechoslovakia 2, Bulgaria 59 and Romania 4. Many authors have argued that the extremely high number of Bulgarian banks seemed enormous compared to the Bulgarian population. However, these banks were small in size and scope of activity, created from the conversion of 59 branches of the BNB. There was also a sale of the remaining branches of the BNB to commercial banks.[53] In 1993, in Bulgaria there were approximately 4,000 branches, this means one branch per 2,100 of the population. Furthermore, Thorne's table (1992)[54] shows that in 1990, the SSB accounted for 46% of the total deposits in Bulgarian banks, when the 59 commercial banks accounted for 17%, the 8 "sectoral" banks for 11%, BNB for 16% and BFTB for 10%. The most impressing result, which supports the argument that the 59 commercial banks were small in size, is that the deposits of the five largest (of the 59 banks) accounted for 44% of the deposits of the 59 banks while their total assets accounted for the 56% of the assets of the 59 banks. At the same time the total assets of all the 59 commercial banks accounted for 25% of the Bulgarian Bank assets (see also table 15).

In 1991, a totally new Bulgarian banking system, which was based on a two-tier system having a central bank on one end and commercial banks on the other, was introduced. Around the same time, several other Central & Eastern European countries, like Poland, Hungary, Romania and Czechoslovakia, initiated reforms in their banking systems, which also based on the two-tier system. According to Thorne (1993), the reformation at that time was completed only in Hungary, Bulgaria and Czechoslovakia, because they consolidated the change by a completely new central banking law, according to western standards. On the other hand, Poland and Romania backed up the reformation with amendments to their existing banking law. Another difference pointed out by Thorne is the model each country selected as a guideline for their reformation. From all five countries, only Hungary separated between commercial and investment banking functions, following the Anglo-Saxon model. The other four countries, including Bulgaria, chose to follow the German-Japanese model of universal banking. Thorne argues that since the

latter model is suitable for banks in mature markets and industrial economies, such as Germany and Japan, the rules imposed on the banks would cause structural problems as well as problems in the application of the system. Overall, Thorne concludes, that the legislation of Bulgaria, Hungary and Romania, was the most liberal, and did not constrain banks in the investments of their capital and reserves. Another point on the liberal status of Bulgarian legislation of 1989 was the lack of any constraints in foreign ownership or participation in local banks.[55]

1.12.4 Commercial Banking Sector

Commercial banks play an important role in determining the money supply, which is a key variable of the macroeconomic policy. The activities of commercial banks are a very important issue, because they are the main mechanism for flow of the money capital from individuals, in the form of savings, to investors, through the commercial banking system.

During most of the communist years the Bulgarian National Bank (BNB), absorbed all existing commercial banks and undertook all banking functions. Bristow (1996)[56] has mentioned that "... *structural changes came in 1989 when 59 new commercial banks were created from branches of the BNB, financed by the transfer of deposits, balanced by further transfer of loans to enterprises*"[see also table 13].

The Law on the Bulgarian National Bank initiated the redefinition of roles and responsibilities in the new two-tier banking system that significantly changed the roles, objectives and functions of Bulgaria's central and commercial banks. Minkov (1993)[57], has mentioned that "*at the beginning of banking reform in Bulgaria there were a number of banks considered commercial, although the parameters and the results of their activities were far from commercial banking. The development of a two-tiered banking system was incomplete, and this was why the banking sector had not yet turned into an effective vehicle for financial capital*".

The Law on Banks and Credit Activity constitutes the regulatory framework for the activities of banking institutions and provides even state-owned banks with significant autonomy. Further, reinforced the operation of the banking sector driven by market forces. The entry of new banks and the development of non-bank financial institutions gave rise to healthy competition among commercial banks.

By the end of 1995 there were already 28 private Bulgarian banks. At the same time, the number of large banks was increasing, and the number of commercial banks decreasing. The number of new private banks was constantly growing and the 59 banks established from the commercialisation of the 59 branches of the BNB were consolidated by the BCC's plan, which was to merge all the small banks into 4-6 big banks ready for privatisation mainly by foreign investors.

Table 16: The development of Bulgarian banks during the transition period

NUMBER OF PRIVATE BANKS IN BULGARIA				
1991	1992	1993	1994	1995
6	11	15	22	28
LARGE BANKS (with assets of 30 billion Lev or more)				
3	4	7	10	9
NUMBER OF COMMERCIAL BANKS				
1989	1995	1996	1997	1998
59	46	34	36	35

Source: BNB

Commercial banks generate funds either by borrowing from other commercial banks and financial institutions (through the interbank money market) or by borrowing from the BNB. The **"refinancing"** of commercial banks by the BNB was presented in forms of loans from the BNB to the banks. The BNB was obliged to carefully control the loans to commercial banks since this activity allows the money supply to expand thus negatively affects the inflation rate. Refinancing includes several facilities[58] like the Lombard Loans[59], the Credit Ceilings[60], the Discount Operations[61], the Overdraft Facility[62], the Open Market Operations[63], the Minimum Reserve Requirements, and the Short-term Deposit Auctions[64].

1.13 Short Introduction to the foreign trade organisation; the CMEA System of Trade

A quick review of the economic development during the 20th century and prior to 1989 presents, among others, the legacy of the communist regime, the strong dependence on the CMEA and the Soviet Union trade and some other specific factors which led Bulgaria to having one of the worst initial economic conditions in the region, making the road for the transition to a market economy a "hard task". Bulgaria's dependence on the CMEA and the ex-USSR trade[65] and the collapse of CMEA trade with figures are also presented. This chapter also analyses the political instability in Bulgaria that created significant delay in the privatisation process, in the establishment and application of the new legal status and in the avoidance of the expansion of the nomenklatura, Mafia and other illegal actions. This

part will present the reasons, which led to the collapse of the CMEA trade and the subsequence collapse of the industrial production at the beginning of the transition period of each Central and Eastern European (CEE) country.

Before any further analysis it is important to understand the function of the institution that prevailed all maters of foreign trade for the six "people's democracies" (Bulgaria, Czechoslovakia, Hungary, Poland, Romania, GDR) and the Soviet Union together with all the other members and associate members and co-operators country-members.[66]

From 1948, Bulgaria, Czechoslovakia, the GDR, Hungary, Poland and Romania, started building the foreign trade monopoly, patterned on the Soviet Union administrative system. They procedure of erecting a foreign trade monopoly included the following elements:

1. the separation of foreign trade from, domestic production and trade, by forming foreign trade corporations, which were employed exclusively in international transactions. Each of those corporations had a monopoly of trade in its own sector.
2. the inclusion of foreign trade in the central plan and the imposition of quantity ceilings on all imports and quantity floors on all exports.
3. the fixing of domestic prices in order to avoid the currency being overvalued owing to domestic inflation.
4. the integration of the Soviet enterprises and joint enterprises into the national system.[67]

The Central Eastern European countries and the USSR traded heavily with each other and these actions became the framework for the creation of the Council for Mutual Economic Assistance (CMEA). In January 1949, the CMEA was established in Moscow. It was an intergovernmental body initially established as a payments' system for the trade of the socialist countries but it also assisted and co-ordinated the economic development of its members.

1.13.1 The CMEA's organizational structure

The "*...political principle of the CMEA was "equality, sovereignty and interest"...CMEA did not have an executive or legislative mandate...*[nor did it] *... create a common market, but it did create a distinct economic region by fostering preferential relationships codified in bilateral treaties between governments...*[The] *... CMEA system of bilateral clearing did not involve international payments through transfer of currency to or from accounts in another country. The TR (transferable rubbles) lacked two major properties of money: it was neither a means of payment, nor was it a store of value. The total volume of TRs in the CMEA system was merely a measure of the volume of the outstanding bilateral surplus or deficit in national clearing accounts held by the countries with the IBEC".* The transferable ruble, however, was not truly transferable, let alone convertible. [Schrenk

(1992)[68]]. For example "... *if Poland built up a credit balance with IBEC by running a trade surplus with Hungary, it could not use the credit to finance a deficit with Bulgaria. For this and other reasons, each CMEA country sought to balance its trade bilaterally with each CMEA partner".* [Kenen 1991][69] Trade was, in principle to be balanced.

The CMEA organization consisted of the following members;

Table 17: CMEA country-members

Bulgaria	Original member	Soviet Union	Original member
Czechoslovakia	Original member	East Germany (GDR)	Joined in 1950
Hungary	Original member	Mongolia	Members
Poland	Original member	Vietnam	Members
Romania	Original member	Cuba	Members
Albania	Ceased participation in the CMEA in 1961		
Afghanistan, Angola, Ethiopia, Finland, Iraq, Mexico, Nicaragua, Syria and Democratic of Yemen and some other developing countries were co-operators and observers		Yugoslavia	Became an associate member in 1964. It never assumed full membership

incorporating, at the same time, with the following institutions:

1. **The Council Session:** It was the highest level of the CMEA, consisting of the regular annual meeting of heads of the governments.

2. **The Executive Committee:** It was the CMEA's permanent board, which consisted of government representatives.

3. **The CMEA Secretariat**: It was the core organisation.

4. **The International Bank for Economic Co-operation (IBEC):** It was a financial institution, which managed the complex clearing between the accounts of the members. These accounts were held bilaterally in transferable rubbles (TR) by crediting and debiting IBEC accounts. TR was the currency for the CMEA trade until 1991.

5. **The International Investment Bank (IIB):** A financial institution, which was mainly concerned with borrowing in convertible currencies and financing joint projects or financed investments projects in the non European CMEA developing countries' members.[70]

The CMEA was perceived, by some, as a continuation of the Soviet autarchic growth

strategy due to its Soviet type structure and the fact that the USSR dominated, in percentage the total trade amount. This was certainly the case of Bulgarian foreign trade; from the second half of the 1950s about 50-55 percent of the total Bulgaria's foreign trade turnover was with the Soviet Union and about 30-35 percent with the other CMEA countries (especially the German Democratic Republic (GDR) and Czechoslovakia). According to Bruno (1992) [71], "*the CMEA collapse in 1989, caused the most damage in Bulgaria, the bulk of whose exports had gone to the CMEA*".

The CMEA had a positive effect on the East European trade. During the period 1956-60 the East European Trade had a larger growth rate than the total world exports and even the trade of Western industrialised countries. The growth rate decelerated from 1961 to 1965, to a rate below the Western one, only slightly above the world total.

During the 1960s Bulgaria had the fastest rate of growth of foreign trade, with exports growing considerably faster than imports. By 1972, Bulgaria had the larger amount of foreign trade among the CMEA countries, followed by Romania, Poland, Hungary, the USSR, the GDR and Czechoslovakia. Still Bulgarian economy was heavily dependent on foreign trade, as it lacked in raw materials.

Most of the trade among the CMEA countries was conducted on a government-to-government basis. It was based on five-year agreements, supplemented by annual protocols which were fixing the quantities and prices of the products to be traded. The commodity composition of CMEA trade and the international trade of the country was planned from the government. That was one of the problems of a centrally planed international trade. "*Central planning tends to be biased against foreign trade. Planners crave certainty, and foreign trade, even between planned economies, involves uncertainty. It is hard to plan production, harder still to plan consumption, and very hard to plan the differences between them. To plan trade between two countries, moreover, the planners have to match the two countries' differences, imparting more uncertainty to each country's plan.*" [Kenen 1991][72] The prices of primary commodities according to the Bucharest formula, adopted in 1975, were based on a five-year moving average of world prices but tended to lag behind them.

1.13.2 The CMEA trade and Trade Relations between CMEA members; The Economic Development prior to 1989

Approximately 60-70% of the intra-CMEA trade, of the Central and East European countries, was with the USSR. Hungary was at one extreme, with the USSR's share in total

foreign trade falling below 20% by 1990, and Bulgaria at the other extreme, had almost totally Soviet-oriented development policies and trade.

The transition brought about a dramatic rearrangement of the geographical distribution in the CEECs' foreign trade. The share of the CEECs dropped radically and that of European Union increased significantly. The CEECs' relations with the Soviet Union and then with Russia stopped to play a dominant role in the region.

Probably no other country employed so much assistance from the combined effects of generous Soviet supplies of energy and raw materials, together with an equal Soviet willingness to accept Bulgarian manufactured goods in return and resulting in extremely generous barter terms of trade. Russian long-term plans are to build new transit oil pipelines carrying oil from central Asia through Bulgaria and Greece to the Aegean Sea. In the West, Italy and Germany are the main trade partners. Trade with the U.S. is negligible. The chief exports were machinery, food products, tobacco, non-ferrous metals, cast iron, leather products, and textiles. The principal imports are petroleum, natural gas, machinery, transportation equipment, steel, cellulose, and timber. On the other hand, though, the already existing industry set up by USSR financial aid, along with Bulgaria's highly skilled and relatively cheap industry workers, gives one strong incentive among the others for foreign investors.

1.13.3. The most important factors behind the collapse of CMEA Trade

There are several reasons that led to the collapse of the CMEA system. The finally decision concerning the dissolution of the CMEA trade was made in June 1991, when the idea of a new organisation was also removed.[73] The following points explain the above:

- The unification of Germany in June of 1990 and the disappearance of GDR as a trade partner for the remaining CMEA members. The trade to GDR amounted to 15% of the total trade among CMEA countries.

- In January, 1991 the transferable ruble was replaced by the dollar payments in effect of the introduction of world markets prices in trade among the CMEA countries

- Prior to the above, was the Sofia CMEA session in January 1990. The Soviet Union has proposed the change of the currency for the CMEA trade. This proposal was a result from the Soviet need to improve its terms of trade, increasing its earnings and

improving its balance of payments.

- Another Sofia CMEA session was held in June 1990. The committee decided to transform of CMEA system into a new organisation like OECD. This new organisation was responsible for analysis of the economic development of member countries and for co-operation in fields such as statistics, energy, environment, etc. Many analysts have argued that this session in fact, had announced the abolition of the CMEA system and as it has mentioned before, after a year there was an abandonment of the idea of creating a new organisation.

- Moreover, this change to dollar payments was necessary, because most of the Central and Eastern Economies has already chosen the road for the transition to market economy and the remaining countries were close to adopting such as policies. It was necessary to abolish the CMEA trade, because the transition is based on economic liberalisation, reorientation of economic relations and outward oriented trade policies.

- As it was mentioned earlier the CMEA trade system was based on central planning system. Therefore, the abolition of central planning, foreign trade monopoly and the liberalisation, privatisation and structural and institutional reform have destroyed the foundations of the CMEA system.

- The war of Iraq and the consequences of international oil crisis in the summer of 1990, which gave a dramatic character to the cost of energy. Until the end of 1990, the CMEA countries imported energy from Russia at lower prices than the world market prices. After the introduction of dollar payments and the significant increase of the oil prices due to the Gulf war, the five CMEA countries (except GDR), faced problems in paying the cost (approximately 15 billion US$) without external financial assistance. This led to a significant increase in the foreign debt in all the CMEA members. Koves (1992)[74] has pointed out that "*the smaller European CMEA countries did, in fact, enjoy more favourable terms of trade in their transferable-ruble trade with the Soviet Union than in their dollar-accounted trade with other countries. They were net exporters of relatively overpriced manufactures, as compared with the energy and raw materials of which they were importers. This meant that in any given period of time, Central and East Europeans had price benefits when exporting to and importing from the Soviet Union.*"

- Moreover, there was an economic and political crisis in USSR in 1991. This Soviet

Union inability to pay for imports and the subsequent unwillingness to export led to a significant decrease in the trade flows among the CMEA countries (we have already mentioned that 60-70% of the intra-CMEA trade of the Central and East European countries was with the USSR). Koves (1992)[75] has argued that *"the single most important factor behind the collapse in trade was the Soviet economic and political crisis, eventually leading to a crash and disintegration"*.

- Furthermore, the USSR from 1988 onwards has faced several problems, which led to a political fragmentation after the Moscow coup of August 1991. In September 1991, the CIS was created and on 26th of December 1991, there was the formal dissolution of the USSR. In addition, similar problems appeared in the associate member of the CMEA system, named Yugoslavia. In June, 1991, a civil war began and followed by the recognition of the independence of Slovenia, Croatia and Bosnia-Herzegovina in 1992. In June 1992, was also the separation of the Czech and Slovak Republic. This political disintegration has influenced the relations between the members and has resulted to a decrease in the trade flows between the members.

- Although, in this thesis it has been argued that the abolition of the CMEA trade was a result of the above reasons, it has also to be mentioned that there was a significant decline in the trade flows during the 1980s among the CMEA countries. Furthermore, the economic crisis of the member countries and the considerable decrease in output and the overall decline was another reason for the collapse of the CMEA trade.

1.13.4 Why the CMEA trade did not collapse earlier

During the years 1990-1991, the five European country-members of the CMEA trade system continue seeking Soviet Union guaranteed for their exports and stable Soviet deliveries of energy and raw materials. This happened because of their competitive weakness on international markets and the difficulties that they were facing in the reorientation of their trade.

Countries-members of the CMEA system even in 1991 continued to ensure as many Soviet oil deliveries for themselves, as possible. This has happened due to the lack of the necessary infrastructure (pipelines) for importing significant quantities of oil from other countries. Moreover, although there was a payment in dollars, on the other hand, oil deliveries from USSR were indeed, in lower prices than the world market prices. Furthermore, there was a lower transportation cost, and a significant knowledge of the

Soviet oil trade and a subsequent lack of experience of the international oil trade.

In addition, the CMEA countries have continued to ask for Soviet oil deliveries for another reason. They wanted to maintain the same level in their exports. The only chance, at least at the beginning of their transition, was to exchange their exports of manufactured goods with imports of the Soviet oil.

On the other the USSR had reasons to continue the trade with the CMEA countries during the years of transition. Although, the CMEA countries' products were at a lower level of a quality comparing to the western products, a large proportion of them had already generated a favourable image in the Soviet Union. Furthermore, these products were of much higher quality of the domestic products. In addition, Central and Eastern Europe economies, from their previous experience, also had a relatively good knowledge of the USSR market, traditions, practices, language, and had already established a strong enough repair and service network. Koves (1992)[76] has argued that *"for a number of economic, technological, and human reasons, not only did the "five" depend to a large extent on the Soviet Union, but the Soviet Union depended on the "five"."*

1.13.5 Bulgaria as a country case study; Bulgaria's dependence on the CMEA.

Bulgaria was one of the least industrialised countries of Eastern Europe depending mainly on agriculture. After the rise of the communist regime in 1949 Bulgaria developed a strong dependence on the Soviet Union, a country that was the cornerstone of Bulgaria's industrial development, providing the new communist country with capital and energy resources; the two things Bulgaria lacked the most. The country experienced some growth during the communist period but it failed to set solid bases for an independent and prosperous economy. This was due to the controlled economy that prevented competition and gave no incentives for quality and efficiency. By the early 1980s Bulgaria had become an industrialised country with a more or less stable economy and a reported per capita income roughly similar to other European countries such as Poland, Hungary, Portugal and Yugoslavia.[77] However, the stable economy was a product of the protective environment of the CMEA. The data provided in the table below show that the bigger percentage of Bulgarian Foreign Trade was contacted with CMEA country members. Those trade partners had little concern about the quality of the products and where not looking for a better deal elsewhere.

Bulgaria's dependence on the CMEA as well as the USSR is self-proven by the data on foreign trade during the communist years. After the collapse of both[78], Bulgaria was left without its main trade partners, and with production that would not stand a chance, in terms of competitiveness, in a non-controlled market. In general all "*...CEE* [Central and Eastern European] *countries ... needed to restructure in numerous ways, notably from heavy to light industry, from industry and agriculture to finance and services, and from CMEA to world trade. ... Within existing firms, new products lines and production methods had to be developed, while simultaneously reducing input waste, notably in terms of energy, labour and the environment.*" [Estrin et al 1997, p9][79] The "*... CMEA collapse in 1989, caused the most damage in Bulgaria, the bulk of whose exports had gone to the CMEA*". [Bruno 1992, p.80]. The unification of East Germany, who was also a major trade partner during communist years, with West Germany was another strike to Bulgaria's weak economy.

The changes in Bulgaria's familiar trade environment were, most probably, the strongest obstacles for its economic reform. The ex-USSR impact on the Bulgarian economy during the energy crisis was also devastating due to the strong dependence of Bulgaria in oil imports from the USSR. The energy crisis in the USSR resulted in severe energy shortage in Bulgaria[81]. In addition to the above, the UN sanctions on Iraq as a result of the Gulf crisis cost Bulgaria $2,5 billion.[82] Iraq was Bulgaria's largest debtor through trade relations and, thus, the agreement of repayment of the loan with the delivery of 600,000 tons of oil was devastatingly postponed due to the UN embargo. Another crucial reason for the delay of the economic transition was the large amount of Bulgarian foreign debt; one of the larger debt/GDP ratio among the East European countries. Only one country, Romania, started its transition with debt, less than 1 billion US$. Although the Soviet Union and Poland started their transition with more dept than Bulgaria they had 8,5 and 4,5 billion US $ foreign reserves respectively, while Bulgaria and Romania, very soon after the transition, run out of foreign currency reserves. The already - made loans in hard currency together with the devaluation of the national currency increased the adverse initial conditions.

Summarising, the Persian Gulf crisis, which caused higher oil prices, the interruption of the trade between Iraq and Bulgaria as well as the collapse of trade relations with Russia, East Germany, and CMEA members, brought Bulgaria close to disaster in times when the country was most vulnerable. As a result, Bulgaria started the transition to an open market having one of the worst initial economic conditions of ex-communist countries.

1.13.6 What are the reasons behind the output collapse in CEE countries?

The similar large falls in output in the economies of central Europe and the former Soviet Union during their transition period is a very controversial and complicated issue. Despite wide differences in reform policies, the cumulative falls in industrial output, at 40-60 per cent, large and similar between countries. Some of the considerations associated with the subject present different views of the problem.

- **The opponents of the shock therapy like Stiglitz J. (1999)[83] argued that the speed of the transition** greatly affects the output collapse since it might generate inflation as a result of rapid price and trade liberalization, as well as sharp increases in interest rates, and the external shock might take local enterprises by surprise. This argument is proven wrong by the statistical data. Poland, which followed a big bang policy in 1989, did have the largest output drop in 1990, but the effects were short term since it made the better recovery from all other countries even from those that followed a more gradual approach.

- **In situation when the rapid speed is essential for the success of the transition (economic, institutional and political), according to Gomulka, S. (1998)[84] there are** four classes of specific causes of output falls: *"1) massive and rapid changes in relative prices in conditions of limited resource mobility; 2) the elimination of excessive real aggregate demand to establish buyers' markets; 3) the collapse of captive markets within the former CMEA area; and 4) the collapse of the arms industry and of state financed investments in housing, energy, agriculture and the infrastructure."*

- **The collapse of the Warsaw Pact, the CMEA, and the USSR**, the larger facilitators of trade in the region, deprived the CEE countries of their most important trade partners[85]

- Other authors such as Kornai has argued that the output **collapse is due to the change of the economic system rather than to the transition policies**

- **The lack of competitive products** with significant quality and the lack of marketing skills, lead to an inadequate promotion and this lack of trade partners also lead to output decreases

- **The statistical exaggeration (price distortions)** of the output in the communist years led the economists to argue that the collapse during the transition years was

not so significant as the figures show.[86]

- **The price liberalisation** lead to sharp price increases of the products and thus these markets has lost their comparative advantage of the low price and thus led to output decreases

- Most of the state-owned **enterprises were in debt,** thus during the transition most of the governments decided to privatised them, to liquidate or even bankrupt them. Thus, the output has declined

- During the transition there was a trend of **large amount of production keeping the commodities in large storehouses,** without focusing in the quality, and exchange these products with other products from other CMEA countries where the products were in scarcity. After the collapse of this trade there was no need to continue such as behaviour.

- **Shortage of raw materials, energy** and semi-finished goods, which in the communist era were imported from Russia is another reason for output collapse for countries such as Bulgaria, which was heavily depended on importing such as things from Russia[87]

- **The tight financial disciplines** and the hard budget constraints imposed by the governments to the enterprises made companies to be more careful, more efficient and to become profit seekers and not quantity or turnover seekers. Moreover, they did not sell to clients of other state-owned enterprises that raised doubts about their ability or intention to pay (become risk averse). Lastly, banks on which the government had also imposed strict policies did not continue to support financially the enterprises thus, there were not accumulating large amounts of stock of commodities or increasing their production output (lack of working capital or capital for expansion, lack of orders, loss of markets etc.)

- The **low per capita consumption** after economic crises or even before that. A lot of products in the planned economy were subsidized by the government, especially in the food sector, thus after the abolishment of these subsidies and the low purchasing power of the citizens, they did not afford to buy the same quantities of products. There was increased poverty with significantly increased number of unemployment rate.[88]

- The **increases in the unemployment rate** resulted to a percentage to the decline of output.

1.14 CONCLUSION

The legacy of the communist regime in Bulgaria created unfavorable conditions for the transition to a market economy. In 1989, Bulgaria was an industrialized country, which produced low quality products, which were distributed to the CMEA countries and the USSR. The collapse of the CMEA trade created a lack of foreign trade partners. Therefore, finding new partners as well as making changes in the composition and in the geographical distribution of the producing commodities was also necessary. However, the distance, both geographic and economical, from the West for almost four decades and the low quality of the products led to the difficulty of finding new trade partners and thus to the collapse of the industrial output.

At the beginning of transition, the general view among the policy makers in all the transition economies was that the information tools were inadequate to help them in taking significant decisions and using the analysis of the past trends as an indicator to improve policy design.

When studying the statistical data, especially in the communist period, it is necessary to be careful. "*Even in established market economies* ***standard statistical data*** *provide only an incomplete description of economic reality, but in countries in transition data deficiencies and biases are much more serious*".[89] Under central planning, the output of state enterprises was often exaggerated, whereas during the transition, there are strong tax incentives in order to the output of the private sector to be underreported by large margins. Conventional statistics fail to reflect the sharp improvement in the quality of goods and the satisfaction of the demand during the transition period, relative to the previous situation with enormous output and unsatisfied demand. Reported unemployment data and fiscal deficits during the communist period were problematic and cross-border transactions were poorly reported.

The statistical offices of the planned economies were adequate to keep under control the statistical information regarding state-owned enterprises with strong governmental control of the bookkeeping system. In the post-communist era, the introduction of a significant number of private firms, created problems to those statistical agencies, which did not expect and were not ready to prepare and measure economic facts of a market economy with quickly increasing private sector. Under the planned- economy there was a continuous attitude for an increase in output. This was apparent in the figures, but at the same time it

does not signify economic growth. There was an exaggeration of the data. Balcerowicz[90] has argued that "*even in the established market economies statistical indicators do not provide a fully adequate description of the economic reality, because for example, of well know problems of statistical representation of changes in produce quality, or the inadequacy of comparing data on unemployment in various countries. Even in these countries there are many instances of the poor interpretation of statistics*". The newly emerging output in Eastern Economies is more closely geared to the consumers' welfare than the planned economy's output. Martha de Melo et al. have pointed out that[91] "*Under central planning the output of state enterprises was often exaggerated, whereas during the transition, output of the private sector has tended to be underreported, sometimes by large margins.*" There are strong tax incentives for the output to be underreported by the private entrepreneurs. Lipton et al. (1990) have argued that[92] "*Real growth has been routinely overstated and inflation routinely understated in the data of Eastern Europe and the Soviet Union*".

The statistical data show that countries from the Balkan region such as Bulgaria, Romania, Albania, FYROM, Bosnia and Yugoslavia lag behind not only from the Western advanced economies, but also from the other countries of the CEE region. Furthermore, the Balkan countries are unable to reach the statistical data (such as industrial output, unemployment rate and trade) they had in 1989. On the other hand, countries like Hungary and Poland have managed to overcome (more than 30%) the levels of industrial output they had in 1989[93].

A few basic reasons, which led the Balkan countries to a significant delay in economic growth, are:

- the geographical distance from the Western market
- the strong dependence on the ex USSR and the CMEA trade organization
- the different initial adverse economic conditions (the worst in the whole region) together with the severe exogenous shocks (wars on Yugoslavia and Kossovo and the subsequent embargo and the dissolution of Yugoslavia)
- the political instability and the continuous hostilities in the Balkan region
- The insufficient quality and variety of products, which were unable to offset the lost trade partners with others from the West and the limitation of natural resources.

Countries such as Albania, Bulgaria and Romania had in 1991 a decrease of approximately 50% of the figures of 1989 in trade exports and nowadays (2000) do not manage to reach

the levels of 1989 (with the exemption of Romania). On the other hand, countries such as Hungary and Poland (regions close to the western markets) did not have large decreases in their exports in the period 1989-1991 and in the year 2000 have managed to double or even to triple their exports (their main export destinations being the West). Actually, it is obvious, that the most advanced economies from the whole CEE region (Slovenia, Poland, Hungary, the Czech Republic, Slovakia, together with the Baltic states), which have better opportunities of becoming future members of the EU, have also managed to increase significantly (double or triple) their exports in 2000 compared to the figures of 1989. However, it can be pointed out that most, if not all, of the CEE countries had a positive trade balance (or very close to zero balance) in 1989, but on the other hand, they have a negative trade balance in 2000.

Finally, there are a lot of chances for a few countries from Central and East European region to become future members of the European Union (under the European Union Enlargement Policy). Nowadays, the economic situation of CEE countries is far away from that of the EU and the macroeconomic data of CEE economies (especially that of the Balkan countries) did not satisfy the Copenhagen economic criteria. However, most of the CEE countries have strong hopes to join the EU and to proceed in an economic (nominal) convergence with the Copenhagen criteria until the end of this decade[94].

Although early analysts have seen Bulgaria as a country, which undertook a 'big bang' transition path, the eleven years of Bulgarian transition studied by the author indicate otherwise. The instant price liberalization of more than 70% of the commodities in 1989 was the only sign to point toward a 'big bang' strategy, when even the prices of the remaining commodities have not been liberalized after those years and the big state monopolies are still under state control. Although a few countries from the CEE region have chosen the shock therapy model of transition in early years (such as Poland, Czechoslovakia, Bulgaria, Russia, Albania, Estonia, Latvia), most of them shift to gradualism (Russia, Romania, Ukraine) or "failed" due to the postponing of reforms as a result of inadequate governmental abilities, fragile coalition governments, political cost of reforms, political concerns for re-election etc. or some other countries started from the beginning as gradualists (such as Hungary, Lithuania), but never shift to shock therapy models[95].

All the signs of Bulgarian economic life were negative until mid-1997. The governmental failed to increase the private sector and to create adequate financial intermediaries having at the same time one of the weakest stock markets in the region even in the present day.

The development in Bulgarian privatisation is not only far away from a 'big bang' path, but also raise doubts on whether it falls under gradualism. An explanation may be that Bulgarian governments in the sense of thinking political cost impose a gradual approach, first to restructure and then to privatize.

However, after the mid-1997, things have changed and only positive signs in the Bulgarian economy can be seen. There is acceleration in privatisation and restructuring (Bitzenis, A., 2003 forthcoming[96]), an increased private sector (near to 65% in 1999), one-digit inflation rate, low interest rates, macroeconomic stability, increased FDI inflows, significant participation of foreign banks, starting the abolishment of the remaining monopolies, imposing hard budget constraints and adaptation of an adequate legal framework.

Although the signs for economic growth (after July 1997 and especially in 1999-2000) are obvious positive, Bulgaria is behind most of the other CEE countries since it has not yet recovered economically, neither in GDP (table 18) and industrial output (table 19) nor in trade balances, so increases in the growth of the low level of stock market performance, real GDP, exports and imports and industrial output are needed. Moreover, the Bulgarian government should try to decrease the high unemployment rate (table 20), to balance the current account deficit and to proceed to the finalization of the remaining privatisation deals together with the abolishment of the remaining monopolies.

Table 18: Real GDP/NMP in Central & Eastern Europe, 1980, 1987-2000, (Indices, 1989=100)

	1980	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Eastern Europe	88.7	99.4	100.8	100.0	93.2	82.9	79.3	79.0	82.1	86.9	90.3	92.1	93.8	95.0	98.7
Albania	79.4	92.4	91.0	100.0	90.0	64.8	60.1	65.9	71.4	80.9	88.2	82.0	88.6	95.0	102.6
Bosnia and Herzegovina	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Bulgaria	76.2	99.3	101.9	100.0	90.9	83.3	77.2	76.1	77.5	79.7	71.6	66.6	68.9	70.6	74.1
Croatia [a]	99.0	102.5	101.6	100.0	92.9	73.3	64.7	59.5	63.0	67.3	71.3	76.2	78.1	77.8	80.7
Czech Republic	..	93.7	95.7	100.0	98.8	87.3	86.9	86.9	88.8	94.1	98.7	97.7	95.5	94.8	97.7
Hungary	86.3	99.4	99.3	100.0	96.5	85.0	82.4	81.9	84.4	85.6	86.8	90.7	95.1	99.3	104.5
Poland	91.1	95.9	99.8	100.0	88.4	82.2	84.4	87.6	92.1	98.6	104.5	111.7	117.1	121.8	126.8
Romania	88.5	106.7	106.2	100.0	94.4	82.2	75.0	76.2	79.2	84.8	88.2	82.8	78.3	75.8	77.0
Slovakia	..	97.1	99.0	100.0	97.5	83.3	77.9	75.1	78.7	84.0	89.2	94.8	98.6	100.5	102.7
Slovenia	98.9	103.5	100.5	100.0	91.9	83.7	79.1	81.4	85.7	89.3	92.4	96.6	100.3	105.5	110.6
FYROM	93.3	101.4	98.1	100.0	89.8	84.3	78.7	72.8	71.6	70.8	71.6	72.6	74.8	76.8	80.7
Yugoslavia [a]	95.7	100.2	98.8	100.0	92.1	81.4	58.7	40.6	41.7	44.2	46.8	50.3	51.5	41.6	45.7

Source: UN/ECE Common Database, derived from national and CIS statistics.

Note: Data for the east European countries are based on a GDP measure, except where otherwise mentioned. For the countries of the former Soviet Union, NMP data for 1980-1990 were chain-linked to GDP data from 1990. Country indices were aggregated with previous year PPP-based weights obtained from the European Comparison Programme for 1996. [a] Gross material product (1980-1989 for Croatia).

Comment: In all the CEE countries, there was a similar reduction in real GDP, with the negative exceptions of Albania and Yugoslavia. Bulgaria did not recover in 1999 like the rest of the other CEE countries.

Table 19: Real gross industrial output in Central & Eastern Europe, 1980, 1987-2000, (Indices, 1989=100)

	1980	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Eastern Europe	82.8	98.5	100.6	100.0	85.9	70.2	63.0	61.5	65.5	70.3	73.9	77.5	78.6	78.5	85.0
Albania	77.0	93.3	95.2	100.0	86.7	50.4	35.2	31.7	25.8	23.9	18.1	18.6	22.7	26.3	29.4
Bosnia and Herzegovina	106.0	101.1	98.1	100.0	101.8	76.9	25.5	2.0	1.7	2.8	5.2	7.0	8.7	9.6	10.5

Bulgaria	71.3	98.0	101.1	100.0	83.2	66.4	54.2	48.8	54.0	56.4	59.3	53.4	49.1	43.1	44.1
Croatia	88.7	102.0	100.6	100.0	88.7	63.4	54.2	51.0	49.6	49.7	51.3	54.8	56.8	56.0	57.0
Czech Republic	81.5	96.5	98.5	100.0	96.6	75.7	69.8	66.1	67.4	73.3	74.8	78.1	79.4	76.9	80.9
Hungary	92.9	106.4	105.3	100.0	90.7	74.0	66.8	69.5	76.2	79.7	82.4	91.5	103.0	113.7	134.5
Poland	86.3	95.5	100.5	100.0	75.8	69.7	71.7	76.3	85.5	93.8	101.6	113.3	117.3	122.9	131.6
Romania	76.9	99.2	101.9	100.0	81.9	63.3	49.4	50.1	51.7	56.6	60.1	55.8	48.1	44.3	47.9
Slovakia	76.7	98.6	100.8	100.0	94.0	75.9	68.6	66.1	69.3	75.1	76.9	77.9	80.9	78.0	85.1
Slovenia	90.3	101.6	98.9	100.0	89.5	78.4	68.1	66.1	70.4	71.8	72.5	73.2	75.9	75.6	80.2
FYROM	72.1	97.3	95.6	100.0	89.4	74.0	62.3	53.7	48.0	42.9	44.3	45.0	47.0	45.8	47.4
Yugoslavia	80.0	97.6	98.4	100.0	88.0	72.5	57.0	35.7	36.2	37.6	40.4	44.2	45.8	35.2	39.1

Source: UN/ECE Common Database, derived from national and CIS statistics.

Note: Data for former Czechoslovakia and the former SFR of Yugoslavia for 1980 until the breakup obtained as sum of individual country data for former members. For the countries of the former Soviet Union, data for 1980-1990 were chain-linked to national or CIS data from 1990. Country indices were aggregated with previous year PPP-based weights on the basis of data obtained from the European Comparison Programme for 1996.

Comment: In 1990, all CEE countries had a similar reduction of approximately 50% in industrial output, with the negative exception of Albania and the positive exceptions of Slovakia, Poland, Slovenia, Czech Republic and Hungary. Bulgaria did not recover in 1999.

Table 20: Registered unemployment in Central & Eastern Europe, 1990-2000, (Per cent of labour force, end-of-period)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Eastern Europe	..	9.6	12.4	14.0	13.6	12.5	11.7	11.9	12.6	14.6	15.1
Albania	9.5	9.2	27.0	22.0	18.0	12.9	12.3	14.9	17.6	18.2	16.9
Bosnia and Herzegovina	..	..	..	..	..	..	..	39.0	38.7	39.0	39.4
Bulgaria	1.8	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0	17.9
Croatia [a]	..	14.1	17.8	16.6	17.3	17.6	15.9	17.6	18.6	20.8	22.6
Czech Republic	0.7	4.1	2.6	3.5	3.2	2.9	3.5	5.2	7.5	9.4	8.8
Hungary	1.7	7.4	12.3	12.1	10.9	10.4	10.5	10.4	9.1	9.6	8.9
Poland	6.5	12.2	14.3	16.4	16.0	14.9	13.2	10.3	10.4	13.1	15.0
Romania	1.3	3.0	8.2	10.4	10.9	9.5	6.6	8.8	10.3	11.5	10.5
Slovakia	1.6	11.8	10.4	14.4	14.8	13.1	12.8	12.5	15.6	19.2	17.9
Slovenia	..	10.1	13.3	15.5	14.2	14.5	14.4	14.8	14.6	13.0	12.0
FYROM [a]	..	24.5	26.2	27.7	30.0	36.6	38.8	41.7	41.4	43.8	44.9
Yugoslavia [a b]	..	21.0	24.6	24.0	23.9	24.7	26.1	25.6	27.2	27.4	26.6

Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.

[a] The data reported on employment cover only the social sector in agriculture, hence unemployment rates are biased upwards.

[b] Since 1999, excluding Kosovo and Metohia.

Comment: Bulgaria's unemployment rate increases every year (with an exception for the period from April 2000 to June 2001).

On the other hand, the Bulgarian government may consider all the above as the most important tasks to achieve or to overcome, while simultaneously keeping at the same level or increasing the growth rate of the macroeconomic performance within the period of the following years (up to 2010) will give Bulgaria the chances for becoming one of the next members of the EU. This is mainly based on the level of the "black economy", which occurs in the CEE countries and especially in Balkan countries, which is around 40%-50% of the GDP level of each country (the EU countries have around 10%-15% level of "underground economy", and Greece is the only country among the EU, which has the biggest level of "hidden economy" - around 30%-35% of GDP). Considering firstly that the GDP per capita of Greece (a member of the EU), Cyprus and Malta (which both are countries that satisfy the Copenhagen criteria for an accession to the EU) is around 13,000 US$ (for each of them) and secondly the GDP growth for most of the CEE countries is around 5%-7% per year, then we conclude to the following: with such a growth rate, if we assume the level of black economy in 50% of the real GDP, then we also conclude that the GDP per capita of one country, such as Bulgaria, will reach the level of 13,000 US$ in a

period of 7 - 10 years. However, estimations and other researches from organizations and institutions are more optimistic and they are talking for earlier EU accession (e.g. for Bulgaria in 2005-2006).

The transition theories are exaggerated models of the economic development and operation of every country since the variables considered are the same in all macroeconomic analyses. The extreme effects observed in countries that are faced with the disability of all sectors of the economy, reveal the roots of the lesser effects of the policies regarding the same variables in less troubled economies. Theorists through close observation of the experiences of many countries have set up the guidelines for the transition economies. The results are valuable not only for countries in transition, but also for other countries, developed or not, in the application of any reform strategies.[97] Despite "... *the similarity of ultimate objectives and basic direction of changes required, countries' actual transition experience has differed enormously, with respect to both policies implemented and results achieved to date. The reasons for the differences include the country's initial conditions, the external environment (notably external shocks), and the specific policies pursued during the transition.*" [98]

1.15 ENDNOTES

[1] After the denomination, the new banknotes in circulation on the 5th July, 1999 are: 1 lev, 2 levs, 5 levs, 10 levs, 20 levs, 50 levs and the coins: 1 stotinka, 2 stotinkas, 5 stotinkas, 10 stotinkas, 20 stotinkas, 50 stotinkas. The old banknotes and coins will remain in circulation until 31 December 1999.

[2] **WYZAN L. MICHAEL,** "Bulgaria: A Country Study" in *East-Central European Economies in Transition,* edited by John P.Hardt and R.Kaufman, New York, 1995, pp.531-551.

[3] **BELL, D. JOHN,** "'Postcommunist' Bulgaria", in *Politics, power and the struggle for democracy in South-East Europe,* edited by Karen Dawisha and Bruce Parrott, 1997, Cambridge University Press, UK, Chapter 9, p.355.

[4] Membership in the Front was about 4.4 million in the late 1980s; the Communist party at that time had some 930,000 members. The other political party that functioned in Bulgaria during communist rule was the Bulgarian National Agrarian Union (BANU). The Fatherland Front (FF) had first formed in 1941, but had made little progress because few parties were willing to co-operate with the communists. In the summer of 1942, a second FF emerged, consisting again of communists and the left agrarians under Nikola Petkov.

[5] **CRAMPTON, R. J.**, 1997, A *Concise History of Bulgaria*, Cambridge University Press, p.194, UK.

[6] Todor Zhivkov, Bulgarian Communist leader, born in Pravets. Trained as a printer, he joined the Young Communist League in 1928 and the Bulgarian Communist party in 1932. Zhivkov fought in the Resistance against the Nazis during World War II and was afterwards elected to the National Assembly. A loyal Stalinist, he became a full member of the party's Central Committee in 1948, a member of its Politburo in 1951, and its first secretary in 1954. In 1962 Zhivkov assumed the Prime Minister's office, and by 1971 he was the titular head of state, thus holding the highest positions in both the state and the party. Re-elected party chief in 1981 and again in 1986, Zhivkov was ousted in a coup in November 1989 and expelled from the party a month later. Convicted in September 1992 of corruption in office, he drew a seven-year prison sentence.

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[9] Council for Mutual Economic Assistance (COMECON or CMEA), former intergovernmental body established in Moscow in January 1949 to assist and co-ordinate the economic development of its members. The original members were Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the Soviet Union.

Albania, admitted in February 1949, was expelled in 1961. East Germany joined in 1950, the Republic of Mongolia in 1962, Cuba in 1972, and Vietnam in 1978. In 1964 Yugoslavia became a partial member; other countries, including Angola and Ethiopia, held observer status. In 1973, Finland was the first non-communist country to sign a co-operation agreement with COMECON. In 1975, similar agreements were signed with Iraq and Mexico.

[10] According to **NEUBURGER MARY,** 1997, "Bulgaro-Turkish Encounters and the Re-Imaging of the Bulgarian Nation (1878-1995)", *East European Quarterly,* XXXI, No.1, March, p.5, there were 140,000 Turks that moved across Bulgarian Southern border into Turkish territory, and according to **SNAVELY KEITH** and **LENA CHAKAROVA,** 1997, "Confronting Ethnic Issues: the Role of Nonprofit Organisations in Bulgaria", *East European Quarterly,* XXXI, No.3, September, p. 312, there were 150,000 Turks.

[11] **CRAMPTON, R. J.,** 1997, A *Concise History of Bulgaria,* Cambridge University Press, p.195, UK.

[12] **NEUBURGER MARY,** 1997, "Bulgaro-Turkish Encounters and the Re-Imaging of the Bulgarian Nation (1878-1995)", *East European Quarterly,* XXXI, No.1, March, p.6

[13] **CRAMPTON, R. J.,** 1997, A *Concise History of Bulgaria,* Cambridge University Press, p.203, UK.

[14] 344,000 according to **CRAMPTON** (1997), over 300,000 according to **SNAVELY KEITH** and **LENA CHAKAROVA,** 1997, "Confronting Ethnic Issues: the Role of Nonprofit Organisations in Bulgaria", *East European Quarterly,* XXXI, No.3, September, p. 312, about one half of Bulgaria's 900,000 Turks according to **NEUBURGER MARY,** 1997, "Bulgaro-Turkish Encounters and the Re-Imaging of the Bulgarian Nation (1878-1995)", *East European Quarterly,* XXXI, No.1, March, p.6., and 300,000 mentioned by **BELL** (1997).

[15] **NEUBURGER MARY,** 1997, "Bulgaro-Turkish Encounters and the Re-Imaging of the Bulgarian Nation (1878-1995)", *East European Quarterly,* XXXI, No.1, March, p.7.

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[17] **STEN BERGLUND** and **JAN AKE DELLENBRANT,** 1994, "Prospects for the New Democracies in Eastern Europe", *The new democracies in Eastern Europe,* in Sten Berglund (ed), Chapter 10, 241.

[18] **EBRD,** 1997, *Transition Report,* Chapter III, "Transition: the Challenge of the coming years, UK, pp.2-9.

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[56] **BRISTOW, A.,** 1996, *The Bulgarian Economy in Transition,* Chapter 6, p.132, Edward Elgar Publishing Limited, UK.
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[59] Refinancing of commercial banks through Lombard loans extended by the BNB against collateral of treasury bills, gold or foreign exchange, began in October 1991. During 1996, Lombard loans were extended to eight commercial banks with temporary liquidity deficiencies, as well as banks with acute liquidity deficiencies. On 23 September 1996, the BNB placed some of these banks under conservator-ship. In 1997, the bulk of Lombard Loans disbursed was repaid, including a portion of those classified as overdue.
[60] The BNB had to abandon credit ceilings as an instrument for monetary control at the end of June 1994. The failure of credit ceilings was in the fact that is an efficient instrument to control money supply only if commercial loans were the only possible alternative solution for borrowing / lending money. In Bulgaria, such as alternatives were the governmental securities and thus, for the banks was possible to reallocate their credit portfolio. Another shortcoming for the credit ceilings was the penalty fee. Dobrinsky (1994) has argued that "*banks may decide to deliberately violate the credit ceilings in cases where they have a chance to allocate resources in projects which (due to high enough efficiency) may enable them to offset the negative*

impact of the penalty." [**DOBRINSKY, R.**, "Reform of the financial system in Bulgaria", Chapter 14, p. 329, 1994, Bonin (eds. 1994).]

[61] Refinancing of commercial banks through discount operations began in October 1991, when the BNB initiated its discount policy. At the end of 1996, outstanding discount loans totalled 389 million BGL, with the whole amount classified as overdue. Since 1997, the central bank did not extend discount loans.

[62] By a resolution of BNB Board in July 1992 and in connection with the introduction of gross settlement at the BNB, commercial banks were permitted overdrafts up to the amount of their minimum required reserves held with the BNB. Later the ceiling on the overdraft facility was lowered to 50% of the minimum reserves

[63] In early 1993, the BNB started open market operations with commercial banks. These transactions are made mainly in treasury bills. In 1993, the existing variety of monetary policy instruments increased because of the new open market of government securities. This instrument allows more precise adjustment of monetary policy. This also promoted the process of replacing direct methods for regulation of liquidity in the banking system with indirect methods. As an element of adjustment to the introduction of a currency board, repo-operations with terms of over two working days were gradually reduced and from 13 June 1997 entirely discontinued.

[64] The BNB adopted and started applying the system of auctions for short-term deposits with commercial banks on 15 September 1991. Since then auctions have been held twice a month. The BNB Board set the interest rate for this type of refinancing at several percentage points above the interest rate attained at the latest deposit auction. After the discontinuation of deposit auctions in the middle of 1994 this interest was set at 7 percentage points above the base interest rate for the respective period.

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CHAPTER TWO

2 Literature review on the FDI Theories

The dynamics of the world economy and global competition patterns are encouraging multinational enterprises to expand into emerging economies. Due to the political and economic changes in the Central and Eastern Europe, the unexplored and undeveloped markets opened up for western companies. Many MNE's felt the need to move quickly and grasp the potential opportunities there. The addition of approximately 430 million people to the countries operating under Western economy principles, following the political upheaval in the region in 1989, has been an important factor in this development. All these countries are being in stage of transition from centrally – planned economies to market – driven economies. For this reason, and especially in the Balkan region there is lack of economic and political stability. Taking into consideration the economic and political environment of the Central and Eastern Europe, the important question arises for many potential entrants to the new emerging markets: What are the major reasons to enter and which is the most convenient entry mode for the western investors into CEE? (for more discussion see endnotes)[1]

Firstly, consumers in CEE had no access to many consumer goods that have been readily available in countries at similar levels of per capita income elsewhere. This created a catch-up demand that unleashed immediately after trade liberalization. Dominated firms may see the new markets as an opportunity to gain competitive advantages, while global leaders wish to prevent such challenges and the emergence of new competitors from within the region. Multinational enterprises established in both Western and Eastern Europe may have superior opportunities to exploit price discrimination, product differentiation or vertical integration. Moreover, for many companies the presence in the region may be necessary for global competitiveness.

The key issue to address is how to prepare successful international strategy in such an environment that is characterized for countries in transition. The environment of Eastern European countries is characterized as an unstable, uncertain and risky. Consequently it is impossible to prepare accurate business forecasts in the fast changing and uncertain economic, political and legal environment. The common problems that the investing company has to cope with are the overall state of economy, unclear government priorities, lack of necessary legislation, inexperienced bureaucracies, different culture and business practices, underdeveloped court systems, inexperienced agents in business negotiations, bribery and corruption. The level of technical skills is not matched by managerial skills, nor

entrepreneurial culture and willingness to take business risks. Further costs arise from weak infrastructures, outdated capital stock, social costs, and the regulatory environment. Although rapid improvements are being reported for these criteria, it may still be difficult to find a local partner with the necessary business skills.

Investors who seek to enter these markets find necessary to engage in some a priory marketing research, but the problem is to find reliable data to base a decision on. Moreover, the institutional framework does not provide the efficient protection of intellectual property rights. Consequently, to do a business in an environment that does not provide legal protection of any kind of property represents enormous difficulties and potential risks. Even though, there are plenty of obstacles that can make entry to the Central and Eastern Europe difficult, for many western companies it still represents a great opportunity to establish an FDI project.

The choice of market entry strategy is the crucial part of international business strategy. Companies have special modes to cope with international markets that differ in the control that the entrant attains over the local operations and the resources that are required for the entry. Firms entering a foreign market can choose among an array of possible organizational modes, including exports, contractual modes of coordination and equity investment as joint- or wholly-owned venture (FDI, privatisation, merger & acquisitions, strategic alliances, joint ventures etc.).

This thesis examines foreign direct investment practices and determination on FDI in the Bulgarian transition economy; thus, an overlook on the theories on FDI provides several key elements, which are considered when studying FDI.

- The relationship between the firm size and the market size: the comparison clarifies the velocity and direction of small and medium size firms.
- The internal and external constraints that influence growth patterns: the internal constraints (within the company) may be shortages of capital, managerial skill, information etc. and the external may be government constraints, market constraints etc.
- The internal and external opportunities, which provide reasons or incentives for FDI.
- The internal and external disadvantages that may be corrected with FDI.
- The role of risk and uncertainty

2.1 Internalization Theorists: General Theory or another specific theory

Dunning (1973[2], 1981[3]) was the first to provide a more comprehensive analysis based on ownership, location, and the advantages of internalization. Dunning's eclectic theory provides some answers about the geographic distribution of FDI by analyzing location factors. His taxonomy of location factors emphasizes possession of raw materials, labor costs, government incentives, and servicing of local markets. Dunning's model has been criticized for being tautological: it provides taxonomy for a wide variety of variables that may be important. But the taxonomy does not provide theoretical justification of why certain location factors are important.

2.1.1 The Eclectic Approach (OLI 1976)

The OLI theory aims in explaining the multinational operations of firms, their level of success and the pattern through which they emerge. FDI is determined by the special regional characteristics of the home and the host country, the range and type of the products of the activity or the industry that the firm belongs and the strategy of the management, organization and structure the firm wishes to achieve with the investment. According to Dunning (1981,1988,1991), the level of FDI of a firm is governed by three sets of factors, namely ownership (firm-specific) advantages (O), location (country-specific) advantages (L) and internalisation advantages (I). The advantages discussed are different in separate countries, industries, and firms and in different time periods. The optimal use of these advantages may lead a firm to FDI.

Dunning's main contribution to the theories of FDI is that he draws on several important approaches to set up his own "general" paradigm. This is the major reason why his theory is called eclectic.

According to the normal meaning of the terms, while such factors as know-how, management and marketing skills and national product functions are advantages owned by a firm or a country (ownership and location advantages), the advantage of internalisation in itself is not. This is because internalisation of a market refers to the replacement of an arm's-length contractual relationship (i.e. the external market) with unified ownership (i.e. the internal market); it is a firm's strategic choice: whether to export its goods which embody the ownership-specific advantages, to set up foreign subsidiaries, or to license the use of such intangible assets. Though internalisation can bring advantages, it is hard to say that these are advantages intrinsic to the nature of the firm.

2.1.2 The Investment Development Path (IDP) (1979)

The IDP refers to a specific country in relation to the others, in regard to the elements presented in the OLI model. The country incorporates its locational advantages, the firm specific advantages of the local firms, and the extent to which local and foreign firms chose to exploit the L advantages in relation to their O advantages through internalization of different markets. The level and specifications of all the factors are observed through time and in relation with the factors of the other countries. The main point of the IDP is that the level of inward and outward FDI may be determined by the level of the above factors. The country passes through different stages depending on the level of all the factors so in each stage there is a predicted level of inward and outward FDI.

The IDP is a dynamic model describing the amount of inward and outward FDI in a country, considering the development of its OLI configurations in relation with the spillovers of FDI and analyzing their effects on additional investment activity.[4]

2.1.3 RUGMAN

Rugman has developed a general theory that studies the FDI activities of the MNEs regarding the concept of internalization as the link between the various theories explaining the motives for FDI[5]. Based on the market imperfections theory by Coase, and several early theories about internalization by Coase (1937), Hymer (1976), Buckley-Casson (1976), Dunning (1977) and others, Rugman incorporated many FDI theories in one general theory of internalization. The first step towards accepting the absence of free trade was realizing the imperfections in all markets (good and factor markets, capital markets etc.), which made arm's length transactions a utopia. Some market imperfections are the different trade barriers, the asymmetry of information and technology, the transactions costs (real and nominal), and other factors that emerge in the market by the fact that trade activities do not only aim in smooth and efficient trade but also in making profits for governments and individuals. Those market imperfections suggest that there is not really free trade; instead the transactions are effected by external factors as well as the maximum benefit of the parties involved. What Rugman, and previous writers, suggest is that companies turn to internalization in order to bypass these imperfections and achieve maximum efficiency and profits in their operations. When internalization is conducted out of the national borders then an MNE is created.

The **general theory of internalization** suggests that MNEs internalize in order to either avoid

or exploit the different international market imperfections by developing an internal market. The internal market is dominated by the benefit of the company itself, it distributes the firm-specific assets such as knowledge in a way that maximizes efficiency, and it reduces the market imperfections and the cost that would arise if the same transaction took place in an external market.

According to Rugman if "... *the world were characterized by a model of free trade, there would be no need for the MNE.*"[Rugman 1980, p366][6] The theory of FDI up to 1980 (the time of the Rugman theory) suggested that MNEs arise from imperfections in goods and factor markets and turn the county-specific advantages (that lead to trade) to firm-specific (that lead to FDI). Internalization is dictated by the recognition of market imperfections and the fact that they prevent the efficient operation of international trade. Rugman has mentioned that "*internalisation is a refinement of the market imperfections approach and that it explains why the MNE has a firm specific rather than a country specific advantage*"[7]

2.1.4 Parry (1985)

Rugman has received criticism by Parry (1985)[8] for not establishing the internalization theory as 'general' since it cannot explain all aspects of FDI by MNEs. Parry suggests that internalization theory may explain only some kinds of FDI, namely vertical integration, transfer pricing and quality control of inputs. Vertical integration is generated by the need to control the raw material production and/or the final good distribution, terminating long-term, not profitable and not efficient contracts. Transfer pricing responds to tax regulations or other related imperfections and can reduce the global taxation of the firm, and since it can only take place among subsidiaries of the same firm it leads to FDI. The MNE may also answer to the lack of reliable providers of input or distributors of the final products, and in order to control quality in foreign countries it undertakes FDI. Parry argues that these are the only ways that the benefits of internalization can help avoid market imperfections.

Rugman responds to the criticism by stressing the fact that his theory does not actually reject the conclusions of Parry, but in comparing and combining various explanations of FDI the theory comes to the conclusion that all motives or incentives for FDI are rooted in various market imperfections and the firm overcomes or exploits them by using internal markets economy, thus efficiently allocating the firm specific advantages. The locational advantages are second in consideration and are determined in relation to the firm specific advantages.

There have been many elements of the market that have been considered imperfections, all of

which are used as incentives for FDI in other theories and the suggested 'cures' exploit the benefits of internalization. "The process of internalization explains most (and probably all) of the reasons for FDI. Previous writers in the literature on the motives for FDI have tented to identify one or more of the imperfections in factor or product markets, or have noticed a response by the MNE to government induced types of market imperfections such as tariffs, taxes, and capital controls[9]. All of these types of market imperfections serve to stimulate one short of MNE or another. The MNE is in the business of internalizing externalities. It is now time to recognize that internalization is a general theory of FDI and a unifying paradigm for the theory of the MNE."[10]

2.1.5 Buckley-Casson

Buckley and Casson have discussed the internalization process as a response to market imperfections, but in a somewhat smaller scale than Rugman. According to them *"the MNE* ...[is]... *a special case of a multiplant firm, bringing under common ownership and control several interdependent activities linked by flows of intermediate products."*[1991, p36][11] The answer to why the firms chose to internalize independent activities lay in the market imperfection, because there is no reason in replacing a perfect market with a centrally planed market. The MNEs create a 'perfect' internal market in order to avoid the market imperfections. The authors give five kinds of imperfections (without rejecting the possibility of the existence of others). They explain the reasons for internalization and the growing (at that time) trend of MNEs by listing the benefits in internalization.

1. Increased control and planning of production, because of better coordination of flows of crucial inputs.
2. Generation of market power by discriminatory pricing.
3. Decreasing effect of other firm's market power.
4. Secure transfer of valuable knowledge and/or technology.
5. Reduction of governmental intervention (through for example transfer pricing).[12]

In later articles (mainly 1988-1996) the two theorists added several other variables in the internalization theory.

- The **management decision making**, has a significant influence in all company actions. The same external environment may lead managers of different mentalities of different firms to different decisions.
- The **cultural influence** in management decisions is acknowledged and the parameters are examined both by economic concepts and anthropological or organizational

behavior theories. The "... *development of an entrepreneurial culture and geographical factors which confer entrepôt potential as an initial locational endowment may go some way to explaining the pattern of differential growth an ownership in the world economy.*"[13]

- The **cultural differences and the physical distance** between the home country and the host country(s), which are of course interrelated may cause difficulties in terms of language or mentality of doing business (cultural shock), if it is a first time experience. Cultural differences may be observed in different regions of the same nation, but on international they are usually more sever. A different view is presented by Morosini, Shane and Singh (1998). They argue that cultural distance may prove beneficial for the performance of the investing company, since it provides an insight of different methods that may be useful to the company, and draws the attention of the locals to the different culture they present[14]. Anyway the cultural differences can be overcome by an organized MNE but they may greatly affect a new company.
- **Multinationality** is a great asset for a company, since MNEs have easier and cheaper access to information and technology and they can distribute them to the subsidiaries in minimum cost.
- **Innovation and arbitrage (Casson 1985 p.175)** are two special cases of entrepreneurial activity. The entrepreneur *"must take important decisions that are difficult to make"* [p.171-172]. The entrepreneur may be the owner of a firm or a manager hired by the owners. Any wrong decision, any mistake will be very costly for the firm. Successful entrepreneurship requires to synthesize different kinds of information from different sources. Innovation must be useful in order to synthesize the technology, the inputs, the demand price and the law and institutions governing transactions in the markets. An arbitrager must combine information about technology, price differentials and laws and institutions governing transactions in the markets. "*Arbitrage consists of buying 'cheap' in one segment of a market and selling 'dear' in another. Arbitrage is the fundamental economic mechanism by which price uniformity is achieved. The arbitrager sets up transactions in an attempt to appropriate the discrepancy between the lowest selling price and the highest buying price* [p.177 Casson 1985]... *Innovation and arbitrage are, to some extent, merely different facets of the same phenomenon: spill-overs from innovation by one entrepreneur change the environment of other entrepreneurs and thereby create arbitrage opportunities for them.*" [p.176 Casson 1985]

Those elements[15] cannot be measured, but they give a more complete view of the decision making process.

Buckley (1995) gave great significance to the role of the manager in the firm, justifiably so, since managers are the actual participants in decision-making. The manager coordinates all operations of the company, from communications to the operation of the different production lines, inputs and products, and from transaction costs to separation of functions such as financing in order to achieve the best result for the firm. An effective management may achieve economies of scale and economies of scope, which are primary goals of a MNE. The management role is also vital in reducing the transaction costs arising from multi-plant enterprises. The quality of management is far more important in a multinational company than in a local firm still, management "*...decision taking in*...[the context of limited information]... *is perforce plagued with errors ... and unintended consequences.*" [Buckley, p. 49][16]

2.1.6 Casson (1985)[17]

Casson has added the **entreprencurship** element in the internalisation theory. "*A manager is responsible for deciding upon and implementing the production plan, that is, for choosing technique, setting the scale of output and ensuring that each input is available in the right quantity at the right time and place*...[Manager] *is also responsible for choosing institutional arrangements and thereby determining the boundaries of the firm. The essence of the manager's role is not ownership but negotiation and control.* [p.173].

Casson (1990) has suggested that the theory of FDI is a "logical intersection" of three distinct theories: the theory of international capital markets, which explains the financing and risk-sharing arrangements; the theory of the firm, which describes the location of headquarters, management, and input utilization; and trade theory, which describes location of production and destination of sales. Although each theory provides some insight about the complexity of FDI flows, an integrated theory that combines these elements in an analytically persuasive way has not been developed.[18]

2.2 STRATEGIC THEORISTS

2.2.1 Michael Porter[3], Porter's Determinants[19]

Porter's theory has analyzed the reasons for the international competitive advantage of a country's products in exports. This theory is highly related with the capability of a country to attract FDI inflow. Porter has set four country specific determinants that are related mainly to a country's non-transferable advantages, and to the prevailing market environment (**Factor**

Conditions, Demand Conditions, Related and Supporting industries, and Firm strategy, structure and rivalry). Porter introduced two more determinants that are not directly related to the business environment, but have significant effects in its development (**Chance and Government).** The competitive advantage is determined by the interaction of all six determinants that, inevitably, affect one another. Porter has described the evolution of a non-competitive country to a competitive one, through the development of the four country specific determinants. Porter's research has assisted to the comprehension of behavioral patterns of MNE's regarding their choices in terms of location (country) of investment and specific sectors in these countries *"...that have been able to attract the participation of foreign-owned firms in some value-added activities but not in others."* [Dunning p137][20]

2.2.2 Bruce Kogut: sequential investment

Bruce Kogut separates the process of becoming an MNE, into the initial investment that is the company's first step into a foreign market, and the sequential investment that any other expansions through FDI in the same or other host market is. In general Kogut treats FDI as a sequential process that leads to the creation of MNEs. Kogut has successfully argued that although theories that explain the behavioral patterns of the expansion of MNEs may apply in some level in the decision process still multinational companies should be studied under the hypothesis that the advantages gained by being an MNE often become more important than the original reasons for FDI.[21] The learning and experience of managing diversified activities in different locations and the spreading of environmental risk gives the company a significant edge when competing in either local or international markets. By effectively running subsidiaries in dispersed locations the company manages to improve the managerial structure increasing efficiency in intra-firm trade, but also with in every subsidiary. By spreading the environmental risk the company overcomes its dependence on one country gaining leverage in negotiations with governments and economic agents, either in the countries it operates in or in countries that it plans to invest. Also the international operations may facilitate the exploitation of financial and factor markets and provide opportunities to arbitrage cross-border information. In the case of multinationals Kogut has raised another issue. To what extent do MNEs take advantage of the international market imperfections? *"These imperfections, which are carefully considered in the studies on the political dilemmas posed by multinationals and on multinational planning and control, are curiously understated in the mainstream economic literature"* [Kogut 1983, p65][22]. Consequently the power derived from multinational operations, the expertise and flexibility gained by operating in different markets, constitutes another reason for FDI when it is undertaken by a already international company,

thus when the FDI is sequential.[23] Kogut's theory is applicable for capital-intensive primary products and high technology industries and a firm gain from common governance of geographical dispersed activities.

2.2.3 The corporate decision making approach (Aharoni's approach)[24]

Aharoni presented the FDI decisions, in small first- time-investor, companies as a managerial process that depend, among other things, on the discretion of the managers and on the pursue of their personal goals. The other parameters he presented are the "*cost of information, the limited decision horizon of the managers, conflicts within the firm and uncertainty*". He presented the five-stage of a common FDI decision process. (1) The company needs a 'strong initiating force' in order to consider FDI. A single opportunity is not enough, but it, usually, should be followed by either specific interest from within the company, or by a strong statement of support or recommendation by an influential party like a client, a supplier or a government agency. (2) The 'investigation process' is a sequential, biased process and if at any point the results are negative the project is abandoned. Since it is not an overlook of the opportunity and does not examines the environment as a hole, the sequence of the search is important: (a) establish the degree of risk by examining general indicators (b) on the spot indicators (c) presentation of the report. This process is followed by the building of commitments within the firm among managers. (3) The 'decision to invest' is finally taken. (4) This is the stage of the 'reviews and negotiations' where there are attempts to reduce uncertainty, and the powerful groups within the firm impose their wishes. (5) The last stage is the 'changes through repetition'. In this stage the firm tries to improve control over the subsidiary by an international division. This time, the risk and the uncertainty seems less frightening to the managers and they are intrigued to develop the company into an international one.

2.3 FDI as a Transfer of Technology

2.3.1 Transfer of technology-knowledge as a monopolistic asset

Apart of the money-capital, the foreign investor also transfers in the host country knowledge and technology. The most significant 'holder' of intangible assets such as knowledge, technology, and managerial and marketing skills are the MNEs. The fact that MNEs can utilize R&D outcomes in more than one market (so the expense is justified) and that they hold technological knowledge and assets, leads to the development of new products and processes. MNEs again through their access to technology, have the ability to differentiate their products

either in order to stand out from similar products or to fit specific regional needs. The ability to detect the need for differentiation, and the kind of changes needed reflects the general marketing skill of the MNEs that also provides the company with sophisticated advertisement and promotion activities that secure the customers loyalty. Behind all functions of an MNE lays the managerial skills and techniques developed through experience as well as the need for efficient coordination and control. All these qualities are more important than the money-capital transferred, because, in a long-term perspective, they can be absorbed and utilized by the domestic firms. They are also one of the reasons MNEs prefer to invest themselves rather than rent their know-how through licensing[25].

2.3.2 H. J. Johnson

H. J. Johnson indicates that MNEs treat knowledge and technology as a 'public good' the public being the subsidiaries. This means that the cost of the R&D process is undertaken entirely by the domestic/central firm while all subsidiaries enjoy the results (new products, efficient production, new managerial techniques etc.). The *"...marginal cost of exploiting* [the knowledge and technology derived from R&D]... *abroad through direct investment is practically nil for the firm that owns* [it]." [Ragazzi 1973, p484][26] The knowledge should be easily transferred among the subsidiaries but should no be easily copied by the competition. Johnson also suggested that the output of the knowledge (like differentiation) is not easily separated from other qualities of the firm (like marketing skills). The MNE promote direct investment over licensing when there are no potential buyers or when the return from FDI is higher than from licensing.[27]

In the same subject **Kindleberger** argued that a significant part of the decision to undertake FDI is based on the advantage of knowledge and high economies of scale, that enable the MNE to operate the subsidiary more efficiently and with less cost that any local firm. The company before undertaking FDI is analyzing all the alternatives (exports, licensing, FDI) and decides on the optimal solution[28].

2.3.3 D. J. Teece

Teece was concerned with the cost and the effects of the transfer of technology in the host country and in the growth of world economy in general; his conclusions will be examined in terms of MNEs and FDI. The cost of the transfer depends on the nature of the company and the technology it uses, the level of technological advancement of the host country (particularly the labor and the infrastructure). The cost of the initial transfer is much higher

than any activities to renew the technology; still in industries with high rate of technological growth it is difficult to maintain the technology level up to date if the location is separated from the source of the developments. The cost of the transfer is higher when the technology is transferred to centrally planned economies, possibly due to high documentation requirements, or differences in language and managerial skills. Nevertheless the smooth flow of information and knowledge is very important to the growth of disadvantaged countries, and the world economy in general. [29]

2.4 INDUSTRIAL ORGANIZATION APPROACH; market imperfections approach

2.4.1 Definition of Market imperfections

The root of market imperfections is in the various theories of free trade, and the assumptions that theorists (like H/O or Ricardo) have taken in order to develop them. The "free trade" is a frictionless model of the real market environment assuming equal and immediate distribution of information, technology and knowledge, no costs other than production cost (no transportation costs, no tariffs, no legal costs etc.), equal tastes of all consumers, equal production functions, no government intervention, no equity differences, no time-lags in the transactions, trust and honesty among the transacting parties, strict cost-based pricing of the products and other utopist rules for trade. Latter theorists like Coase, MacManus, Hymer and others studied the imperfections of the 'free trade' model, realizing that those imperfections of the market is actually the essence of the market and should no be left out of the study of the market. Of course, not all variables can be incorporated in econometric models but the empirical study of statistics can plainly explain their effects in different theories.

According to the reversion of the 'free trade model' any market factor that gives advantage to 'carriers' of trade, differentiating them in any way is based on a market imperfection. So by reversing the assumptions of 'free trade' one may develop the following kinds of market imperfections.

- Imperfections related to the biased distribution of information, technology, and knowledge (managerial superiority, knowledge of the nature or value of the product)
- Transaction costs (transportation costs, legal costs)
- Time lags in transactions
- Trade barriers (tariffs, quotas, quality specifications)
- Imperfections related to consumer preferences (cultural and social differences,

marketing effects)

- Production function imperfections (differences in nominal supply scarcities, elasticity of demand, overpricing)
- Governmental interventions (associated with trade barriers, subsidies, political gains)

Basically, most of the market transactions are biased, and fall under some imperfections. The key to exploiting or 'curing' these imperfections for the benefit of a company is to properly evaluate and compare the importance of the imperfections affecting it in different situations.

2.4.2 Hymer's theory on FDI

One of the basic contributions on FDI theory was that of Stephen H. Hymer. In his Ph.D. thesis written in 1960, and also in an article written in 1968 he outlined a newly appeared perception of FDI, based on ideas of Joe Bain (1956) and Ronald H. Coase (1937). His arguments have been discussed extensively through the years, and although they were doubted, they were the incentive for several economists to expand the theory of FDI, a fact the led to the creation of a new field of international business studies.

According to Dunning [1993, p69][30] *"... Hymer's[31] work is best known for its application of an industrial organizational approach to the theory of foreign production."* In order for a firm to undertake an FDI project, it relies on certain advantages, which may be called monopolistic, exclusive or ownership advantages, such as monopoly control of raw materials, financial or marketing advantages, managerial and research skills etc. He argued that FDI involvement was merely a geographic expansion that exploited the power coming from the use of the above advantages. He also mentioned, in his article in 1968[32], that [Casson, 1990 p17][33] *" the expansion of a business is more difficult beyond national boundaries than inside one country. The firm has to enter a new environment where information is scarce and communication is difficult."* [Dunning 1993, p.69.][34] *"The emphasis placed by Hymer on the organization of economic activity by MNEs as a means of advancing monopoly power, rather than of reducing costs, improving product quality or fostering innovations, also led him to consider the alternatives between FDI and other forms of international involvement in normative terms, rather than by a reasoned analysis of the costs and benefits of these options."*

Hymer mentioned that there is a significant difference in the portfolio theory for the capital transfer (indirect portfolio investment) and FDI (direct investment). He based his argument

on the following reasons:

1- Neoclassical portfolio theory referred to the financial capital market, which it considered a perfect competition market with no transaction costs. Based on the arbitrage theory the moves of capital are caused by the changes of interest rates in order to generate profit.

Hymer pointed out that the MNE is a creature of market imperfections, overemphasized the market power advantages of a MNE and mentioned that a MNE transferred its assets abroad in order to minimize risks and to achieve monopolistic power. The whole work (1960) of Hymer is based upon structural market imperfections (knowledge of the market, distribution networks, product diversification etc), which are Bain-type advantages, but he failed to mention the transaction cost market imperfections that are Coase/Williamson-type advantages. In the present time it is accepted that market imperfections should be taken into account even for portfolio investment. Lack of information for an acquisition of shares from a company that participates in the host stock market exchange or a depreciation of the local currency, has as a result the return of the investment to be lower than expected. Thus, the risk is more or less the same either for portfolio investment or for FDI taking into account the above market imperfections. Still Hymer was the first to separate portfolio from FDI. [Dunning 1985, p228][35] " ... *capital is assumed to be transacted between indented buyers and sellers, that is, no role for the MNE.... The pioneering conceptual insight of Hymer was to brake out of the arid mold of international trade and investment theory and focus attention upon the MNE per se.... The unique feature of FDI is a mechanism by which the MNE maintains control over productive activities outside its national boundaries, that is, FDI means international production.... Hymer's great insight was in focusing attention upon the MNE as the institution for international production, rather than international exchange."*

According to Rugman [1982, p13][36] "*the first application of the market imperfections approach in an international context was by Hymer in his 1960 dissertation...*"[37].

2- While portfolio investment concerns movements of financial capital alone, FDI involves transferring of other resources as well such as technology, managerial skills. [Dunning, 1993, p69][38] *"Firms are motivated to produce abroad by the expectation of earning an economical rent on the totality of their recourses, ..."*

3- [Dunning, 1993, p69][39] *"... FDI ... involved no change in the ownership of resources or rights transferred, whereas indirect investment, which was transacted through the market, did necessitate a transfer in ownership."*

As it has been mentioned, the widely accepted definition of FDI is the following: FDI "*...is defined as investment in equity to ... have a significant degree of influence ... or have a lasting interest...or influence management operations of an enterprise in a country other than the investor's home country* ".[40] The definition of FDI is refereed continuously to control and influence the management of a firm, and this is actually the fundamental difference between FDI and portfolio investment. In portfolio investment the investor has no intent to gain any control over the company, while in FDI control and influence are the main targets.

Although (according to Hymer) portfolio investment is caused by interest rates differentials these may also affect an FDI project because the investment might be financed from the host country. Moreover, exchange rate fluctuations, lack of information and other market imperfections affect both types of investment (direct and indirect). In other words, market imperfections should be taken into account even for portfolio investment. Lack of information for an acquisition of shares from a company that participates in the host stock market exchange or a depreciation of the local currency, has as a result the return of the investment to be lower than expected. Thus, the risk is more or less the same either for portfolio investment or for FDI taking into account the above market imperfections.

As for Hymer's third argument, it is not considered valid in today's market since any investment on a foreign company that exceeds 25% or even 10% of it, is considered FDI. Thus, a foreign involvement without having the majority of the shares of a company, or even with a percentage between 11% and 49% is considered FDI and simultaneously has a transfer in ownership. There is a requirement the investment to have a lasting interest in participation in the control of the firm. Nowadays, it is also accepted that there are new kinds of ownership, too complex. Thus, a company that has a great spread of shares and the major shareholder own a percentage of less than 50% having or not the management of the firm, it is considered to be the owner of the firm, without having a transfer of ownership. On the other hand, it is possible a shareholder to posses a significant percentage, even more than 50% of the total shares of a company and it is impossible to manage the firm as an owner and thus, their investment have a transfer of ownership.

According to Casson [1990, ch1, p. 2][41] "*Hymer places much more weight that have subsequent writers on capital imperfections. According to Hymer, these imperfections explain why shareholders prefer to diversify risks through holding shares in diversified forms.*" His contribution focused greatly on market imperfections such as volatile exchange

rates, risk and uncertainty and cost of acquiring information and making transactions. This analysis was an extension of Joe Bain's classic theory of 1956.

John Cantwell [1991, p20][42] argued that in Hymer's approach *"... economically advanced countries, owing to their relative abundance of capital but scarcity of labor, have low rates of profit or interest but high wage rates prior to international transactions. They, therefore, tend to export goods requiring capital-intensive production methods to less advanced labor-abundant countries; or, as a partial substitute for this, to export capital direct through FDI in developing countries. Capital thereby flows from countries in which the interest rate is low (owing to the abundance of capital) to those in which it is high (owing to capital scarcity)."*

In his 1968 article, Hymer extended his ideas regarding FDI theory but he [Dunning 1993, p70][43] *"... drew very heavily on the ideas of Coase (1937), whose work he did not acknowledge in his thesis."* [Casson 1990, p.1][44] *"This paper* (1968) *is important because it shows that Hymer developed a Coasian theory of the MNE. ... His theory embraces both horizontal and vertical integration..."* [45]

Hymer supported in his theory that instead of separating internalization and market structure, as other writers such as Cantwell suggested, one should consider the interaction between them. The entrance of a new firm in an industry through internalization it is bound to affect the concentration of the market and hence the market structure. On the other hand the market structure affects the internalization process by displaying the business opportunities. The concentration of the market determines if the firm will profit by expanding horizontally, or if it should seek solutions in expanding through activity diversification. If the market structure, in an industry concerning a stage of production in a multi-stage production process, is a form of imperfect competition, it implies price distortions and can be exploited by moving vertically rather than horizontally in an internalization process. [Hymer, 1968, p18][46] *"If markets were perfect and the firm could buy everything at a fixed price determined by competition, then the incentive for direct investment would be very weak."* Other market imperfections may also be exploited through vertical integration.

In Hymer's 1968 article there was also a presentation of several other reasons for FDI.

- Eliminate international transport costs
- Protection of the firm from a foreign producer
- Avoiding tariffs on imports

These factors were roughly discussed and not supported with arguments. He also presented a comparison between the two forms of foreign involvement, FDI and licensing, supporting FDI. He based his support on the fact that it is very difficult to predict the future profits of the investment and estimate the income generated by the foreign subsidiary, so it is safer to internalize than license the advantage of your company. Again the arguments are very few and one-sided, not taking in mind many other factors like for example the risk of failure (deficit) or the cooperation with local partners (joint venture).

Hymer argued in his thesis that the tariff may be considered as an instrument inducing FDI instead of exporting. However, he did not mention either the geographical and location advantages in the decision of undertaking and FDI project, or the costs and benefits of FDI or technology transfer and the impact of MNEs in the host countries. Furthermore, Hymer was the first to indirectly correlate the idea of international diversification with the participation of individual investors in MNEs. He mentioned that the profits may differ between countries, and that there is greater stability in individual profits if a portfolio diversification exists. Dunning et al [1985, p. 231]47 has argued that Hymer's contribution at this point is important because he was the first to present a role for MNEs that appeared later in the modern theory of finance. Dunning has also pointed out that Hymer considered more or less a MNE as an indirect vehicle of the individual investment, in the sense that through international diversification with the help of an MNE, individuals avoid transaction costs which they would have to face if they will undertake such diversification alone.

Hymer has also mentioned in his article in 1968 elements that it can be found most of them in Coase (1937) work such as management costs and techniques, transaction costs, transport costs, financial costs, coordination costs, organization costs and entrepreneurship, adopting new technology and innovation, scale of economies, horizontal and vertical integration, uncertainty, lack of information, price determination, control of quality, financial market imperfections, risk diversification through vertical integration, geographical proximity, taxation, tariffs, licensing vs. FDI and differentiation of the product as a reason for horizontal integration.

2.4.3 Richard Caves

Caves also examined in his 1983 article the behavior of MNEs towards the transfer of technology. He concluded that the MNEs prefer research-intensive sectors, and consciously allocate the R&D results to the subsidiaries while keeping the R&D base close to the mother

company for matters of control, and scale economies.[48]

After an extensive literature review in 1996, Caves agreed with the following theories

- The theory of international movements is relevant to FDI because direct investment involves some net transfers of capital
- If the demand curve faces a downward-sloping curve in both markets and the firm can achieve economies of scale then the production is concentrated in one location and exports are encouraged unless there are trade barriers that forbid exports. It may concentrate production in one sizable national market although production is more cost-efficient in a smaller market.
- MNEs make value-maximizing decisions on the location of the investment based on demand-side factors such as production and transportation costs, production differentiation, scale economies etc.
- Tariffs provide incentives for MNEs to invest rather than export
- When exchange rates are expected to be long-lived they affect FDI
- Capital flows can substitute trade where trade is restricted, so trade and FDI are alternatives for both the firm and the economy
- Sector-specific mobile factors tent to locate in the most cost-minimizing country creating this way an absolute rather than a comparative advantage in determining patterns of commodity trade.
- Despite the common tendency foreign direct investments have to flow from capital-rich countries to capital-poor countries, two-way FDI and the significance of the human resources of a country in attracting FDI reduces the predictive accuracy of the standard trade model.
- Countries with similar per capita income need more or less the same specifications in differentiated goods. Also the cultural closeness a common language make MNEs transaction costs fewer.
- The pure cost-efficiency factors prevails the FDI decisions only when the investment targets export-processing facilities[49].

Caves in a previous article (1974) with statistical analysis has found[50] that the intangible-asset variables (industry's advertising and research intensity) are significant determinants for Canadian and UK industries. Moreover, the "Multiplan economies factor (*...the organization of multiplant firms becomes a rational technique for minimizing costs* [p.280]" works well only for Canada due to geographical proximity of FDI outflows from USA. Finally, the statistical results are poor to support empirically the "entrepreneurial resources hypothesis"

(*... the MNC expands abroad in order to give full employment to the coordinating abilities of its fixed stock of entrepreneurial talent. This hypothesis seems to give content to the popular suggestion that the success of American multinational firms rests on the quality of American entrepreneurial talent... entrepreneurial resources are firm-specific... ")* [p. 280].

2.4.4 Kindleberger

Kindleberger believed that FDI is a product of market imperfections because for FDI "*to thrive there must be some imperfections in the markets for goods or factors including among the latter technology, or some interference in competition by government or by firms, which separates markets.*" [Hood 1979, pp47-48[51]] These imperfections either create problems to the firm (such as transaction costs or coordination problems with suppliers) leading to internalization of the firm's functions (vertical integration) or present profit generating opportunities that a company is tempted to exploit (exchange rate differentials, governmental decisions). Market imperfections are also the reason a company preserves its ownership advantage. In a perfect market, information and technology would be common, and so would be capital markets, consequently no firm would hold any ownership advantage.

2.5 TRANSACTION COST THEORISTS

2.5.1 Williamson, Hennart and Transaction Cost Theory

Williamson (1973) suggested that there are reasons of market failure that favor the internalization of a firm's operations in the place of market operation. It can be argued that these are also reasons for FDI. The same reasons stand for the transformation of a firm's internal structure from independent departments to a hierarchical structure. He creates a framework that leads to the advantages of the hierarchical organization instead of markets.

He mentioned two groups of factors such as the **human factors** that may affect transactions **(bounded rationality, opportunism and atmosphere).** The other category is the **transactional or environmental factors (uncertainty, small numbers of firms)**. These two groups of factor interact and produce **information impactedness.** The fact that information level is not equal among the agents of a market, thus there is **information impactedness** (one of the agents to a contract has deeper knowledge than does the other), may lead to the opportunistic use of information by one party that will cost the other party. Although, these factors are not transaction costs, Williamson mentioned a third group of factors, namely, the **contractual costs**, which may be considered as transaction costs. These are: information costs

(the cost of informing traders), bargaining costs (the costs of reducing – bargaining) and enforcement (the costs of enforcing the terms of trade) costs.

"Transaction costs would be zero if humans were honest and possessed unbounded intelligence."[52] Thus, Williamson' types of limitations exists in reality as transaction costs. Bounded rationality occurs since individuals are unable to absorb all available information in order to facilitate the decision-making. Thus, there is a cost in the acquisition and absorption of information. Moreover, opportunism is the incentive for individuals to act by self-interest in order to take opportunities to cheat if it is necessary and profitable for them. Thus, there is a problem when managers act for their self-interest with guile. Finally, he also mentioned in his book (1975)[53] the **asset specificity,** which refers to the fixed costs of an asset and the difficulty of arranging liquidation and recontracting. Thus, internalisation provides the opportunity of recontracting under the most favorable long-run circumstances.[54]

The above factors are the reasons why, according to Williamson, a company may internalize, through vertical integration and this may happen through FDI. [Williamson 1973][55] Williamson's contribution to FDI theory was also the introduction of the importance of managerial skills in the operation of a firm and the importance of internal organizational structure in the efficiency of a firm. In a later article Williamson (1992) examined, based on earlier studies by Coase, the value of transaction costs in the cost-efficient operation of a firm and how they work as incentives for internalization. This study, although of a microeconomic nature, constituted the base for many contemporary theories of FDI[56].

Little discussion of conglomerate integration has been made by the transaction-cost theorists, though Hennart analysed the existence of free-standing firms (**Hennart,** 1991) which have basic characteristics of conglomerates.

By definition, free-standing firms set up a head office in major capital exporting countries, but all their productive assets are located abroad. According to Hennart, these firms "arose to bypass international capital markets when loan transactions would have been subject to high transaction costs" (Hennart, 1991, p.94). However, capital is a very common and homogeneous intermediate good. Information on its value is readily available, and transaction costs of capital are not high. On the other hand, substitution of internal organisation for the capital market may be subject to distortions in capital allocation and diminishing returns in conglomerate firms. It seems that internalisation of the market for capital is not necessarily a better choice than market transactions.

2.5.2 Ronald H. Coase (1937)

The theory of R. Coase is discussing the cost of some types of market transactions and how internal organization of a firm may help in avoiding them. There are four types of costs that a management team may want to avoid if high enough

1. "the brokerage cost of finding a correct price"
2. "the cost of defining the obligations of parties in a contract"
3. "the risk of scheduling and related input costs"
4. "the taxes paid on exchange transactions in a market"

[Rugman, 1980, p369][57]

The minimization of those costs is an incentive for the firm to try an approach of vertical integration, so as to control the intermediate products. Vertical integration is efficient only if the costs mentioned above are very high, or if there is no market for the intermediate product, the firm needs for the final one.

Coase in the development process of this theory shared several of the thoughts, that became the base of his theory, with one of his collogues. He was investigating the fact *"...that economic integration is the result of the limitations of small-scale production – in essence it is the joining up of small-scale producers in different industries in order to get the advantages of large-scale production."* Coase considered integration as *"... 'the bringing together under one control of different functions.'"* In this statement he does not distinguish between horizontal and vertical expansion. In particular he argued that *"the distinction between vertical and horizontal integration was without value. 'What is important is that different functions are in fact brought together under one control, what stage they are in being of little account.'"* [Coase 1937, p40][58]

According to Rugman[59] this theory is "readily applicable to the MNE". The costs and inefficiencies of a transaction in the international market are certainly more than that of the domestic. The export costs (tariffs), transportation costs and others resulting from the distance between the producer and the final consumer are added. The multinational organizations are motivated to internalize in order to minimize those costs, only if a thorough examination of the facts indicates that the costs and risks of operating abroad are covered by the gain the firm has by eliminating the other costs.

Coase, through this analysis, was the first to recognize that the market is imperfect although he did not put it in these words. There are some points in his work that are based on market imperfections and refer to the benefits of creating a firm instead of an individual business.

These points may be seen as benefits of integration

- the cost of market transactions is reduced (the cost of using the price mechanism as one spreads the information cost, and the costs of negotiating and contractual cost are reduced as the firm incorporates more functions)

"*the main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism"[p.21].* It is quite difficult to have arm's length transaction, thus each partner that participates in a transaction is also burden of the extra cost of information (collecting information, choosing the fair price etc.).

"the costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must also be taken into account"[p21]. It is preferable to sign long-term contacts in order to avoid time and additional costs for preparing a new contract or renewal the old one.

"It seems improbable that a firm would emerge without the existence of uncertainty...[p22]. In a firm it is difficult profits and sales to be predicted.

"... the exchange transactions on a market and the same transactions organized within a firm are often treated differently by Governments or other bodies with regulatory powers" [p22] (sales tax, tax on market transactions etc.)

"It was suggested that the introduction of the firm was due primarily to the existence of marketing costs"[p23], which marketing costs have been characterized by Coase as *"...the costs of using the price mechanism"[p29]*

"*...as a firm gets larger, there may be decreasing returns to the entrepreneur function, that is, the costs of organizing additional transactions within the firm may rise*"[p23]. Thus, it is needed good management and improvement of management techniques [p25], which will lead according to Coase in minimizing of these costs. He also mentioned the importance of the technology [p25] and the "*...changes like the telephone and the telegraph which tend to reduce the cost of organizing spatially will tend to increase the size of the firm*"[p.25] He added that "*all changes which improve managerial technique will tend to increase the size of the firm*". He also pointed out the existence of organizational and management errors. Thus there are costs of making mistakes and [p.24] "...the less likely the entrepreneur is to make

mistakes and the smaller the increase in mistakes with an increase in the transactions organized"[p.24]

2.5.3 John C. McManus (1972)

MacManus has studied the parameters on FDI by collecting data on the connection of FDI to the tariff barriers, in Canada. He examined the effect of high tariffs in industries that provide the host country with intermediate products or raw material. He came to the conclusion that the increase in the tariffs (1) do not cause and increase in the bid for raw material for either foreign owned or locally owned firms, (2) do not increase the actual transaction cost between foreign and local firms, (3) do not necessarily increase the cost of transferring rights. It does affect, though, the way they will exchange commodity rights. It also makes it easier for companies that are subsidiaries of foreign suppliers to manipulate the transfer prices in order to avoid the extra tariff cost since they have common benefits. It is more difficult for to independent companies to do so because a situation like that implies a lot of trust between the two parties. In that way alone does the specific kind of industry a competitive advantage against the local firms. Nevertheless the statistical data from Canada do not support the assumption that this is a common occurrence.[60] Moreover, he mentioned the importance of availability of capital, technology, product differentiation, management, training and experience [p.37]. He also argued about the price mechanism and the costs of transacting [p.40], the costs of transferring a property right [p.41], the costs of transacting which are *"the costs that are incurred by the parties to a market exchange to enforce their exclusive rights to the assets or services being traded"* [p.41], the costs of establishing and enforcing the terms of an agreement [p.42, 43], and the costs of setting relative prices in order to maximize profits [p.42]. McManus [p.54] also mentioned for transfer pricing method in order to be possible for a MNE to manipulate the prices between parent and subsidiary for their mutual advantage.

McManus (1972) was the first that has acknowledged the term of internalisation of a firm, *"the establishment of a firm can always "internalize" an "external" effect or reduce a particular marginal inequality but only at the cost of reducing non-discretionary constraints on behaviour and replacing them with management control"*[p.46][61]

2.6 Risk Diversification and Foreign Exchange Theorists

2.6.1 HARRY MARKOWITZ (1952) theory of portfolio[62]

The theory of portfolio considers that the investor (individual or MNE) is risk-averse and thus

is prepared to pay less than its expected value for the outcome of a risky project (investors prefer high expected return and low standard deviation (standard deviation is the proper measure of the security's risk)). The investor if he is a rational one, chooses an efficient portfolio, which offers the highest expected return for a given standard deviation of that return, or the lowest standard deviation for a given expected return. By diversification the investors succeeded in eliminating the risk, and hoping for the expected return. Although, there are significant differences in FDI and portfolio diversification, some considerations and theories in FDI has included a function of a MNE with which MNE is assumed to diversify its functions abroad in order to minimize its risk and increase the profits for their share-investors.

2.6.2 Rugman (1976, 1977): Risk Diversification Hypothesis

Rugman (1976, 1977)[63] argued that the MNE has the advantage to exploit the information through an internal market. Having the market imperfections the MNE is a vehicle for individual international diversification. The MNE in order to overcome the market imperfections creates an internal market and becomes "*an indirect vehicle for international diversification when individual investors are confronted with financial market imperfections which make it impossible for them to build up efficient world portfolio themselves.*"[64]

2.6.3 Agmon and Lessard (1977)[65]

According to diversification strategy FDI exist when MNEs diversify their activities into related industries in order to explore their ownership advantages and overcome some of the market imperfections. Moreover, a MNE can diversify its activities into unrelated industries, through a diversification of a product. In both cases there is a hope for increasing sales, profit and market share. From this MNE's strategy arising the issue of diversification strategy between an investor and a MNE.

"*In the presence of barriers to portfolio capital flows, multinational firms (MNCs) have an advantage relative to single-country firms because of their ability to diversify internationally.... If there is no barriers to international capital flows, and if capital markets were uniformly well developed, investors would diversify their portfolio holdings internationally and required rates of return on securities (projects) would reflect only their contributions to the risk of a fully diversified world portfolio*" [p. 1049]. In order to verify the existence of the diversification motive for multinational expansion, Agmon et al. observed two conditions: first if the barriers of portfolio flows are more stringent than the foreign direct

investment flows. They concluded that MNEs might diversify internationally at a lower cost, more probable and easier than portfolio investors. Even if the barriers are the same for investors and MNEs, then it is possible for the multinational to find a way to move investment flows in the host country. A MNE can transfer money-capital, managerial or technology skills that are not restricted as the direct money flows. Secondly, Agmon et al. wonder if the investors recognize the fact that a MNE provides a diversification opportunity, which is superior or otherwise unavailable. Under an econometric analysis they found that the US investors recognize the international composition of the activities of US-based corporations.

Financial market imperfections that give MNEs a financial advantage provide another incentive for FDI, being complement to the real good and factor market advantages. The imperfect correspondence of "company earnings and/or asset values in various countries" is not sufficient to establish relevance of international diversification to the corporate level. The barriers or costs of portfolio capital flow should be higher than those of investment flows in the purpose of FDI, and the opportunity for diversification provided by the MNEs should be viewed as unique by the investors. If the financial markets were perfect ones uniformly well developed then the investors would prefer a worldwide diversified portfolio rather than diversification in the firm level. When "*...coupled with the observation that MNCs often can diversify internationally at a lower cost than portfolio investors, it suggests that the diversification motive should be given more serious consideration than has been the case to date.*" [1055]

2.6.4 Donald J. Lecraw (1991, 1984)

Lecraw's[66] contribution to FDI theory was the assumption that all locational advantages are subject to change when referring to developing countries. He argued that *"inflows of FDI were related to changes in the country's locational advantages, the labour force and domestic capital, and to changes in barriers that might impede TNCs from investing in the host country, such as government restrictions on FDI."* [Lecraw, p170] After the regression analysis of data collected in developing countries, several patterns emerged.

Lecraw came to the following conclusions regarding the relationship between FDI inflow and the country specific characteristics of a developing country. FDI inflow is influenced, firstly by the country specific factors that are not influenced by the government (like natural resource base, rate of growth of the labor force etc.), secondly factors that are partially influenced by the government (like the rate of growth of the consumption, the perceived risk of the country, the real exchange rate etc.) and thirdly by the factors directly controlled by the

government (like the tariff rate, the investment incentives system etc.). In general, FDI inflows are influenced by the general conditions of the country. [67]

In a previous article (1984)[68] Lecraw concluded that according to his regression analysis' results for 200 largest manufacturing firms in Canada "*the foreign-owned firms* [have a] *diversification strategy* [that] *was influenced both by the parent firm's strategy and by characteristics of the subsidiary and the base industry in which it operated*"[p.196]. Moreover, he has pointed out that "... *industry structural variables influence the diversification strategy and the profitability of the firms within the industry... on the other hand, it allows for the possibility that different firms in the same industry may follow different diversification strategies based on management's formulation of the firm's goals and assessment of its strength and weakness, ... and that the success (profitability) of a firm may depend on the strategy it chooses, the appropriateness of this strategy, and the extent to which it follows this strategy, as well as the profitability of the industries in which it is operating.*"[p.180]. For that Caves (1980)[69] has also argued that "*the structures of markets have been affected by the organizational options open to firms. The productivity with which resources are used depends on whether or not firms make the best choices of strategy and business organization, given the market and technological environments in which they operate.*"[p. 88].

2.6.5 FROOT (1991)[70]

The markets are subject to informational imperfections. These imperfections cause external financing needs, which may be more expensive than internal financing due to the fluctuations of the foreign exchange between home and host country. Moreover, a depreciation of the currency of the host country may lead to acquisitions of foreign assets from the MNE to the host country. Froot, with the results of his model has concluded that the exchange rates has a systematic effect on FDI more than with the other forms of foreign involvement. "*the correlation of FDI with the exchange rate is very different from that observed for other forms of capital inflows, including passive portfolio investments... a depreciated currency can give foreigners an edge in buying control of productive corporate assets.*" *[p. 1215].*

2.6.5.1 Criticism

From the definition of FDI, MNE through direct investments seeking profits and controlling interest, thus this point is in the contrast with the definition of portfolio diversification. Therefore, the theory of FDI regarding diversification of risk it can be seen in a different way

than that of portfolio diversification although MNE can easier diversify in different countries, overcoming the barriers. However, investors can easily invest in many MNEs simultaneously and thus diversifying their risk better than each individual MNE. On the other hand, MNEs with the existence of market imperfections they can acquire information easier and most probable than the individual investors and thus MNEs are in the unique position to predict the future returns of an investment. However, the manager of a MNE is more risk averse than the shareholders, because manager is seeking for his salary, while shareholders are seeking for their dividends. As a preferable conclusion, MNEs should diversify in activities of a related market in many countries in order to achieve except all other goals, a diversification of a risk, having from its experience the correct and appropriate information

2.6.6 ROBERT ALIBER (1970, 1983)

Capital arbitrage theory assumes that there is a moving of equity capital from countries where returns are low to countries where they are higher, so that profit is generated from the difference (arbitrage) among returns. Aliber has update this theory and mentioned that *"...there are substantial differences among countries in nominal and real interest rates. Because nominal interest rate differentials are poor forecasts of future changes in exchange rates, a wedge is introduced between returns on similar securities denominated in different currencies.* [David J. Teece, 1985, p.233][71]"

In essence, Aliber treats exchange rates as an incentive for MNEs if favorable and as a barrier if unfavorable in regard to the MNE's home and host country. [Dunning 1973, p316][72] "*Since the value of any one currency fluctuates over time it immediately follows that in addition to the variables which influence the worthwhileness of an investment in the local currency, its value in relation to other currencies has to be considered. A rate of return of 10 per cent with a currency that devalues by 5 per cent is worth 5 per cent less the depreciated value of the assets in other currencies.*"

[Grosse et al 1992][73] "*Robert Aliber (1970) showed that a plausible explanation for at least part of United States-based overseas expansion was the low real cost of borrowing in dollars during the 1950s and 1960s relative to other currencies. That explanation may also explain the increase in direct investments in the United States, from Japan and the Federal Republic of Germany during the 1980s, as real borrowing costs fell in those countries.*" One of the things Aliber has failed to explain is why there is a simultaneously cross investment between two countries with different currency and exchange rates, in the same sector of the economy, since, according to Aliber, the firms aim to arbitrage the exchange rates differentials.

Moreover, his theory failed to mention why investments between countries from the same currency area exist. Aliber also pointed out that MNEs from strong currency area can profitable borrow cheaply than the domestic firms, in a way of importing low-cost money-capital flows. Moreover, Aliber argued that portfolio investors are 'myopic', because they believe that the foreign investment and operations of a MNE are in the same currency area as the parent firm and the investor does not take into account the foreign exchange risk involved in the repatriation of the profits to the parent firm.

This theory is applicable but one sided since it fails to take into consideration a variety of other factors influencing FDI decisions. In any case it must be combined with other kinds of analysis. Nevertheless [Dunning,1993, p282][74] "*it is likely to be used in explaining MNE investment in capital- intensive sectors...*"

Aliber also made some interesting observations about the sequel usually followed by a firm in order to exploit a foreign market; export-licensing-FDI. He based his analysis on comparing the variable costs of exporting a product (tariffs, transportation costs etc.) and the product cost in the home country, to the fixed costs of producing in the host country. After a certain time during which the product is being exported by the firm, the foreign market may grow substantially. At this point the size of the market implies that it is more efficient to produce within the foreign market than exporting to it, but still it does not justify a direct investment. That leads the firm to license the product to local producers. When the local market expands further then the licensing is not profitable for either side, so the firm chooses the way of establishing an FDI project.[75]

2.7 Trade Theorists – Market Seeking – Locational Advantages

2.7.1 H/O and Ricardian models

The "*...theory of FDI is the converse of the pure theory of international trade. If the world were characterized by a model of free trade there would be no need for the MNE*".[76] Some of the trade theories though are useful in FDI, if we use them in an extension mode. One of the most discussed trade theories is the factor endowment theory of Heckscher and Ohlin (H/O theory or model). The theory states that a country would produce and export products that depend mostly on the production factors (particularly capital and labor) that are abundant in the country and import the product that depends mostly on production factors that are rare in the country. H/O theory assumes that the production factors are completely mobile domestically and capital and labor are completely immobile internationally. Moreover, H/O

assumes that production functions are the same and technology freely and instantly available in all countries. Although the H/O theory is not absolute it reflects the locational specific advantages of a country that an MNE takes into consideration before directly investing in it. [77]

David Ricardo created a model in which trade was based on comparative advantages such as international differences in labor productivity. These differences resulted from differences in production functions and the use of technology. Differences in productivity functions are exogenously or derived from differences in national characteristics such as climate and the quality of natural resources. These differences it can be said that are based to country – specific advantages according to FDI theory. This model also assumes complete international immobility of factors of production. The model considers technological differences, which result to productivity differences. It can be said that there is a link with trade and FDI using Ricardian model if we expand it with factor endowments mobility and keeping in mind the international differences in technology and production functions as a firm – specific advantage and country-specific advantage.[78]

Neither H/O nor Ricardian models can explain FDI. However, extensions of these models such as the H/O extension model (neo-factor trade theories), which introduce additional factors such as human capital and natural resources and the Ricardian extension model (neo-technology theories) which introduce economies of scale, product differentiation etc. can be both used as a basis for significant number of FDI theories.

Dunning (1995)[79] suggested that *"what is wrong with trade theory is its failure to address techno-economic micro-organizational and macro-organizational issues and, particularly, the effect on trade of coordinating resources and transacting across exchanges by alternative modalities"*. In the world economy there are new elements that have made changes such as the increasing mobility of assets, the declining significance of arm's length transactions, the increasing role of governments and their intervention via imposition of barriers or providing FDI incentives.

2.7.2 Vernon Raymond, (1966, 1979)

Vernon with his well-known theory of international product cycle tried to explain the patterns of international trade and FDI in the manufacturing sector. He developed his theory arguing exclusively about the USA as the most fertile country for innovation in product development. Vernon overcame the classical assumption that factors of production and the products

themselves were immobile, and suggested that it is the decision of the firm to continue producing and trading locally, to export or to directly invest in production facilities abroad. [Grosse 1992, p114] [80] *"It is a theory of shifting production location but it does not incorporate the role of Governments in influencing cross-border locations. It is, therefore, a theory of location in the absence of national boundaries."* [Dunning 1993, p70][81] *"In a classic article published in 1966, Vernon used a micro-economic concept - the product cycle – to help explain a macro economic phenomenon, viz. the foreign activities of US MNEs in the post- war period."*

Vernon was the first to focus on the so-called country-specific/ locational advantages. Given that there is cross-national trade and all natural and human resources are immobile, Vernon has pointed out that trade also depended upon the technological capability of the firms to upgrade those inputs and/or to create – innovate new ones. The ability to renew ones resources may be considered as an ownership/competitive advantage. At first the firm is willing to export its products to foreign markets with similar demand patterns and supply capabilities. When the product matures, and the demand becomes more price elastic the attraction of establishing foreign direct investment activities in a foreign location increase. The final decision of choosing the host country depends on various factors such as the conditions in the host country. The distance between home and host country is also an important factor as the MNE may intent to make the products manufactured in the host country, available for re-exportation to the home country. (Geographical proximity) One of the basic assumptions of Vernon is [Vernon, 1993, p4] [82] "... *that the enterprises in any one of the advanced countries of the world are not distinguishably different from those in any other advanced country, in terms of their access to scientific knowledge and their capacity to comprehend scientific principles. ...It is a mistake to assume, however that equal access to scientific principles in all the advanced countries means equal probability of the application of these principles in the generation of new products. There is ordinarily a large gap between the knowledge of a scientific principle and the embodiment of the principle in a marketable product. An entrepreneur usually has to intervene to accept the risks involved in testing whether the gap can be bridged."* The risk in undertaking a project of developing a new product, focusing on high-income consumers, is financial since research and development is very costly for the firm.

On the other hand, Vernon considers knowledge as a variable, still very important for the decision-making, but depended on communication levels, which are influenced by distance. On those bases Vernon abandons [Vernon, 1993, p4][83] *"the powerful simplifying notion that*

knowledge is a universal free good, and introduce[s] it as an independent variable in the decision to trade or to invest." The knowledge that the entrepreneur holds leads him to the production of an innovative product. The production of the new product takes place in a highly developed country such as the USA, because the willingness and the ability to spent on a new product is positively related with the per capita income. Especially when the product is highly differentiated, or the firm enjoys a monopolistic advantage, the price elasticity of demand is very low, so the firm is able to make a profit even if the production costs are high. Thirteen years after his original approach, Vernon summed up his conclusions.

- "According to the product cycle hypothesis, firms that set up foreign producing facilities characteristically do so in reliance on some real or imagined monopolistic advantage."

[Vernon, 1979, p255]

- "The home market in fact plays a dual role in the hypothesis. Not only is it the source of stimulus for the innovating firm; it is also the preferred location for the actual development of the innovation."

[Vernon, 1979, p256]

- "Once the innovator has set up its first production unit in the home market, any demand that may develop in a foreign market would ordinarily be served from the existing production unit."

[Vernon, 1979, p257]

- "Eventually, however, the firm may consider other alternatives, such as that of licensing a foreign producer or setting up its own producing subsidiary abroad. ... If licensing is not the preferred choice, then the firm makes the usual familiar comparison between the delivered costs of exports and the cost of overseas production. That is, the marginal costs of producing for export in the home unit plus international transport costs and duties are compared with the full cost of producing the required amount in a foreign subsidiary."

[Vernon, 1979, p257]

- "...the original innovator... [was intimidated by] ... the thread... of the difficulty of deciding what is at stake in failing to find the least-cost location, what alternative sites need to be investigated, and what the costs of investigation are likely to be. [this being the reason for not investigating lower-costs cites, outside the home market, from the beginning]"

[Vernon, 1979, p257-258]

- "These conditions change, however, as the threat begins to crystallize. Eventually, it may be clear that the innovator is threatened with the loss of its business in a given foreign market. At that point, the areas to be investigated as possible production sites have been narrowed

while the size of the risk has been more explicitly defined."

[Vernon, 1979, p257]

In the same article he revised some of his thoughts under the light of new developments, explaining why they could not be applied at the time of the article.

- ...the leading MNCs have now developed global networks of subsidiaries
- ...the US market is no longer unique among national markets either in size or factor cost configuration.
- ... the improved position of European and Japanese firms as innovators.

[Vernon, 1979, p265]

There are, though, some occasions where this theory may be fully applied (at the time when the article was written).

- in cases of smaller firms that are in the first stages of internalization
- in the cases of certain European and Japanese industries that have an advantage of innovation but only temporarily
- in less developed countries where many innovations are yet to be absorbed
- in the case of companies operating in developing countries, that develop an innovative product, suited to fit the needs of specific markets, and introduce it to other developing countries with less industrialization.

[Vernon, 1979, p265-266]

Vernon's conclusion was that "*the product cycle concept continues to explain and predict a certain category of foreign direct investments. Although it no longer can be relied on to provide as powerful an explanation of the behavior of US firms as in decades past, it is likely to continue to provide a guide to the motivations and response of some enterprises in all countries of the world*".[84] [Vernon, 1979, p267]

2.7.3 Kojima

Kojima's theory on FDI direction and sector is a trade-oriented theory that is based upon the comparative advantage pattern. It is a macroeconomic approach that is focused on the benefits a country derives from capital and technology inflow provided by FDI, rather than the benefits an MNE derives from FDI. The concept is simple: if a product is produced in country I in a lower cost than in country II, and country II has a comparative advantage that can assist in producing the product even more cost-efficiently in country I then country II should undertake an FDI project in country I and export back to country II. In other words, inward FDI should target the country-specific advantages that can be assisted by the input of

the investor company (such as managerial skills or technology) in industries hat the home country is disadvantaged, in order to exploit the opportunity of exporting to the home country and other countries and assist the development and expansion of the specific industry in the host country. Kojima disagrees with the concept of shifting the production of a good efficiently produced in the home country to the host country in order to substitute trade. In this theorem Kojima tries to integrate trade with FDI, supporting a kind of FDI that is complement rather than substitute to international trade. It is called the 'Japanese FDI' theory and it is considered opposite to the 'American FDI' theory because the first perceives FDI as an activity that should assist trade relationships while the second perceives FDI as a substitute to trade.

Kojima's theorem is very much based on the H/O assumption. The H/O assumption suggests that the bulk of a country's exports are products that mostly utilize each country's strong comparative advantages. If the comparative advantage is mobile (capital, technology, managerial skills) it can be utilized in another country complimenting the host country's specific advantages.

Kojima suggest two 'prescriptions' based on the 'Japanese FDI' theory.

(1) Oversees resource requirements should not be satisfied by FDI but by long-term trade agreements

(2) The developing countries should take deep consideration about the industries toward which they receive FDI. They should start with industries in which they have a potential comparative advantage, and they should try to slowly and steadily assimilate technology. Another 'tip' for developing countries is that they should use FDI as a "tutor" and derive the superior technology, skills, the training of labor etc. in order to assimilate the technology and not just facilitate it. The positive spillover effects fade-out if there is a massive 'invasion' of many firms that reinforces the negative effects of FDI by putting the local firms in an inferior position. The foreign investor should slowly depart after the conclusion of the transfer of any intangible assets and invest in another country that waits for a 'tutor'.

Kojima has received a lot of negative criticism about (a) ignoring the transaction and transportation costs and (b) ignoring the market imperfections. These criticisms, though, do not take into consideration the fact that Kojima sets as a goal of FDI the reinforcement of a foreign industry for the good of the home country and, if one takes it further, the macroeconomic prosperity of a country, and not the profit margins of an individual MNE.

Certainly this approach may be characterized as a utopia, still given its goals it is very much valid.

2.7.4 Hirsch Seev[85]

Hirsch tried to determine the optimal point for exports to be substituted by FDI through a capital-budgeting formulation. Hirsch's model also shows that foreign production may lead to the improvement of the competitiveness of intermediate products. What the Hirsch model lacks, according to Kogut is a variable to represent the cost savings from having more than one subsidiary[86].

2.7.5 Horst Thomas

Horst in his 1970 paper, explored the strategy a monopolistic firm operating in two national markets simultaneously should follow in order to maximize profit. The strategy concerned the decisions of the distribution of production in each country, the export level from one country to the other and the size of the intra-firm transfer prices and was examined in terms of marginal production costs in relation with the level of production, and the level of tariffs in imports in relation to the changes they bring in the production and export policies.

His model was purely theoretical and was mainly based on the assumption that the firm was only selling in two countries exporting from country1 to country2 and that the demand was depended solely on the price. Nevertheless the model adequately explained the relationships in question and came to some interesting conclusions. From the side of the government imposing the tariffs the main concern is to favorably affect policy goals like the balance of payments, the employment level, the performance of local firms, the price level for local consumers etc. and are usually hoping in replacing imports with local production of the imported goods (FDI). Although the prices will most probably rise, reducing the demand and consequently the imports, the decision of the foreign firm to undertake FDI is not assured.

When the firm's production allows economies of scale it is less possible to split production in order to avoid price increases from tariffs since the gained percentage will be offset by the cost increases resulting by not achieving economies of scales.[87] The model is more or less valid when small enterprises are concerned or for territorial moves of MNEs but it cannot sufficiently explain or predict moves of MNEs worldwide.

Horst[88] in an article in early 1970s has pointed out the issues that a MNE must consider such

as how much to produce, to sell, to export, what transfer price to put on intra-firm exports, which is the correct price to sell, the importance of tariffs and taxes. Horst tests a model using a monopolistic firm with a profit-maximization strategy, which sell in two countries simultaneously. He concluded that "*high tariffs are often imposed with the hope of getting firms to replace imports with domestically produced goods* [FDI substitute of trade]... *a country might encourage local production, not only for domestic consumption, but for export as well* [export base]...*tax policy might be used to both reduce prices and expand domestic production and employment* [tax incentives]...[and there is a willingness] *of investor countries to refrain from double taxation*" [Horst, p.188, Chapter 10].

2.7.6 Graham, M. Edward: 'exchange of threats' hypothesis[89]

According to the product-cycle analysis, as firms grow and their product matures the production becomes more capital-intensive, the fixed cost rise in relation to total costs and the product's demand becomes more price-elastic. In that stage achieving economies of scale becomes very important to the company, and any price-cutting strategies by rivals may prove disastrous for the company. Still oligopolistic firms give up their potential for very efficient economies of scale and create foreign subsidiaries, thus splitting the production. According to Graham the reason for this is the threat of other companies invading in your market reducing the company's market share and by acting this way companies exchange profitability with security. This results to an increase of oligopolistic interaction among foreign firms.

"*Graham hypothesized that an MNE which found its home territory invaded by a foreign MNE would retaliate by penetrating the invader's home turf.*" [...72] A firm may even predict the invasion by a significant competitor and take the first step itself. The "... *leading firms in each industry would have to aim to have similar geographical distribution of sales or production as one another*... [at the point when]...*collusive agreements to ensure security would reach a peak*". This action makes collusive agreements and cartels less possible but still maintains competition. This can also occur involving smaller companies in neighboring countries.

2.7.7 Follow the leader or reaction to competitor's investments[90] (Knickerbocker)[91]

Knickerbocker argues that in oligopolistic industries, which characterized by high seller concentration one reason for FDI is the tendency of firms to "match their rivals move to move". The firm that takes the first step in a new market exploiting any business opportunity

draws the attention of similar firms that can exploit the same opportunities. If the 'leader' company faces difficulties then the companies that follow learn from its previous mistakes. If, on the other hand, the quality of the opportunity was misused then the competitors, again taking advantage of the 'leader's' expertise, may diversify meeting the opportunity in a better way. Even if the 'followers' have no real gain in investing in the new market they tend to do it anyway in order to prevent the 'leader' from dominating the new market making it very difficult for the 'followers' to enter in later times. Firms try to maximize their profits in a world where information about market conditions is unequally distributed. Soon or later will decide to exploit the opportunity of investment, thus all the firms monitored the market and especially the market intelligence system's firm. This theory and the "exchange of threat hypothesis' are valid for industries such as car rental, life insurance, banking, advertising, consultant etc.

2.7.8 Caves 1982

Caves (1982) developed the rationale for horizontal integration (specialized intangible assets with low marginal costs of expansion) and vertical integration (reduction of uncertainty and building of barriers to entry).[92]

2.8 NEW Trade Theorists / Vertical Integration

Brainard (1997) has argued that the explanation of the new trade theorists about MNE's expansion can be termed as "*factor-proportions hypothesis,* [which] *holds that firms integrate production vertically across borders to take advantage of factor price differences associated with different relative factor supplies*"[93]

2.8.1 The technological accumulation approach (Cantwell)

Technology, as a firm-specific asset, is developed within a company through R&D in response to the market needs and the competition. The technological advancement and innovation, as well as the assimilation of the new technology in the company, is a cumulative process depending on the company's previous technological status. The more complex the technology used, or developed within a firm, the greater the need for internalization. The competition is also a strong incentive for a company to intensify the efforts for technological advancement, and competition is very intense among international companies.[94] Deriving from those assumption one may conclude that internationalization may intensify the technological competition among MNEs and that high accumulation of technology within a

firm calls for even more tight internalization, which again, supports further internationalization.[95]

2.8.2 Multinational Firms and the New Trade Theory (Markusen and Venables)

This theory discuses a model in which multinational production may be triggered by local (national) competition, and MNEs are in equilibrium when pant-scale economies cost less than firm-scale economies plus transport and tariff. The main considerations are the country size, the factor endowments and the technology of the country. The general conclusion is that, as countries grow similar in size, relative endowments and technologies, the multinational production becomes more important than trade. In order to determine the 'national ownership' of the firm the model differentiates between the relative factor advantage and the country-size advantage. In the first case the firm ownership may reside entirely in the advantaged country, unless transport costs are minimum. In the second case there are more than one parameter to determine the equilibrium. The effect of multinational activity in the two countries depends on the size of the investment. If the initial investment (from the most advanced to the less advanced country, in terms of size, endowments and technology) is medium and the transport costs high, then both countries are benefited. If, on the other hand, the relative advantage of the countries is large, and the transport costs medium then the more advanced country may lose from multinational activity whereas the less advanced country gains significantly96

2.8.3 Krugman-FDI and Geographical Concentration

Krugman suggests that firms of certain industries tent to concentrate in regions that have already a high sectoral activity. This happens, according to Krugman for sector-specific rather than location-specific reasons. The industries that usually agglomerate in a specific location share the following characteristics[97]:

- Low transportation cost of the products
- Increased ability for economies of scales
- High value of technological knowledge and breakthroughs
- Increased need for skilled labor
- Dependence on suppliers of input (raw materials or intermediate products)

When many firms of the same sector are concentrated in the same location, it consequently, concentrates skilled labor, technology and suppliers. Therefore the location attracts other firms, given that they can overcome the transportation cost and trade barriers of exports. The firm may establish a subsidiary in the certain location in order to be close to the technological information flow, supporting in the same time the production stage that is not complicated by exploiting location specific advantages (like cheap unskilled labor) in another location. A typical example of agglomeration is the Silicon Valley in the USA, which is the center of R&D activity concerning computers. The choice of location is initially based on the location-specific advantages like demand, or (immobile) labor force but the concentration of the firms lead to the further development of those advantages in favor of the specific sector, for example the individuals in the labor force are consciously trained on the subject and the government adjusts the laws. The pattern may change when the region is saturated then the same procedure is initiated in another region, and may eventually, create a new center for the sector.

This theory may explain certain paradoxes in FDI, like the reason why certain firms ignore locations that provide them with very cheap labor, or other advantages. The theory is reinforced by FDI activity of suppliers of input or service firms following their customers. Consequently another reason for FDI is the 'tradition' a location carries in certain sectors[98].

2.8.4 Ignatius J. Horstmann and James R. Markusen[99]

Horstman and Markusen developed an econometric model in order to prove the widely held notion that the existence of MNEs is based on the knowledge-based firm-specific advantages they hold such as technology, expertise and know-how. This kind of assets can be transferred to other production facilities in minimum marginal cost (public good property). The public good property creates economies of scale in a multi-plan firm and gives the firm cost advantage against many independent factories. MNEs develop through this advantage and they perform international transactions servicing the foreign subsidiaries with the firm specific assets (management, engineering, marketing, financial services). MNEs may develop considerable market powers, from the use of the firm-specific assets, since the host country enjoys the benefits without making local investments, so the MNE gains significant monopoly rent. The outflow of FDI has been shown to be in favor of the home country too. Although many production jobs are lost there is welfare maximization (that is a social objective) given the assumption about domestic and foreign cost structure.

2.8.5 Helpman

Helpman in his 1984 article[100] examined the equilibrium circumstances that make it profitable for a company to become a multinational, to choose the foreign location of its activities and to predict its pattern of foreign trade. The equilibrium depends on the cost minimizer factors and the location choice. Helpman has argued in favor of vertical and horizontal integration and firms making profits when they choose cost-minimising locational-choices for their production lines. The study came to the following conclusions:

- MNEs posses firm specific assets (marketing, management, R & D) that treated as inputs that can serve product lines in many locations.
- It is assumed the existence of product differentiation, economies of scale and monopolistic competition
- MNEs play an active role in the international trade
- There is a simultaneous existence of intersectoral trade, intra-industry trade, and intra-firm trade
- Horizontal and vertical integration lead to cost-efficiency
- Relevant factor endowments determine the location of cost-minimizing single production line of a MNE
- Possible locational determinants such as transport costs, tax advantages and tariffs are assumed away, so that the production facilities are not established in order to save transport costs or avoid trade barriers
- The larger the relevant factor endowments differences in home and host country the larger the volume of trade or FDI
- The larger the country (host) size in terms of GNP the larger the volume of trade or FDI
- For given relative country size (host), the larger the relevant factor endowments differences in home and host country the larger the share of the intra-firm trade

Helpman (1984) in his conclusions mentioned that "*the current theory can also explain cross-country penetration of multinational corporations as a result of impediments to trade (such as transport costs or tariffs)... the theory explains the simultaneous existence of intersectoral trade, intra-industry trade, and intra-firm trade*...[an extension of this theory for horizontal and vertical integrations for MNEs appeared in Helpman (1983) in which he argued that]... *integrated multinational corporations end up having production facilities in parent as well as in host countries and the existence of vertical integration brings about intrafirm trade both in*

H [H is a general purpose input] *services and in intermediate inputs"*[101].

2.9 Conclusion

What derives from the literature review from 1937 up to 2000 is the comprehension of the relativity of each theory; there is no theory that dominates the decision making process of FDI. The opportunities a country has to offer change through time, and the different ways in which MNEs evaluate the opportunities. Each theory applies in a limited number of sectors, and that a given firm may be served by different theories in different time periods.

After the consideration of the FDI theories the author made an attempt to present, in the simplest possible way, the incentives, motives, reasons, possibilities, opportunities, externalities, imperfections that an MNE considers before the decision of FDI. A company, when considering FDI, it tries to exploit or overcome any factor that has stimulated or motivated its management to proceed in investing in a foreign country. Moreover, the barriers, which discourage an FDI decision, are in fact, the other side of the same coin, meaning that the negative side of an incentive constitutes a barrier.

Some of the theories presented may be viewed as static, while others may be considered dynamic. The static theories studied only the factors that lead to the decision of FDI, while the dynamic theories also consider the evolution of the foreign company and its interaction with the host industry and the host country. The dynamic models led the author to the presentation of the direct and indirect effects of FDI on the host country, on the transition process to a market economy and on the MNE.

One must consider that the market conditions are always changing and the changing character of the boundaries, the globalization, the European Union etc. will definitely create new challenges and opportunities for a company to seek value-adding activities internationally in ways different from the ones studied up to now. This model may be expanded with every new theory developed that derives from the above changes. As the authors of the above theories concluded on reasons on why a company may undertake FDI by examining certain subjects (countries, incentives, barriers) in certain time periods, the author of this thesis, studying all those FDI & new trade theories, creating a questionnaire and studying nearly 100 foreign companies operating in Bulgaria in the time period 1989-1999, ended up with two conclusions: the first is that no theory can be general and the second is that in the case of Bulgaria some specific incentives and certain FDI theories are appropriate for application (see

chapter 3).

The changes observed in the last decades certainly have a significant growth rate, much larger than that of the past. Respective changes are likely to occur in much larger growth rate in the years to come. These changes will cause many static theories on FDI, and on other economic aspects, to become obsolete. For example consider how the theory of Aliber on FDI as a way of exploiting the differences in exchange rates, will apply after the monetary unification of the countries of the European Union.

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CHAPTER 3

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CHAPTER 3

Before any discussion regarding the determination of foreign direct investment (FDI) [for a discussion of statistical problems, inaccuracies and problems regarding the definition of FDI see appendices of this chapter], we must outline the literature review of other questionnaire surveys. In doing so we can conclude that the findings of econometric studies tend to support questionnaire survey results.

3.1 Literature Review of other questionnaire surveys regarding the determination of FDI

The following discussion attempts to be a literature review of the most relevant and important articles on our subject. Their main effort focuses on determining the most significant incentives and barriers of FDI, based on questionnaire analysis.

> Benacek V., et al., 2000 concluded[1] that *"the findings of econometric studies tend to support survey results. This suggests that* ***market size and growth potential have been the driving force behind FDI, with factor cost advantages playing a lesser but still significant role.*** *Macroeconomic and political stability are also taken into account. Market seeking was the primary motive for FDI, however, the role played by the absence of trade barriers and membership in free trade areas suggests that export oriented investments are also present. Inflows of FDI have improved the overall growth potential of the economies, but primarily through productivity improvements within the foreign firms, rather than through linkages with the domestic firms or spillovers into them [abstract].... Investment incentives have not, in general, had a decisive influence on the investment decision, but the privatization process has had an important influence on the timing of FDI. Evidence on the attraction of the skilled labour force in Central Europe has been more variable. ... There is some indication that foreign investment has had a negative impact overall on the trade balance in Central Europe, which supports the evidence that foreign investors have been primarily market rather than export oriented, at least in the analyzed period. ... Incentives are less important in attracting FDI. However, once an investor decides to invest in the region, incentives may influence the choice of location among similar locations inside the region...* ***The privatisation process*** *should also be taken into account. It acts as a strong signal of the commitment of the government to private ownership.* ***The one-off opportunities offered by the transfer of state monopolies into the private sector give a strong incentive for strategic investments.*** *First-mover advantages are intrinsic in the privatisation of a monopoly, as the new owner is likely to gain a degree of market power even if the monopoly is divided.... The Visegrád economies appear to be converging on a level of about 75 per cent, close to the levels of the market economies in Western Europe....* ***The privatisation process played a key role in determining the level of direct investment in the early years of transition.*** *The earliest countries to embark upon significant privatisation programmes were those in Central Europe. These economies have also*

> *attracted the highest shares of inward investment* [conclusions, Benacek V., et al., 2000].

Benacek et al. also claimed that:

> *Certain factors will affect which countries (i) receive higher levels of investment, while other will affect which sectors (j) receive higher levels of investment. For example, political stability may influence the distribution of investment across countries, while specific incentives may direct investment towards certain sectors.* [conclusions, Benacek V., et al., 2000].

On this basis, we drew the conclusion that it was necessary to run the chi-square statistical test in the specific questionnaire survey for each sector of the Bulgarian economy in order to determine the incentives and barriers for FDI inflows.

> Benacek V., et al., 2000 also concluded that *"Taken individually, a single survey may suggest misleading conclusions. For example, a study that excludes Hungary and the Czech Republic may conclude that political and economic stability is not very important to investors. But a study that does include them will indicate that their relative stability can help explain why such a large share of investment in the transition economies has gone to these two countries"*

We have run a questionnaire survey in a specific country trying to avoid the above-mentioned misleading results when the determination of the incentives and barriers in Bulgaria was based in the consideration of each sector of the Bulgarian economy and each origin of MNEs.

> *In general, survey respondents who already had an investment in a country rated its risk substantially lower than those that did not* (Lankes and Venables, 1997).

According to the literature review, in a survey[2] by **Klaus E. Meyer** (1995) a questionnaire was sent to 677 German and British companies in the winter of 1994/95. The companies[3] were selected randomly from a database (AMADEUS). Stratified sampling was followed and each stratum was defined by firm size. 269 (39%) companies responded that they share business relationships with the Czech Republic, Hungary, Poland, Romania and Russia from which only 212 companies were included in the study as the rest questionnaires received had uncompleted/misleading observations. 38% of the investing projects were acquisitions or joint ventures and 19% of the 38% (7% of the total) were through privatisation programs. The local market was the dominant attraction and factor cost orientation came almost exclusively in combination with market-oriented investment. Those aiming towards low factor cost preferred the Czech Republic (38%), Poland (31%), Hungary (29%), Russia (26%) and Romania (21%). The most important conclusion drawn from the survey is that labour costs play a secondary

role in the investment motivation of western investors in the CEE region. Local markets were the main attraction with only 9% considering factor costs as the primary attraction of the region. Only a combination of low factor costs and an attractive local market motivates the potential investors to implement their plans. Meyer has also found that Germany prefers neighbor countries such as the Czech Republic and Poland.

Meyer (1996)[4] reported that the purchasing power of consumers is important to the investment decision for market oriented investors. The most significant factor for market oriented investors is the size of the market in terms of population. Factor price oriented investments also find access to local markets to be important, although to a somewhat lesser extent, as would be expected. Meyer went on to say that a qualified labour force is one of the most decisive determinants of foreign investment in Hungary, especially for assemblers and domestic supply based exporters. Labour quality is of lesser importance to non-exporters. Furthermore, market oriented investors in Hungary regard political and economic stability as a crucial factor in the location decision. Factor-price oriented investors are less concerned with stability. Finally, Meyer concluded that market oriented investors in Hungary are influenced by the lack of competitors in a given market.

Arthur Andersen (OECD, 1994)[5] in an OECD survey[6] found that the main barriers or constraints regarding FDI and according to their importance were the following: bureaucratic or administrative issues, legislative issues, economic climate, business infrastructure, political volatility and cultural considerations. Access to a large domestic market, market share, market potential, low cost production, the source of raw materials, geographical location and following the clients theory, were the primary motives for an investment decision. Moreover, Andersen mentioned that the Austrian firms gave priority, when deciding to invest, to both geographic proximity and the strong historical links with Hungary and Czechoslovakia and to a lesser extent with Poland.

In another survey by **Hans-Peter Lankes and A.J. Venables (1997)**[7] a total of 11.000 worldwide firms were contacted in January 1995. Of these 11.000, only 1.435 responded, of which 628 that indicated they were willing to be interviewed at senior executive level. Finally, executives from 117 of these firms with 145 investments in Central & Eastern Europe and the former Soviet Union were interviewed between June and November 1995. The results were:

- The 1st investor motivation was the local market size for Poland and the Commonwealth Independent States (CIS) countries and political stability for the Czech Republic and Hungary
- The 2nd investor motivation was political stability for Poland, natural resources for the CIS and stability of macroeconomic policy for Hungary and the Czech Republic.
- The 3rd investor motivation was the stability of macroeconomic policy for Poland while the regulatory environment was for the Czech Republic and Hungary and access to other markets was for the CIS countries.
- The 4th investor motivation was the geographical proximity and access to other markets for Poland as well as the skilled labour costs for CIS countries and geographical proximity for the Czech Republic and Hungary
- The 5th investor motivation was the unskilled labour costs for the CIS, although the skilled labour cost was for Poland, the Czech Republic and Hungary.

Lankes and Venables (1997)[8], also found that market size is the most crucial determinant for market oriented investors, except in Hungary and the Czech Republic, where political and economic stability dominated. The importance of factor costs seems to depend, not surprisingly, on the purpose of the investment. They found that export oriented firms place much greater importance on production costs and cheap skilled labour, as would be intuitively expected. Transport costs were found to be relevant for heavy industry, which is also expected. The attraction of a skilled labour force was of significant importance only in Hungary and the Czech Republic. According to Lake and Venables, trade barriers are not considered as an impediment to investment in Hungary and the Czech Republic, although import tariffs from the EU are thought to deter investment in Poland and other Central European countries. Geographical proximity to the EU was considered important, especially to market oriented investors. However, survey respondents indicated that investment was not primarily motivated to gain access to EU markets, suggesting that proximity was important mainly to enable intra-firm trade. Hungary, the Czech Republic, Poland, Slovenia and Slovakia are thought to be considerably less risky than other transitional economies. The Czech Republic and Hungary are popular partly owing to the low inflation throughout much of their transition period. Surveys of investors in Poland show that economic growth trends are among the factors influencing the decision to invest. Lankes and Venables (1997) found that tax incentives for foreign investment do not play a key role to the location decision in CEECs,

although individual agreements between the investor and the government are significant for a small group of investors. This is especially the case in Hungary. First-mover advantage appears to have played a strong role in the investment decision, especially for market-oriented investors. The aggregate data indicates that acquisitions of formerly state-owned firms by foreign investors outnumber greenfield investments in the Czech Republic, Hungary and Poland. However, even in the early years Hungary received significant levels of greenfield investment, while bureaucratic barriers curtailed greenfield investment in the Czech Republic. Lankes and Venables (1997) also found that almost half of the investors are positively influenced by similar investments by competitors in the same country (following the competitors' theory).

The survey[9] by **Simona Iammarino and Christos Pitelis (2000)[10]**, focused on the Greek outward FDI in Bulgaria and Romania whereas our survey focused on worldwide inward FDI flows in Bulgaria. However, both surveys yielded similar and comparable results. According to Pitelis et al. their response rate was high, due to the use of 80 research assistants and to the fact that the coordinator, was at the time, engaged in a related project at the Greek Ministry of Development, which facilitated access considerably. Pitelis et al. reported the type of FDI by motivations was perceived as the most important in determining the choice to invest; thus according to their importance we the following ranking: expected economic growth, geographical location, incentives, labor costs, increases in market shares. Moreover, the constraints and risks faced by investors in undertaking production activities were: bureaucracy and administrative constraints, general uncertainties of rules, business infrastructure, and legislative and economic climate constraints. Furthermore, custom tariffs, technological backwardness, foreign indebtedness and local currency strength seem not to be so influential. Finally, half of the investments in their sample were joint ventures, followed by wholly owned (usually greenfield rather than based on acquisitions) and then came FDI using licensing/franchising modes of entry. In the case of both Bulgaria and Romania, the form of participation in the investment preferred by Greek parents was the establishment of an entirely new firm through a joint venture, with the foreign investor having the majority stake of the total company's shares.

> *The empirical analysis is based on the results of a survey carried out in 1995-96 as part of an ACE Project supported by the European Commission on the economic integration through FDI in the less favoured CEECs and the impact on the LFRs of the European Union. A questionnaire was sent to Greek companies that had undertaken foreign direct investment projects in Bulgaria, Romania and the Slovak Republic: the responding firms were 96 and the total number of investments in the three countries was 104. In this paper we focus on Greek outward FDI in Bulgaria and Romania, using part of the database in trying to draw some implications for the home country, with a sample of 76 Greek parents and 85 direct investments in the two CEECs* [Pitelis et al., 2000].

The overall number of FDI is 85 and, as already explained, it does not coincide with the number of investors, i.e. 76 parent companies, because some of them have invested in both countries. First of all, the survey was mainly addressed to large firms, operating in both manufacturing and service sectors. Thus, the FDI considered here is mostly attributable to rather old and experienced firms, exhibiting a relatively high propensity to invest abroad - the actual Greek multinational corporations, such as, Rolco-Vianil (detergents and soaps), Intracom (telecommunication equipment, information systems and related services), Hellenic Bottling Company (soft drinks) and Delta (dairy products, frozen food). While many of them are long-term operating firms, for which the internationalisation process had started long before the collapse of the centrally planned economies (the European Union partners being their main locational target), only a tiny proportion of Greek parents declared to have been in operation in the CEECs for more than one or two years (as stated the survey was carried out in 1995-96).

Table [A] reports the type of FDI by motivations which was perceived as most important in determining the choice to invest. The number of possible motivations was set up equal to a maximum of eight answers. Several issues can be raised from that table. Expected economic growth scores highest, as a general expectation from the opportunities created by investing abroad, followed by geographical location, incentives, labour costs and, with a slightly lower frequency, increase in market shares (both domestic and regional), which attached approximately the same importance to all three type categories (exporters, local suppliers and distributors). Unsurprisingly, both geographical location and proximity to the EU market are - in relative terms - more significant for exporters than for local suppliers, whilst for the latter relatively higher scores are attached to factors strictly linked to the local social environment, such as cultural similarities and historical links. As expected, the source of raw materials is relatively more relevant to exporters than to the other two categories, while, rather surprisingly, labour skills seem to be relevant in none of the cases (Pitelis et al., p.11).

Table A. Type of FDI by motivation

MOTIVATIONS	TYPE			
	Exporters	Local suppliers	Distributors	Total
Expected economic growth	9	41	3	53
Geographical location	9	20	2	31
Investment incentives	8	22	1	31
Labour costs	7	22	2	31
Increase in domestic market share	4	23	2	29
Increase in regional market share	4	23	1	28
Proximity to the EU market	8	8	3	19
Source of raw materials	6	9	0	15
Cultural similarities	4	10	0	14
Transport costs	3	6	1	10
Political and economic climate	2	4	2	8
Country's chance to join the EU	2	3	2	7
Historical links	1	5	1	7
Energy costs	1	1	1	3
Labour skills	2	1	0	3

Source: Pitelis et al., 2000

The constraints and risks faced by investors in undertaking production activities in Bulgaria and Romania, always grouped by type of FDI are listed in Table [B] (maximum number of possible answers set up equals to eight) (Pitelis et al., p.12.)

Table B. Type of FDI by constraint

CONSTRAINTS	TYPE			
	Exporters	Local suppliers	Distributors	Total
Bureaucracy/administrative constraint	14	40	9	63
Business infrastructure constraint	9	32	4	45
Legislative constraint	11	25	4	40
General economic climate constraint	11	26	2	39
Incoherent and unstable legal system	8	22	3	33
High investment risk	8	20	5	33
Slow pace transition	7	22	3	32
Uncertain or imprecise property rights	9	18	4	31
Undervalued local currency	8	18	2	28
Political uncertainty	8	17	2	27
Custom tariffs and policy constraint	2	16	6	24
Cultural considerations constraint	2	16	5	23
Technological backwardness	2	9	2	13
High foreign indebtedness	2	6	2	10
Overvalued local currency	2	5	0	7

Source: Pitelis et al., 2000

Bureaucracy and administrative constraints are at the top for all three categories. On the whole, it emerges that general uncertainties of rules are perceived as the most discouraging factors, as shown by the high scores attached to business infrastructure, legislative and economic climate constraints in all three categories. Cultural considerations are again perceived as relatively more important for local suppliers and distributors, as well as custom tariffs, while technological backwardness, foreign indebtedness and local currency strength seem not to be so influential (p.12).

> *Finally, Table 5** [in Pitelis et al., 2000] *presents the three categories of control mode of Greek FDI, associated with the type of investment, the host country and the industry in which the MNE operates. As emerges from the table, half of the investments in our sample are joint ventures, followed by wholly owned (usually greenfield rather than based on acquisitions) and then FDI in licensing-franchising. In the case of both Bulgaria and Romania, the form of participation in the investment preferred by Greek parents was the establishment of an entirely new firm through joint venture, the share of foreign investor, although not always specified, being usually of majority stake (p.13).*
>
> [*Table 5: wholly owned= 12 in Romania and 14 in Bulgaria. Joint ventures= 25 in Romania and 17 in Bulgaria. Licensing/franchising= 9 in Romania and 8 in Bulgaria].

In another questionnaire survey, **Pye (1998)**[11] considered a sample survey of investment from the major European and North American countries into the Czech Republic, Hungary, Poland, Romania and Slovakia between 1989 and 1996 (334 firms). The results showed that the primary motive in 34 per cent of the sample was the size of the market, together with the growth potential and maintaining market share. Strategic motives, which include serving regional and EU markets, were listed second. Pye (1998) also found that financial efficiency factors account for 10 per cent of the secondary motives of investors. In the Czech Republic and Slovakia, labour cost advantages were considered the most important factors, along with overall stability, profitability and local market access. Elsewhere, labour cost advantage was viewed as less important than market access. The attraction of a skilled labour force was found to be of significant value only in Slovakia. Pye (1998) confirmed earlier findings that export oriented firms are in the minority of firms surveyed. Those that did exist were geared towards supplying neighboring CEECs. Pye (1998) also discovered that overall stability of the host country for investment is thought to be somewhat important, especially in the Czech Republic. He found that strategic advantages are particularly valuable in Romania and Poland and that acquisitions have dominated greenfield investment in Poland, Hungary and the Czech Republic[12]. However, the share of greenfield investment has increased significantly in Hungary, now that the privatisation process is complete. This strongly suggests that the privatisation process has played a decisive role in the majority of foreign investments, even if it is considered insignificant by certain managers interviewed in the surveys. If the firms surveyed were actually dominated by greenfield investments, this indicates that the sample was not representative of the real population of foreign investors.

Altzinger (1999)[13], in a survey of 150 Austrian firms investing in CEECs, found that market potential was the primary motive for investors. It is especially important for investors in finance and insurance, construction and food and beverages. He also discovered that Austrian

investors, with the exception of the engineering sector, view low wage costs as significant, but to a lesser degree than market potential. Labour costs were of particularly low importance to investors in finance and insurance. The creation of an export base was significant to Austrian investors in Central Europe, especially in the food and beverages sector. Nonetheless, 83 per cent of output in this sector was sold locally in 1995.Altzinger concluded that proximity to Austria is important to Austrian investors, especially in the finance and insurance sector, partly due to historical and cultural ties.

A survey conducted by **Southeast European Cooperative Initiative (SECI)**[14] in 1998, revealed that Greek companies show a preference for Bulgaria, Romania and the former Yugoslav Republic of Macedonia, because of their geographical and cultural proximity, their common religious beliefs, existing trade relations and lack of other significant western investment interest. At the same time they consider these three countries and the Balkans in general, as an initial investment opening with a view to later expansion via these nations into Russia and the Black Sea states. Moreover, the most significant disincentive to development in all the countries under examination proved to be political and economic instability.

The basic conclusions, which can be drawn from SECI survey, are summarized below:

- All disincentives are rated on a scale from less restrictive to most restrictive.
- The most significant disincentive to development in all the countries under examination was found to be ***political and economic instability***. More specifically:

Table C: The most important disincentives according to SECI research

Disincentive	Average rating	Country
1. Political and economic instability	8,03	Albania, Moldova, Yugoslavia, Romania, Russia
2. Crime - lack of transparency - corruption	7,14	Bosnia and Herzegovina, Bulgaria, Hungary
3. Deficient infrastructure	6,93	Croatia, Slovenia
4. Insufficient legal and administrative framework	6,89	The former Yugoslav Republic of Macedonia
5. Inadequate policy towards foreign investments (Bureaucracy, difficulties in land ownership)	6,37	
6. Negative business environment (non-existent financial and banking systems, the Black market)	5,19	

Source: SECI, 1999

Lastly, in April 1998, **KPMG** International (a consultant company)[15] initiated a survey of the foreign investors in Bulgaria in order to identify key factors such as major incentives and barriers to foreign investment, present business opportunities and further investment considerations. The skilled labour force has been one of the driving considerations for more than a third (36%), followed by low labour cost (34%), former business contacts (34%), strategic geographic location (31%), good local market 29%, proximity to home operations 9% and tax incentives with only 2%. Moreover, 37% of the surveyed companies indicated that green-field investment was the most common form of foreign investment. 23% of the investors have chosen to use local expertise and know – how in the form of joint ventures. Another 23% have participated in the government's privatisation program and another 17% have acquired private businesses. Nearly half of the investors (47%) have pointed to the customer base in the region. The majority of foreign investors (84%) have pointed out that the incoherent and unstable legal system was one of the most serious problems for their operations, followed by bureaucracy with 80%, limited purchasing power with 71%. Next came excessive taxation 57%, lack of infrastructure 55%, high investment risk with 32% and crime and corruption with 8%.

In general, the conclusion from the above literature review is that all these surveys are considering a questionnaire (sample) survey in more than one country (except the KPMG research) having interviewed sample of answers ranged from 334 MNEs in 5 countries, 212 MNEs in 5 countries, 162 MNEs in 4 countries, 150 MNEs in the most Central European Countries, 117 MNEs in 4 countries, 92 in 10 countries, 76 MNEs in 2 countries, up to less than 70 MNEs in Bulgaria. All these surveys have a sample size bigger than ours, however all those except one conducted in more than two countries each one. Our sample size consisted of 64 MNEs which were in the top 120 ranking places according to the Bulgarian Foreign Investment Agency (BFIA) due to their significant investment volume in US$. Moreover, from the above studies only one survey was considered specifically Bulgaria as a country case study and another two were partially considered Bulgaria. Moreover, when a survey was conducted in more than one country simultaneously, you have the limitations mentioned above by Benacek et al. Nonetheless, from the presentation of these surveys useful conclusions can be drawn especially from the comparison of the outcomes of those surveys with the results of our survey.

According to the literature review (table 1a), paying attention to similar works, having a sample country, Bulgaria, we can conclude to the following: we can argue that the well-known international consultant company, KPMG ran a survey with an answered sample of around 70 MNEs (same sample size with our research). This sample was not significant due to the following limitations: around 50% of the total sample had invested less than 1 million USD$ (non important investments according to the official BFIA catalogue), and only 50 companies out of the 200 asked (population), were also from the official BFIA catalogue. The proportion of the sectors that those companies belong to, was biased and did not capture the introduction of the currency board and the consequent Bulgarian political and macroeconomic stability.

Moreover, SECI conducted a survey in many Balkan countries in search only for investing barriers. The survey, though had an unclear sample (the selection of companies criteria was also unclear). Bulgaria was only one country out of ten surveyed countries and only 92 companies participated in the whole research. However, one of the surveys conclusions regarding corruption, crime and mafia which rank high as an investing obstacle for the case of Bulgaria, is also in accordance with our survey results but in contrast with KPMG research results in which corruption has not been considered as an important one (only 8%).

Finally, Pitelis et al.'s survey has considered 39 FDI projects, which have been undertaken in Bulgaria. At the same time 85 Greek FDI projects had been undertaken in both Romania and Bulgaria (85 FDI projects from 76 MNEs). Although the sample, the selection of the sample and the proportion of MNEs participating in the Bulgarian economy are unclear and maybe biased, on the other hand we can say that most of the results are in accordance with our results. Moreover, Pitelis et. al. took into account only the Greek FDI outflows in Bulgaria and thus the incentives for Greek entrepreneurs only were determined. In the present research, we have considered and pinpointed the incentives and barriers for 64 large MNEs from several countries which have invested in Bulgaria.

Table 1a: Determination of FDI inflows according to the literature review; Survey based approach

	SURVEYS		**INCENTIVES**	**BARRIERS**
1	Benacek V., et al., (2000) «... The findings of econometric studies tend to support survey results »		**GENERAL FINDINGS** • market size • growth potential • factor cost advantages • Macroeconomic and political stability	**THIS IS A LITERATURE REVIEW**
2	Klaus E. Meyer (1995, 96)	Czech Republic, Hungary, Poland, Romania, Russia	• The local market (the size) • factor cost orientation (low cost) • geographical proximity • purchasing power of consumer • qualified labour force • political and economic stability	

			• lack of local competitors	
3	Arthur Andersen (OECD, 1994)	Poland, CIS, Hungary, Czech Republic	• access to large domestic market, • market share, • market potential, • low cost production, • source of raw materials, • geographic proximity • strong historical links • geographical location • following the clients theory	• bureaucratic or administrating issues, • legislative issues, • economic climate, • business infrastructure, • political volatility • cultural considerations
4	Hans-Peter Lankes and A.J. Venables (1997)	Poland, Slovakia, Slovenia, Hungary, Czech Republic	• the local market size • political stability • natural resources • stability of macroeconomic policy • the regulatory environment • the access to other markets • geographical closeness (proximity) • skilled labour costs • unskilled labour costs • Geographical closeness to the EU	
5	Simona Iammarino and Christos Pitelis (2000)	Romania, Bulgaria	• Expected economic growth • Geographical location • Investment incentives • Labour costs • Increase in domestic market share • Increase in regional market share • Proximity to the EU market • Source of raw materials • Cultural similarities	• Bureaucracy/administrative constraint • Business infrastructure constraint • Legislative constraint • General economic climate constraint • Incoherent and unstable legal system • High investment risk • Slow pace transition • Uncertain or imprecise property rights • Undervalued local currency • Political uncertainty
6	Pye (1998)	Poland, Slovakia, Hungary, Czech Republic, Romania	• the size of the market, • the growth potential, • maintaining market share, • labour cost advantages • overall stability, • profitability and local market access • serving regional and EU markets, • skilled labour force • supplying neighboring CEECs • Privatisation process	
7	Altzinger (1999)	Central Europe	• market potential • wage costs • Creation of an export base • Geographical proximity • historical and cultural ties	
8	KPMG International (1998)	Bulgaria	• skilled labour force • low labour cost • former business contacts strategic geographic location good local market • proximity to home operations • tax incentives	• incoherent and unstable legal system, • bureaucracy, • limited purchasing power • excessive taxation, • lack of infrastructure • high investment risk, • crime and corruption
9	Southeast European Cooperative Initiative (SECI) (1998)	Balkan Region		• Political and economic instability • Crime - lack of transparency – corruption • Deficient infrastructure • Insufficient legal and administrative framework • Inadequate policy towards foreign investments (Bureaucracy, Difficulties in land ownership) • Negative business environment (Inexistent financial and banking systems, Black market)
10	Bitzenis, A. (1999)	Bulgaria	• market size, • low labor cost of unskilled workers, • geographical proximity, • international pressures from competition, • prospects for market growth, • link to other neighboring countries, • lack of local competition	• unstable legal system, • bureaucracy, • corruption, crime and mafia • high investment risk • limited purchase power • lack of infrastructure • macroeconomic

				Instability

Source: Bitzenis, A, 2003

3.2 Description of how survey was designed to test importance of these incentives

3.2.1 Choosing the sample and constructing the questionnaire

As mentioned in the introduction of this thesis, a questionnaire was designed to extract valuable information regarding the determinants of FDI in Bulgaria during the post-communist period 1989-1999. Its purpose was to identify the type of incentives and entry barriers for inward foreign direct investment considered by foreign MNEs in order to establish whether they should make an investment or not in Bulgaria. From an official document that had been collected from the BFIA, a list with 110 foreign companies was found. This list contains the enterprises that according to the BFIA, had invested over one million US$ dollars (each MNE) in Bulgaria until the middle of June 1998 (Those 64 companies are still in the top 120 biggest foreign investors according to the BFIA catalogue, Jan 2003). The total invested capital from these enterprises amounted to around 50% of the total volume of foreign investments in Bulgaria at that time (more than 65%, end 2002).

According to the existing literature, there has been no other statistically analysed research for Bulgaria with such a magnitude (64 companies have been interviewed and answered a questionnaire) and statistical significant sample, in order to identify the incentives and barriers for the FDI decisions in Bulgaria. Other surveys tried to determine incentives and barriers for more than one country simultaneously with less than 64 MNEs as a sample for one specific country.

The sample is very representative since it is comprised of companies which invested a very significant amount of US $ for the economic magnitude of the Bulgarian Economy and as a percentage of the total Bulgarian FDI inflows. Moreover, the sample is also representative because the answers[16], collected and analyzed, belonged almost proportionally to the sectors of industry, services and trade [see endnotes for more details [17]].

Among the 64 companies 37 were of Greek origin. The reason that 37 companies seem to be of Greek origin is because firstly we have considered the offshore companies with approved

Greek interest as Greek (i.e. Cyprus or Luxembourg based offshore companies). Secondly, we have also considered as Greek investments the joint ventures or consortiums with approved significant Greek participation (i.e. Alico/CEH that bought Postbank, the management and 43% of the total shares belong to the Greek Eurobank and the remaining shares to the American Insurance Group (AIG) and its subsidiary ALICO). Eight out of the 37 above-mentioned companies were of this type[18].

The managers of MNEs, who were interviewed, were asked to mention any number of incentives, which they thought to be crucial to their company in their decision for undertaking an FDI project in Bulgaria. Therefore, the sum of the percentages of the results, found in Figures 1-4 is not equal to 100%.

3.2.2 Research Methodology of the Statistical analysis of the questionnaire survey

The statistical analysis establishes possible relations between the variables for the 64 questioned companies. The nature of the relation between the variables, if any, was investigated with the chi-square statistic, which is regarded the most suitable for this kind of data. Instead of using a statistic method like correlation coefficients, which requires data collected in a continuous form, the chi-square test allows to make inferences for the population of interest, in this case foreign investors in Bulgaria, by making use of the categorical data. The results are valid in most of the cases at 0.01, 0.05 and 0.1 levels of significance and the inferences about the population were based on the results of the p-value.

As mentioned in the general introduction of this thesis the author decided after collecting and examining the results for the questionnaire survey to move one more step in his empirical research and to run a statistical analysis. His purpose was not only to determine the general incentives and barriers for the Bulgarian FDI inflows during the period in question, but also to determine IF the ranking of the incentives and barriers is different when dividing the 64 MNEs into 3 groups of sector. Finally, the author tried to explore and determine IF the ranking of the incentives and barriers is different when dividing the 64 MNEs into 2 groups according to their origin (for more see introductory chapter of this thesis). The results from this statistical analysis underpin the author's expectations and in other words the ranking was different when considering all the 64 MNEs and then dividing them according to the origin and according to

the sector that each one belongs to. To statistically testify all the above, the author used the well-known CHI-SQUARE test, which is an appropriate method for testing associations between variables such as incentives and origin of MNE, groups of sector and incentives, barriers and origin of MNE and barriers and groups of sector of MNEs.

3.2.3 Conclusions derived from the descriptive questionnaire analysis

- The survey lasted 18 months (time period January 98 – June 99), but most of the questionnaires were completed in the period Jan '99-June '99. The total invested amount for the 110 foreign companies was 1,283,419,173 USD$ and for the 21 was 47,6 million USD$. The statistical sample with 64 companies consists of a total investment amount equals to 863 million USD$, which is the 64.7% of the total investments of these 131 companies or the 50.7% of the total Bulgarian FDI inflows. (BFIA catalogue, Foreign Direct Investments over 1 million USD$ (as of 30 June 1998))
- Only 9 companies out of 64 participated in the questionnaire have invested for the first time, after the end of 1997, and the questionnaires were completed only one year after the introduction of the currency board.
- The usual way of replying questionnaires [table 2a], the post way, in any research study, failed (i.e. only 4.7% of the companies replied with this way). So, it seems that the best replying rate came from one to one interviews (35,9% of the total response rate following by e-mail or www with 29.7%). The fax and telephone methods had success in about 30% together. Due to the above bad response rate by post (despite the fact that the questionnaire was sent to all the companies) and the possibility of failing collecting the sufficient data, it was decided a multiple approach of the target group by putting some pressure with various methods of contacting and getting their attention.
- In the first 6 months the author completed questionnaire design, and has taken decisions on the source of data, literature review, theory study, other published articles – empirical studies, methodology (statistical analysis, target group, sample size, way of approaching the target group, financial sources for completing the study, scheduling timetable etc.)
- The reason that 37 companies seem to be of Greek origin is because as Greek have been also considered those that appear as offshore companies (i.e. Cyprus or

Luxembourg based) but with approved Greek interest, and those that appear as joint-ventures or consortiums (i.e. Alico/CEH that bought Postbank, the management and 43% of the shares belongs to the Greek Eurobank) - 8 of 37 companies were of this type.

- The BFIA table helped the author to decide the minimum amount invested by each company in order to be considered in the analysis, having as a result a sufficient number of observations in the population for the purpose of this study.
- However, it is possible that the author was not able to find all the investments over 1 million (or because of the lack of formal government statistics). Thus, if the author has not included in this study a number of important investments (over 1 million), this should be the statistical error and should be added to the statistical error caused by the non-replied questionnaires and this might cause some misleading results.
- Whilst the researcher of this questionnaire is of Greek origin the high rate of responses and the high percentage of Greek answers in the final results were expected.

Table 2a: Author's questionnaire research's properties

AUTHOR'S QUESTIONNAIRE RESEARCH'S PROPERTIES			
Mid 1998 (sample)	**Mid 1998 (Population)**	**End 2000 (sample)**	**End 2000 (Population)**
1.283.419.173 USD$ [**BFIA catalogue** → 110 companies (75% of the total FDI inflows in Bulgaria)]	TOTAL FDI INFLOWS in BULGARIA USD$ 1.7 billion	USD$ 3280,2 million (**BFIA catalogue** → 150 companies (82% of the total FDI inflows in Bulgaria)	TOTAL FDI INFLOWS in BULGARIA USD$ 4 billion
110 companies → BFIA catalogue		150 companies → BFIA catalogue	
110 + 21 = 131 companies → **Extended catalogue**	*21 were excluded from the BFIA catalogue in the year 1998*	150 + 16 = 166 companies → **Extended catalogue**	*5 companies, which were excluded in the BFIA catalogue in mid 1998, were included in the BFIA catalogue in the year 2000*
131 companies → 1,333 billion USD$ (75% of the TOTAL FDI)		131 companies → 2.320 billion USD$ (an increase of 74%)	
		166 companies → 3,330 billion USD$ (83% of the TOTAL FDI)	
RESULTS FROM THE AUTHOR'S QUESTIONNAIRE RESEARCH			
64 companies of the questionnaire → mid 1998	863 million USD$ have been invested by those 64 companies → mid 1998		64 companies → 1,896 billion USD$ (an increase of 120%) → end 2000
AVERAGE amount of investment = USD$ 14 million (13 companies above the average)		AVERAGE amount of investment = USD$ 29.6 million (15 companies above the average)	
Response rate			
863 / 1333 = **64.7%** of the POPULATION (extended BFIA catalogue)	863 / 1700 = **50.7%** of the TOTAL FDI INFLOWS	1896 / 3330 = **56.9%** of the POPULATION (extended BFIA catalogue)	1896 / 4000 = **47.4%** of the TOTAL FDI INFLOWS
The **first 30 companies** in the BFIA catalogue (mid 1998) have invested 981 million USD$, 74% of the		The first **30 companies** in the BFIA catalogue (end 2000) have invested 2,517 billion USD$, 76% of the	

total (BFIA catalogue)		total (BFIA catalogue)	
The **first 50 companies** in the BFIA catalogue (mid 1998) have invested 1131 million USD$, 88% of the total (BFIA catalogue)	27/50 companies (54%), which participated in the questionnaire analysis were among the top 50 in invested volume of the BFIA catalogue → in mid 1998	The **first 50 companies** in the BFIA catalogue (end 2000) have invested 2,852 billion USD$, 87% of the total (BFIA catalogue)	30/50 companies (60%) participated in the questionnaire analysis were among the top 50 in invested volume of the BFIA catalogue → in the end of 2000
Significant investments of Greek interest			
The volume of Investments of Greek interest (that participated in the questionnaire analysis → [37/64 = 57%]) was 265 million USD$ according to the extended BFIA catalogue → mid 1998 (20% of the SAMPLE (265/1330)) and 265/863 = 30% of the 64 interviewed companies.		The volume of Investments of Greek interest (that participated in the questionnaire analysis → [37/64 = 57%]) was 534 million USD$ according to the extended BFIA catalogue → end 2000 (16% of the SAMPLE (534/3330)) and 534/1896 = 28% of the 64 interviewed companies.	

Source: Author's Questionnaire research

* In this table there are some elements of the questionnaire analysis and a few reasons that led the author to the conclusion that the analysis was based on a representative sample and on a high response rate.

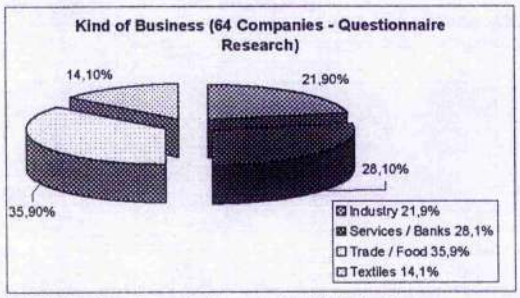
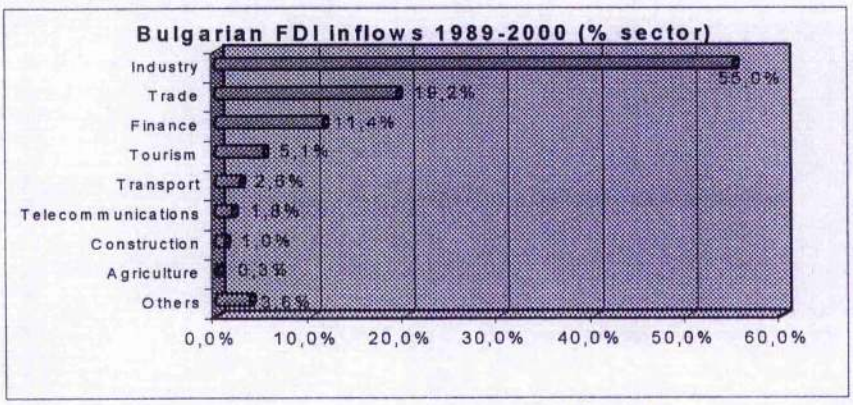


FIGURE 1a: Questionnaire Survey – 64 MNEs by Sector

Source: Author's Questionnaire Research

The sample of the questionnaire analysis is **also representative**, because the answers (see figures 1a and 1b), which have been collected and analyzed, belonged almost proportionally to the sectors of industry, services, trade. Moreover, from the survey the services sector accounts 28% and the FDI inflows in Bulgaria in the same sector were 18%(Finance 11,4% + Tourism 5,1% + Telecommunications 1,8% =18.3%). Trade in the survey accounts 36% and the FDI inflows in Bulgaria in the same sector were 19,2%. Finally, the answers from the industrial sector were 22% and textiles 14% (total 36%) and at the same time the FDI inflows in Bulgaria in the industrial sector were 55% of the total.

FIGURE 1b: Bulgarian FDI inflows (by each sector)



Source: BFIA Catalogue

3.2.4 Construction of the questionnaire

The questionnaire used in the research study consisted of three parts. In the first part, the questions provided necessary background information on certain issues that were considered important in characterising the sample population. In the second part, one question included seven groups of sub-questions with related factors that were considered to be of major importance and allowed the managers of the enterprises to select the most appropriate for their case. These groups of sub-questions were initially selected based on Dunning's theory, but necessary amendments were made during the research period of eighteen months (the research was started in January 1998, six months were needed for the construction of the questionnaire, studying the theories and deciding the way of contacting the companies and creating the sample. Twelve months were needed for the interviews and the statistical analysis of the results of the questionnaires). Similarly, part three contained only one question with a group of factors that describe the barriers discouraging the firms to invest in Bulgaria. More specifically, in the first part there are questions searching for some general characteristics of the company, such as the sector that the company belongs to, the year of investment, the amount of investment, the home country of an MNE, entry mode etc. In the second part there is the theoretical part of the questionnaire survey. In this second part, seven groups of hunters (seekers) have been created: Locational hunters (historical links, cultural closeness or distance, geographical proximity, stability, climate etc.), factor hunters or natural resource hunters (access to low cost of acquiring natural resources and raw materials - p. 13 "the eclectic paradigm of international production: a restatement and some possible extensions", John H. Dunning, Journal of International Business Studies, Spring 1988), market hunters (size of the market, prospects for market growth, increasing market share), strategic market hunters (follow the competition, follow the clients, a way to survive, acquiring of assets, international pressures, globalisation etc.), efficiency hunters (economies of scale, of scope, risk diversification), exploiting the ownership advantages (brand name, know-how, past experience, existing business links etc.), hunter of financial aspects (favourable investment law framework, subsidies, tax exemptions). In the third part, there are twenty entry barriers (instability, bureaucracy, corruption, unstable legal system, etc.) The construction of the questionnaire was based on the Dunning's theory [the eclectic theory (OLI – eclectic paradigm of international production)]. According to Dunning we have: Locational (L) (natural resources availability and cost, investment incentives, characteristics of the country –

language, culture...), Internalisation (I) (avoid costs, control supplies, avoid or exploit government intervention), and Ownership advantages (O) (intangible asset advantages, product innovations, know how, multinationality). Dunning has also define natural resource seeking (vertical integration, availability, cost), market seeking (market size and characteristics, investment incentives, p.82 Multinational Enterprises and the Global Economy, John, H. Dunning, 1993, chapter 4), efficiency seeking (economies of scale and scope, risk reduction through product diversification – p.13 "The eclectic paradigm of international production: a restatement and some possible extensions", John H. Dunning, Journal of International Business Studies, Spring 1988) and strategic asset seeking (gain new product lines or markets, economies of synergy, economies of common governance, improved competitive or strategic advantage, reduce or spread risks- p.82 Multinational Enterprises and the Global Economy, John, H. Dunning, 1993, chapter 4). At this point it is worth saying that the researcher spent a lot of time explaining to all the interviewers the questionnaire's questions and the questionnaires were completed with the presence of the researcher.

3.3 Potential incentives and barriers for FDI in Bulgaria

3.3.1 Overview of aggregate data on FDI in Bulgaria

3.3.1.1 FDI Progress in Bulgaria

The cumulative value of all foreign direct investment flows in Bulgaria reached 4.8 billion USD at the end of 2002. About 80% of them have been generated during the period 1997-2001. The FDIs through green-field, joint ventures (JVs), reinvestments and additional investments in acquired enterprises exceed the FDIs through privatization, which had been the main source in 1997. Bulgaria 'lost its chance' in the period 1992-1996, when the developed countries extensively invested in the Czech Republic, Hungary, Poland, Slovakia and Slovenia (BFIA, 2002)(see Table 3a).

TABLE 3A: FOREIGN DIRECT INVESTMENT INFLOWS IN BULGARIA BY YEARS

YEAR	VOLUME IN $USD million			NUMBER
	Privatization	Non-privatization	Total by years	
1992		34.4	34.4	1715
1993	22	80.4	102.4	3052
1994	134.2	76.7	210.9	4269
1995	26	136.6	162.6	5646
1996	76.4	180	256.4	6168
1997	421.4	214.8	636.2	5503

1998	155.8	464.2	620.0	6226
1999	226.7	592.1	818.8	4845
2000	366	635.5	1001.5	5153
2001	19.2	675.0	694.2	9089
Jan-Sept 2002	62.7	251.0	313.7	
Total	1510.4	3306.3	4816.7	51666

Source: BFIA 2003, *"Non-privatization"* - Greenfield investment + Additional investment in companies with foreign participation + Reinvestment + Joint ventures

The top investor in Bulgaria is Greece followed by Germany, Italy and Belgium. Other major investors include the USA, Austria, Cyprus, Russia, the Netherlands and the UK (see Table 4a).

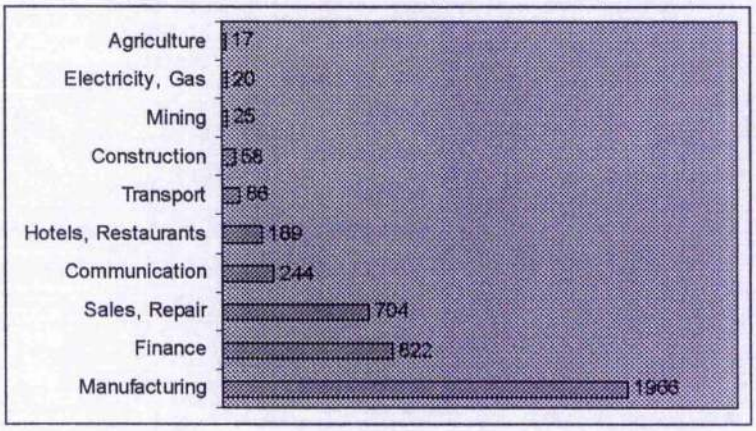
Table 4a: FOREIGN DIRECT INVESTMENT INFLOWS IN BULGARIA BY EACH COUNTRY BY YEARS In USD$

Nr.	Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Jan-June 2002	Total by countries
1	GREECE	0.2	5.1	3	29.8	14.6	16.1	3.3	14.9	241.1	213.6	78.2	619.9
2	GERMANY	0.1	56.6	111	16.2	53.1	31.4	55.7	101	72.3	65.1	23.0	586.2
3	ITALY	0	0.2	5.2	2.3	1.2	0.4	2.1	23	339.7	77.3	13.9	465.3
4	BELGIUM	0	0.1	0.3	10	0.8	264	31.2	66.2	39.8	3.1	0.6	416.5
5	AUSTRIA	13	1	14.7	1.4	12.1	12.5	46.9	23.4	88.8	137.4	8.6	359.8
6	USA	0	10.5	16.2	16.1	20.7	46.6	38.6	49.8	37.1	41.4	8.4	285.4
7	CYPRUS	0.3	1.2	0.4	1.4	7.5	20.6	109	109	-11.3	29.1	6.1	273.3
8	RUSSIA	0.3	1.4	2.3	15.1	14.4	2	14.8	104	50.8	0.5	0.1	205.4
9	NETHERLANDS	0.1	0.5	37.9	0.9	46.3	10.8	41.3	28	17.4	21.6	-6.3	198.5
10	UK	6.2	5.6	2.4	13.7	7.3	15.8	58.9	48	22.6	15.5	-0.8	195.2
11	TURKEY	0	9.8	1.3	13.7	7.3	9.9	23.8	39.4	19.5	3.8	7.5	136.0
12	SPAIN	0	0.1	0	0	0	49.6	56.8	3.2	0.7	19.4	-0.5	129.3
13	SWITZERLAND	0.4	6.7	0.2	7.9	23.1	31.4	6.6	13.1	15	1.5	16.8	122.7
14	FRANCE	0	0.2	4.2	5	6.5	0.8	3.4	62.7	28.9	12	-1.6	122.1
15	CZECH REP	0	0	0.1	2.3	2.3	4.7	0.6	0.1	0	0.4	50.2	60.7
16	LUXEMBURG	0.4	0.6	0.6	0.4	0.2	11.8	22.7	3.8	0	17.1	0.7	58.3
17	SWEDEN	0	0	0	0	1.4	2.4	0.9	1.6	0.3	3.7	15.6	25.9
18	IRELAND	0	0	0	17.4	0.2	5.2	1	3.7	1	-5.5	2.3	25.3
19	HUNGARY	12.3	0.1	0	0	0.1	0	0.7	1.7	2	1.9	1.5	20.3
20	ISRAEL	0	0	0.9	0	1.5	0	0	13.8	1.9	-0.6	1.1	18.6
21	KOREA	0	0	0.3	0.2	22.3	22.9	1.8	2.8	6.6	2.9	-41.5	18.3
22	LIECHTENSTEIN	0	1.1	0.1	0	0	2.5	0.8	1.3	3	3.2	1.5	13.5
23	JAPAN	0	0	0.1	0.5	0.6	1.9	1.9	0	1.3	2.8	4.0	13.1
24	MALTA	0	0	0	0.1	0.1	0.1	8.9	0	0.5	1.5	0.3	11.5
25	DENMARK	0	0	1.1	0	0	1.1	1.6	0.3	1.3	0.4	0.2	6.0

Source: Bulgarian Foreign Investment Agency, 2003

The European Union is the major source of FDIs for Bulgaria with over 60% of the total. FDI distribution by sectors shows the major role of industry (around 50% of the total), followed by finance (20%), trade (over 15%), tourism (around 5%), infrastructure and construction (5%) (see FIGURE 1C).

Figure 1c: Bulgarian Foreign direct investment stock by sectors in USD m (1992-2001)



Source: Bulgarian Foreign Investment Agency, 2002

By the end of the year 2002, around 60% of the long-term assets of the state owned enterprises were transferred into private hands (BFIA), 2001). Privatization in the banking sector is close to its completion with only two state-banks still operating on the market. About 99% of the agricultural lands have been restituted to their former owners.

In the years 1998-2001, the amount of FDI inflows was more than 3000 million US$ while in the first six transition years it was less than 1400 million US$. 32% of the total FDI inflows (1510/4816) were derived from the privatisation deals when at the same time less than 5% of the total FDI inflows were acquisitions of shares through the stock market. 55% of the total FDI inflows were conducted in the industrial sector, followed by the trade sector with 19.2% and the financial sector with 11.4% (see Tables 3a, 4a and Figure 1c).

In Table 4a, although Greece appears in the 1st position, this accumulated data does not include the Greek investments and the Greek entrepreneurs which used offshore companies from Cyprus and Luxembourg in order to invest in Bulgaria.

From Table 3a (last column), we can argue that there was a continuous yearly increase in the number of MNEs that entered the Bulgarian market (FDI projects) during the transition years with an exemption of the year 1999. The peak number was in 2001 with 9000 FDI projects when at the same time in 1992 it had been only 1700.

Finally, from Table 5a we can conclude that the majority of FDI inflows in Bulgaria have been accumulated in the capital of Bulgaria, Sofia. From the total 4531.7 million USD an amount of

$2166.83 has been invested (around 48% of the total) in Sofia, followed by Varna with only 418.35 millions USD.

Table 5a: FOREIGN DIRECT INVESTMENT INFLOWS BIGGEST DESTINATIONS IN USD$ (IN BULGARIAN REGIONS YEARLY)

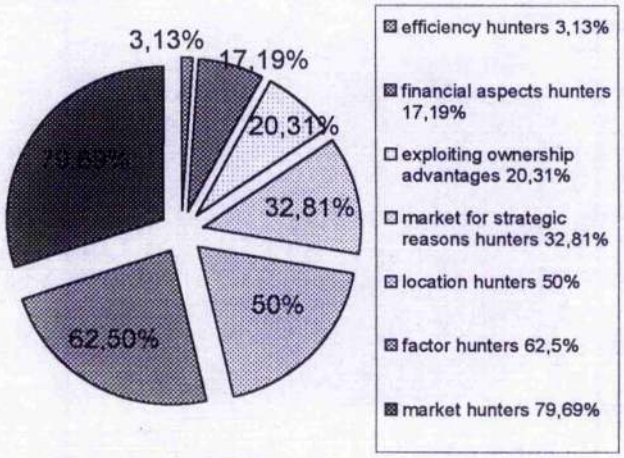
N	Region	1992	1993	1994	1995	1996	1997
1.	Sofia	26.96	81.54	183.07	59.08	101.98	130.37
2.	Varna	0.16	2.39	1.51	0.72	8.58	214.12
			1998	1999	2000	2001	Total
1.	Sofia		316.11	267.02	651.76	348.95	2166.83
2.	Varna		57.12	46.85	75.80	11.09	418.35

Source: Bulgarian Foreign Investment Agency 2002

3.3.2 General Results from a questionnaire survey for foreign MNEs

In order to determine the incentives and barriers of inward FDI in Bulgaria and to divide them into several groups according to the FDI theory (Dunning Eclectic Theory), a research was run using a questionnaire and the results were analyzed and studied with the help of statistics.

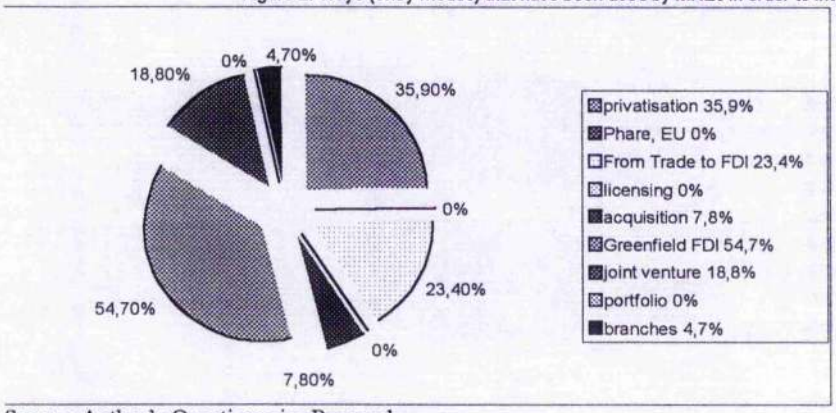
Figure 1. Groups of incentives (hunters)



Source: Author's Questionnaire Research

According to the above figure, foreign investors have proved to be market hunters with a percentage of 80%, followed by factor hunters with 62%, locational hunters with 50% and strategic market hunters with 33%. At the same time 20% have invested in Bulgaria in order to exploit their ownership advantages and 18% to exploit financial advantages. Only 3% of the investors were efficiency hunters. Thus, one can infer that in a country such as Bulgaria having a customer base of eight million people with many unsatisfied needs, foreign investors focus primarily on the characteristics of the market.

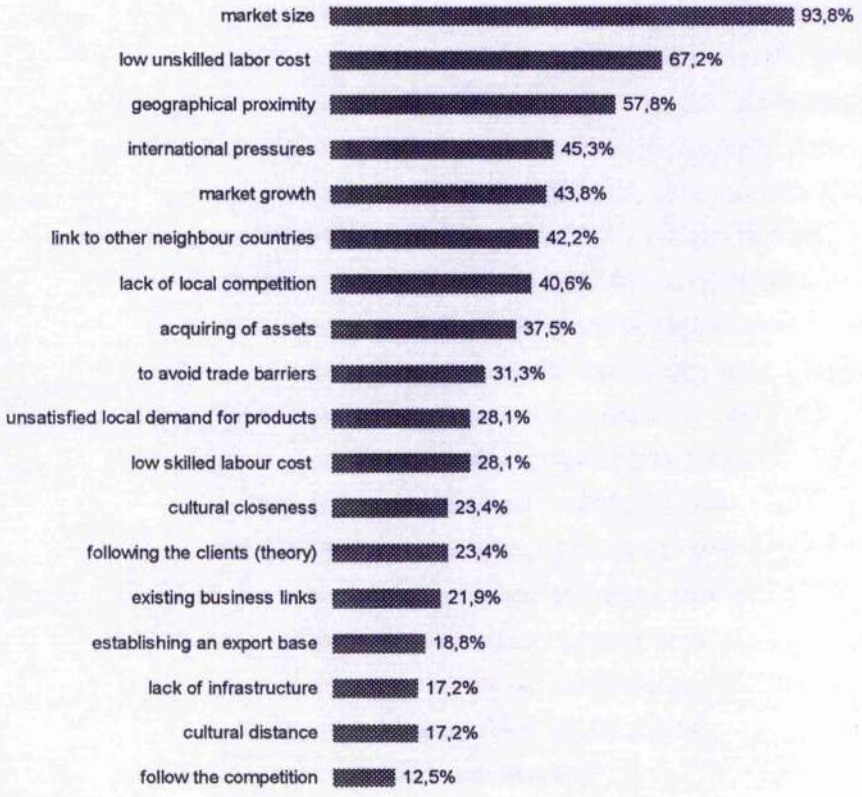
Figure 2. Ways (entry modes) that have been used by MNEs in order to invest in Bulgaria



Source: Author's Questionnaire Research

Regarding the entry mode of MNEs in the Bulgarian market, the author's research has revealed that 55% of the sixty-four foreign investors have chosen as a best or preferable way for their FDI projects the green-field way, followed by 36% of the investors, which took advantage of the opportunities that the Bulgarian privatisation programs offered and 18,8% of MNEs, which created joint ventures (Figure 2). Although it is well – known that joint ventures was the most preferable way of foreign entry in the ex-communist countries in the early years of their transition, this low percentage of joint ventures can be explained from the fact that the survey took place in the time period 1998-1999. At that time, most of the joint ventures which had been created in the early years of transition, had collapsed either due to insufficient cooperation of the local partners with foreigners or due to the acquisition of the remaining shares by foreign investors. Later establishments of FDI projects in the Bulgarian market followed other forms of foreign entry such as the greenfield FDI or acquisitions through privatisation programs, either because there was not the same lack of knowledge regarding the sluggish Bulgarian economic environment as it had existed at the beginning of the transition or due to the registered failure of many joint ventures.

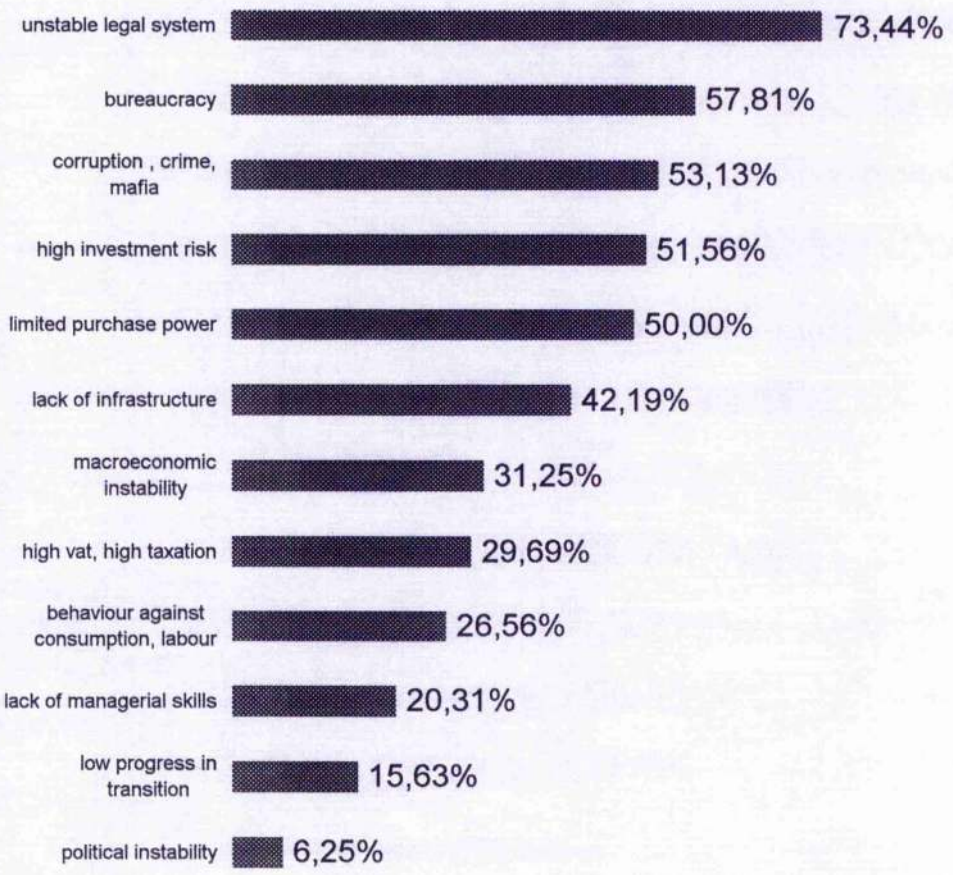
Figure 3. The Most Important Incentives for FDI in Bulgaria (Research from 64 MNEs)



Source: Author's Questionnaire Research

From Figure 3, it can be pointed out that the main incentives (as expected) were: market size (94%), low labor cost of unskilled workers (67%), geographical proximity (58%), international pressures from competition (45%), prospects for market growth (44%), link to other neighboring countries (42%), and lack of local competition (40%).

Figure 4. The most important barriers, obstacles or disincentives for Bulgarian FDI inflows (Research from 64 MNEs)



Source: Author's Questionnaire Research

The primary barriers that the investors had to deal with, in the Bulgarian market, are shown in Figure 4. The biggest obstacle was the unstable legal system in Bulgaria (74%), followed by bureaucracy (58%), corruption, crime and mafia (53%) and the high investment risk with 52%.

3.3.3 The most important incentives and barriers: an analysis

The main incentive for FDI inflows in Bulgaria was the **market size** with a high percentage of 94%. Although Bulgaria is not a big market such as France, Germany, etc, on the other hand, this high percentage was not a surprise for the author due to the following: firstly, 37 out of 64 interviewed companies were Greek, which in turn considered Bulgaria as an important market with a population of over 8,300,000 people (which is "another Greece" for them). Secondly, for companies such as Coca Cola, Kentucky Fried Chicken and McDonalds every country and

every market is significant and their policy is to participate in almost every country (market hunters – global companies) in the world (even in Bulgaria). Thirdly, it is significant for a large MNE from a western market to gain a large percentage of 50% - 80% of the Bulgarian market share when the same company owns a percentage of 10%-15% of the German market share. Fourthly, the majority of the 27 foreign (western) MNEs that participated in the questionnaire research have also considered Bulgaria as a link to other neighbor countries and especially to CIS countries (considering Bulgaria as a "bridge" for a future expansion into CIS countries or creating an export base to feed with products the neighbor markets). One can infer that in a country such as Bulgaria having a customer base of more than eight million people with many unsatisfied needs, foreign investors focus primarily on the characteristics of the market, taking into consideration simultaneously the prospects for growth of the Bulgarian market and the possibility of Bulgaria joining the EU during this decade. Lastly, foreign MNEs believe that there are extremely high similarities in the economic environment of the Balkan markets and when they choose one country from this region as a destination for an FDI outflow, then they proceed to the establishment of FDI projects in the most of the remaining Balkan countries. This has happened due to the similar characteristics, similar risks, incentives and barriers that exist in those markets. Thus, an MNE which has invested in a few Balkan countries, views an additional FDI project in Bulgaria as a subsequent investment and part of the general MNE's global strategic plan.

Table 23: Prospects for Market Growth as an incentive for FDI inflows

			Origin for MNEs		
			Greece	Europe & Other	Total
CX22	No	Count	26	10	36
		%	72,2%	27,8%	100,0%
		%	70,3%	37,0%	56,3%
	Yes	Count	11	17	28
		%	39,3%	60,7%	100,0%
		%	29,7%	63,0%	43,8%
Total		Count	37	27	64
		%	57,8%	42,2%	100,0%
		%	100,0%	100,0%	100,0%

From Table 23, we can argue that only 11/37 Greek MNEs (29,7%) invested in Bulgaria due to its **prospects for market growth**. On the other hand, 17/27 (63%) of other foreign MNEs investing in Bulgaria believed that one of the most important incentives were the Bulgarian prospects for market growth (CX22). Thus, it is obvious that the origin of MNEs played a significant role in the consideration of the prospects for Bulgarian market growth as an incentive for FDI. From a statistical point of view, we underpin the same, when the continuity correction (2X2 Table) was 0,017 and thus at a 5% level of significance we conclude that there is an association between the origin of MNEs and those prospects.

Table 25: As a Link to other neighbor countries as an incentive for FDI inflows

			Origin of MNEs		
			Greece	Europe & Other	Total
AX7	No	Count	17	20	37
		%	45,9%	54,1%	100,0%
		%	45,9%	74,1%	57,8%
	Yes	Count	20	7	27
		%	74,1%	25,9%	100,0%
		%	54,1%	25,9%	42,2%
Total		Count	37	27	64
		%	57,8%	42,2%	100,0%
		%	100,0%	100,0%	100,0%

From Table 25, we conclude that only 7/27 (25,9%) foreign MNEs (other than Greek) have considered as an incentive that **Bulgaria is a link (bridge) for its neighbor countries** (AX7). In contrast, 20/37 (54.1%) Greek MNEs, investing in Bulgaria mentioned that Bulgaria was a market with opportunities, and can be used as a first step of investment in order in a later time point to invest in other neighbor markets. Furthermore, Greek MNEs claim that they used Bulgaria as an investment base due to its strategic position, geographical proximity or even to exploit favorable trade agreements with neighbor countries. This is actually true when most of the significant Greek MNEs (3E/HBC, Intracom, Panafon, OTE/Cosmote, National Bank of Greece, Delta, Titan), participating in the Bulgarian market, have also invested in other neighbor countries such as FYROM, Yugoslavia, Albania, Romania and Moldavia, using Bulgaria as a first step in their foreign expansion strategy. Again, the origin of the MNEs played a decisive role and thus the Greek MNEs focused not only in Bulgaria as an investment destination, but also in the whole SE region. From a statistical point of view, we support our findings when the continuity correction (2X2 Table) was 0,046 and thus at a 5% level of significance we conclude that there is an association between the origin of MNEs and the incentive of using Bulgaria as a link with neighbor countries.

Table 17: Low cost of unskilled labour as an incentive for FDI inflows

			Origin of MNEs		
			Greece	Europe & Other	Total
BX16	No	Count	6	15	21
		%	28,6%	71,4%	100,0%
		%	16,2%	55,6%	32,8%
	Yes	Count	31	12	43
		%	72,1%	27,9%	100,0%
		%	83,8%	44,4%	67,2%
Total		Count	37	27	64
		%	57,8%	42,2%	100,0%
		%	100,0%	100,0%	100,0%

Looking at Table 17, we see that Greek MNEs significantly acknowledge that one of the most important incentives (31/37=83.8%) in their decision making of an FDI project in Bulgaria was the **low labour cost of unskilled workers** (BX16). At the same time, 12/27 (44.4%) of

other foreign MNEs took into account the above incentive as important. The extremely high percentage of the Greek MNEs can be explained from the fact that they were smaller in economic magnitude if we compare them with the remaining foreign MNEs. A few of them belong to the textiles sector which is labour intensive industry. Moreover, most of the Greek enterprises used Bulgaria as an export base (geographical proximity) either to re-export their products back to Greece or to export them to other neighbor countries (minimization of the production cost due to low labour cost and low transportation cost). From a statistical point of view, we can assume the same when the continuity correction (2X2 Table) was 0,002 and thus at a 1% level of significance we can conclude that there is a strong association between the origin of the MNEs and the incentive of low unskilled labour cost.

The existence of **geographical proximity** in the 3rd place (58%) in the ranking of incentives for Bulgarian FDI inflows was an expected outcome due to the fact that 37/64 interviewed companies were of Greek origin and thus geographical proximity together with the **lack of western investment interest** (40%) were strong enough reasons for expanding their activities in Bulgaria. Finally, the new global economic environment supports incentives such as **international pressures from competition and physical presence in many countries** (global strategy) (45%) and **acquiring assets of other companies under globalization pressures** (37%), which have been proved significant for the case of Bulgaria.

3.3.3.1 Bulgarian Legal Framework regarding Foreign Direct Investment

Having chosen the road of economic reforms and through the introduction of the market principles in the past several years, Bulgaria has taken a number of steps to introduce a liberal economy and attract foreign investment which are the prerequisites to a modern economy with a developed infrastructure. This is particularly true for the legislative initiatives where many new acts have been adopted or old ones have been amended. Currently, there is an acting legal framework for doing business by modern standards which favours the inward investment. The conditions for doing business in Bulgaria are quite liberal and **there are no restrictions for foreign investors** to settle in the country.

According to the **Encouragement and Protection of Foreign Investments Act (1996)**[19] *"(1) Any foreign person shall have the right to make investments in Bulgaria and to acquire shares or participating interests in commercial partnerships according to the procedure provided for Bulgarian persons, being equal in rights thereto, save as otherwise provided by statute. (2)*

Save as otherwise provided hereby, partnerships wherein foreign persons hold an interest shall have the same rights as partnerships wherein foreign persons hold no interest. (3) The percentage of a foreign participating interest in newly formed or existing partnerships shall be ***unrestricted***".

However, during the transition period there was an unstable legal system in Bulgaria. A fact which has been mentioned in the questionnaire research as a barrier for foreign investors. The changes in the content of the Bulgarian laws have been so numerous that they have caused a sense of insecurity to local investors and especially to foreign ones. The radical changes in these laws are reflected by the **many names** the laws have changed through the years. The first Law on the **Business Activity of Foreign Persons and on the Protection of Foreign Investments** (1991-1992) was adopted by the Parliament of Bulgaria in 1991 and was promulgated in the State Gazette, Issue No. 47 of 1991. In 1992, it was revoked and the Bulgarian Parliament adopted the **Law on Promotion and Protection of Foreign Investments** (1992-1997) or the **Encouragement and Protection on Foreign Investment Act**, promulgated in the State Gazette, Issue No.8 of 1992. From 16-24 October 1997, the Parliament of Bulgaria adopted a new Law on Foreign Investments. All the laws brought the legal framework on foreign investment in full compliance with the accepted international standards and provided for an even more attractive investment regime.

The prerequisites for an investment to be considered direct (thus FDI) go through a lot of differences and changes existed in each country. The Bulgarian laws concerning foreign involvement and especially FDI have also changed many times. According to the Law on the Business Activity of Foreign Persons and on the Protection of Foreign Investments, 1992, Article[20] 9, foreign investment "*shall mean any investment made by any foreign person acting, inter alia, in a single merchant capacity or through a branch, or by a partnership wherein a foreign person holds an interest* ***exceeding 50 per cent***".

In keeping with the Encouragement and Protection of Foreign Investments Act [published in the Official Gazette issue No. 109 of December 27th, 1996] Article 9. (1) (Amended, Official Gazette issue No 109 of 1996) "*...foreign investment means any investment to the value of not less than* ***USD 50,000*** *or the equivalent thereof in Bulgarian lev or in any other foreign currency translated along the central rate of the Bulgarian National Bank as applicable on the date of investment, made by any foreign person, any subsidiary wholly owned by a foreign*

person, any sole-trader foreign natural person, or any partnership wherein a foreign person holds an interest up to the extent of the said interest..."

The latest Law on Foreign Investments, 1999, Article[21] 12 mentions that, "*a foreign investment* ***shall be any investment by a foreign person or its branch in:*** *1. shares and stakes in commercial companies, 2. ownership title over buildings and limited ownership title over property 3. ownership title and limited ownership title over movable property where considered long-term tangible assets, 4. ownership title over an enterprise, or detached parts thereof, within the stipulations of the Law on Restructuring and Privatisation of State-Owned and Municipal Enterprises, 5. securities, including debentures and Treasury bonds, as well as their derivative instruments issued by the State, by the municipalities or by other Bulgarian legal persons, with a remaining term until maturity not shorter than 6 months, 6. loans, also in the form of financial leasing, for a term not shorter than 12 months, 7. intellectual property title - articles of copyright and kindred rights, patentable inventions, utility models, trade marks, service marks and industrial designs, 8. rights stemming from concession contracts and contracts for the assigning of management.*"

In keeping with the Methodology for Compilation of the Direct Investment in Bulgaria followed by the Bulgarian National Bank (BNB)[22] "*...the presence of a* ***lasting interest*** *presupposes a long-term relationship between the direct investor and the direct investment enterprise and a considerable degree of influence on the part of the investor in the management of the direct investment enterprises. ... in the Balance of Payments Manual is adopted the principle that the acquisition of* ***10% or more*** *of the voting power in the management of the investment enterprise is considered an establishment of a direct investment relationship.*"[23]

The Foreign Exchange Law[24], 1999, Article 1, par. 8, states that a direct investment is: "*a) the establishment or acquisition of a business enterprise, b) the acquisition of unlimited liability partnership rights or a stake in a business which entitles the investor to more than* ***20 percent*** *of the votes in the General Assembly of the business, c) the extension of a loan the maturity of which exceeds five years with the purpose of making a direct investment in compliance with letters "a" and "b" above, or in connection with an agreement for participating in the distribution of profit, d) additional investments to those already made as per letters "a)" or "b)" above.*"

As the author has mentioned, the statistical data for FDI in general are not very accurate for comparisons because of the different ways each county uses to define and calculate them. The problem is even worse in Bulgaria, since the prerequisites for FDI[25] have changed five times in the last eleven years. Perhaps this fact explains the differences in the data available from official sources for the same years.

3.3.3.2 Literature review regarding corruption

A comparative survey was conducted in Albania, Bulgaria and FYROM in January 2000. It was based on the public opinion regarding corruption and conducted with the cooperation of Vitosha Research, Center for the Study of Democracy, Albanian Center for Economic Research, Albania, and Forum – Center for Strategic Research and Documentation, FYROM. The survey was based on a Corruption Monitoring System of Coalition 2000 which was created by Vitosha Research and was an initial step towards implementation of a Regional Corruption Monitoring System.[26]

Vitosha Research was extensively engaged in conducting the surveys of the Corruption Monitoring System (CMS) of Coalition 2000. The CMS included a comprehensive set of qualitative and quantitative techniques aiming at different target groups (general public, businessmen, public officials, professionals, etc.). In 2000, a total of 5 quantitative surveys of population and business elite were conducted.

The results of the CMS (Corruption Monitoring System) showed that in terms of values and principles, public opinion essentially remained negative to corruption but at the year end of 2000, a certain public desensitization to the manifestations of corruption were detected. Public opinion perceives corruption as a widespread phenomenon in Bulgarian society and fairly consistently qualifies the sectors of customs, police, ministries, the tax administration, the court system (including judges, lawyers, court officials, prosecutors) as corrupt. The stability of corrupt behavior suggests that the capacity of Bulgarian society to cope with the problem of corruption depends not only on a change in mass attitudes to this phenomenon, but also on the emergence of new social practices. There is a need for essentially new regulatory mechanisms that should be both morally acceptable and practically effective [p.38 Vitosha Research].

Table i: **Spread of Corruption Practices**[27]

(Do you think that there is a lot of corruption involved in:...)	Yes	No
Obtaining business license and permits	75,0%	14,8%
Clearing goods with customs	72,1%	4,8%
Sanitary regulations	62,0%	24,8%

Procurement of goods and services from government	57,9% 8,2%
Authorizations from municipalities and district councils	57,4% 24,7%
Obtaining a vehicle fitness certificate	51,8% 26,7%
Procurement of goods and services for private companies	43,2% 28,8%
State investments	38,9% 20,8%
Public procurements	37,9% 26,2%
Arbitration/litigation	24,1% 32,9%
Environmental regulations and compliance	20,5% 44,3%
Work safety regulations	20,4% 53,7%
Residence and work permits	14,0% 50,2%

Sample size N = 520
Source: International Crime Victimization Survey of Businessmen

The above survey (Table i) among business-persons showed that crime and corruption pose a real threat to the economy in general and to smaller businesses in particular.

The citizens of the countries of Albania, FYROM and Bulgaria evaluate in different ways the main problems of their societies, as well as the public significance of the problem "corruption". According to public opinion in Albania, corruption is the most important public problem at present. In Bulgaria, corruption is among the four most important problems and in FYROM corruption is ranked at seventh place. In Bulgaria, as well as in FYROM, unemployment is ranked as the most important social problem (see Table ii).

Table ii: Main problems faced by country

	Albania		***-Bulgaria***		***-FYROM***	
	%	***Rank***	***%***	***Rank***	***%***	***Rank***
Political instability	40,3	4	13,1	8	35,7	4
Ethnic problems	5,2	9	1,4	11	28,9	6
Corruption	**68,4**	**1**	**37,5**	**4**	**28,5**	**7**
Low incomes	26,3	5	50,6	2	38,1	2
Crime	54,5	2	27,9	5	32,1	5
Unemployment	44,7	3	65,3	1	69,0	1
Environment pollution	6,4	8	4,3	9	3,8	11
Health Care	22,7	6	18,9	6	10,2	8
High prices	4,9	10	2,9	10	4,2	10
Education	3,7	11	14,6	7	6,2	9
Poverty	20,5	7	41,2	3	38,0	3

Respondents gave up to three answers and the sum total of percentages therefore exceeds 100.
Source: Vitosha Research

According to public opinion in Albania, doctors are the ones who exert the strongest corruption pressure on citizens. More than two thirds of all the respondents have declared that such pressure was exerted on them. Municipality, tax, and police officers also exert substantial corruption pressure on Albanian citizens. In Bulgaria, police and customs officers, doctors, and administrative staff in the judicial system are shown as occupations that most often exert corruption pressure. In FYROM, the ranking of the different professional groups according to

the corruption pressure they exert is led by doctors, municipality, police, tax, and customs officers, as well as administrative staff from the judicial system (see Table iii).

Table iii: "If in the course of the past year you have been asked for something in exchange in order to have a problem of yours solved, you were asked by:"

	*Albania***		*Bulgaria*		*FYROM*	
	% Rank*		*%* Rank*		*%* Rank*	
Doctor	71,0	1	**20,0**	**2**	36,1	1
Teacher	3,8	13	4,9	14	10,1	11
University professor or official	4,2	9	10,1	7	11,3	10
Official at a ministry	2,9	15	3,2	15	12,1	9
Municipal official	20,5	2	11,3	6	25,5	2
Administrative official in the judicial system	4,7	7	**18,5**	**4**	17,7	5
Judge	8,5	5	6,9	10	13,4	8
Public prosecutor	4,1	10	5,9	13	4,5	14-15
Investigating officer	4,4	8	6,1	12	4,5	14-15
Police officer	12,6	4	**23,4**	**1**	18,0	3
Customs officer	7,9	6	**19,8**	**3**	17,8	4
Tax official	15,6	3	8,4	8	16,2	6
Member of parliament	0,9	16	1,9	16	4,0	16
Municipal councilor	4,0	11-12	6,7	11	7,9	12
Businessman	3,4	14	**13,7**	**5**	15,0	7
Banker	4,0	11-12	8,1	9	4,7	13

** Relative share of those who have had such contacts, who have been asked for money, gifts, or services.*

*** The Albanian data concern not only the direct corruption pressure but also report on the respondents' perceptions of the indirect corruption pressure.*

Source: Vitosha Research

According to the public opinion in Albania, corruption is most widespread among customs and tax officers, as well as among all representatives of the judicial system – judges, lawyers, investigators, and prosecutors. In Bulgaria the leading positions in the ranking are occupied by customs officers (who are far ahead of the other occupational groups), lawyers, tax and police officers, businessmen. In FYROM customs officers are also assigned first place in the ranking based on the spread of corruption. They are followed by doctors, ministers, members of parliament, and ministry administration (see Table iv).

Table iv: "In your opinion, how widespread is corruption among the following groups?"

	"Nearly all' and most' are involved in corruption (%)"		
	Albania	**Bulgaria**	**FYROM**
	% Rank	**% Rank**	**% Rank**
Journalists	9,4 21	10,6 21	17,8 22
Teachers	9,0 22	9,5 22	25,6 19
University professors and officials	27,8 18	29,4 18	52,2 7
Officials at ministries	50,2 12	47,9 7	52,7 6
Municipal officials	56,1 9	45,0 10-11	43,6 15
Admin. officials in the judicial system	63,7 7	42,0 13	46,4 11
Judges	85,4 2	48,5 **5-6**	50,7 8
Public prosecutors	72,5 6	46,3 8	39,8 16
Investigating officers	74,3 5	41,0 14	37,9 17
Lawyers	77,2 4	54,8 **2**	45,0 14
Police officers	51,4 11	51,9 **4**	45,8 12-13
Customs officers	95,2 1	77,0 **1**	66,3 1
Tax officials	79,5 3	53,9 **3**	50,2 9
Members of parliament	37,7 15	45,0 10-11	52,8 5
Ministers	47,6 14	45,3 9	53,1 4
Municipal councilors	36,3 17	32,5 16	33,2 18
Business people	54,8 10	48,5 **5-6**	58,2 3
Doctors	58,9 8	42,5 12	62,4 2
Political party and coalition leaders	37,4 16	35,7 15	48,0 10
Local political leaders	49,1 13	31,7 17	45,8 12-13
Representatives of NGO's	21,7 20	16,2 20	22,3 20
Bankers	23,8 19	20,9 19	20,9 21

Source: Vitosha Research

The data show that the institutional spread of corruption in the three countries largely reproduces public assumptions about common corrupt practices among different occupational groups. Among the first five institutions determined by the respondents as "centers" of huge corruption in Albania, Bulgaria, and FYROM are customs, tax offices, and the judicial system. According to public opinion, in the three countries the Army, National Institute of Statistics and Presidency are institutions where corruption is the least widespread (see Table v).

Table v: "In your opinion, how widespread is corruption in the following institutions?"

	Albania	**Bulgaria**	**FYROM**
	Index Rank	**Index Rank**	**Index Rank**
Presidency	3,86 16	4,28 20	4,58 13
Parliament	5,74 12	6,96 10	6,22 9
Government	7,24 6-7	6,94 11	6,52 8
Industry line ministries	- -	7,24 6	6,84 4
Municipal government	7,24 6-7	7,02 8	- -
Municipal administration	7,34 5	6,82 12	- -
Army	5,22 14	5,06 18	4,50 14
Customs	9,72 1	9,02 **1** 8,14 1	
Tax offices	8,86 2	7,68 **3-4**	7,20 2
Judiciary	8,78 3	7,68 **3-4**	7,02 3
Police	7,06 11	7,30 **5**	6,72 6
Committee on Posts and Telecommunications	7,18 8-9	6,32 13	- -
Committee on Energy	7,10 10	7,00 9	- -

Privatization Agency	8,66 4	7,96 **2**	6,82 5
Agency for Foreign Investment	- -	7,20 7	6,60 7
Commission for the Protection of Competition	- -	6,18 15	- -
Securities and Stock Exchanges Commission	7,18 8-9	6,22 14	- -
Audit Office	- -	5,54 16	5,74 11
Bulgarian National Bank	5,54 13	5,34 17	5,82 10
National Institute of Statistics	4,28 15	5,00 19	4,64 12

** In this table are listed some of the Bulgarian organizations and institutions. The Albanian and FYROM's data refer to the relevant institutions in these countries.*

Source: Vitosha Research

In the Global Corruption Report 2003 which was conducted by the *Transparency International*, Dejan Jovic examined Southeast European countries[28] and concluded that...

The countries of Southeast Europe witnessed high levels of corruption in the past 12 months, much of it attributable to ineffectual state institutions and the weak implementation of legislation. Nevertheless, many countries in the region are consolidating state institutions as they proceed with the transition to liberal democracy. The transition is being accelerated by international pressure, which continues to be a major force behind anti-corruption efforts. Yet corruption continues to be widespread in Southeast Europe: old networks of influence and 'parallel systems' offer a semi-legal or illegal way of gaining access to services or products. (p.190)... In Bulgaria, Prime Minister Simeon Saxe-Coburg-Gotha – the former king Simeon II – won the July 2001 elections on an anti-corruption ticket that exploited public disenchantment with the conservative government of Ivan Kostov. In January 2002 Bulgarian newspapers published a list of former ministers in Kostov's cabinet against whom the prosecutor-general had filed charges. One month later, the government established an interministerial anti-corruption commission, called the White Commission, chaired by the minister of justice, with support from the World Bank. Though it has no power to investigate, the commission researches cases of corruption by examining written evidence and witness statements. Members also make proposals for legislative changes. Bulgaria has also targeted the problem of the trafficking of women. Corrupt police officers, court officials, border guards and government officials – including employees of international organisations – allegedly facilitate the trade by taking bribes and cooperating with traffickers. 'Police in Bulgaria ... have reportedly extorted bribes from those who have tried to report cases of trafficked women and to ask for appropriate investigations,' observed the Vienna-based NGO International Helsinki Federation for Human Rights in February 2002. 'Police are often in collusion with criminal traffickers, for example in forcing women back to brothels from which they have escaped, or receiving sexual favours and bribes in return for such cooperation with traffickers.' Proposed amendments to the criminal code include the creation of a new unit to combat the traffic in human beings and a national commission on trafficking at the Council of Ministers. Financial transparency was improved by Bulgaria's Financial Intelligence Bureau, which investigates money laundering cases, and amendments to the law for the National Audit Office (NAO) in June 2002. Staff at the NAO, which serves as an independent external auditor of projects funded by international donors, are being trained with assistance from the EU and USAID, which also aims to enhance access to the financial declarations of officials on the public registry website. Anticorruption measures adopted through legal reforms include the criminalisation of trading in influence, tougher sentences for bribery, wider definitions of bribery and the confiscation of assets gained as a result of corruption (p.193-194).

Considering the literature review presented previously in this chapter, a few well-known surveys which considered Bulgaria as a case study, examining at the same time the barriers that discourage FDI inflows in Bulgaria were as follows:

As mentioned above, in a survey conducted by the **Southeast European Cooperative Initiative (SECI)**[29] in 1998, the following barriers occurred in South East European countries (SEECs) can be viewed.

Table vi: The most important disincentives according to SECI research

Disincentive	Average rating	Country
1. Political and economic instability	8,03	Albania, Moldova, Yugoslavia, Romania, Russia
2. Crime - lack of transparency - corruption	7,14	Bosnia and Herzegovina, Bulgaria, Hungary
3. Deficient infrastructure	6,93	Croatia, Slovenia
4. Insufficient legal and administrative framework	6,89	The former Yugoslav Republic of Macedonia
5. Inadequate policy towards foreign investments (Bureaucracy, difficulties in land ownership)	6,37	
6. Negative business environment (non-existent financial and banking systems, the Black market)	5,19	

Source: SECI, 1999

From the above Table vi we can argue that political instability, corruption, insufficient legal framework and bureaucracy were the most important barriers for all the countries examined by the SECI.

A survey[30] by **Simona Iammarino** and **Christos Pitelis** (2000)[31] found the following constraints:

Table vii. Type of FDI by constraint

CONSTRAINTS	TYPE			
	Exporters	Local suppliers	Distributors	Total
Bureaucracy/administrative constraint	14	40	9	63
Business infrastructure constraint	9	32	4	45
Legislative constraint	11	25	4	40
General economic climate constraint	11	26	2	39
Incoherent and unstable legal system	8	22	3	33
High investment risk	8	20	5	33
Slow pace transition	7	22	3	32
Uncertain or imprecise property rights	9	18	4	31
Undervalued local currency	8	18	2	28
Political uncertainty	8	17	2	27
Custom tariffs and policy constraint	2	16	6	24
Cultural considerations constraint	2	16	5	23
Technological backwardness	2	9	2	13

High foreign indebtedness	2	6	2	10
Overvalued local currency	2	5	0	7

Source: Pitelis et al., 2000

"Bureaucracy and administrative constraints are at the top for all three categories [Table vii]. *On the whole, it emerges that general uncertainties of rules are perceived as the most discouraging factors, as shown by the high scores attached to business infrastructure, legislative and economic climate constraints in all three categories" (p.12).*

KPMG[32] International (a consultant company), in April 1998, in its survey concluded that the majority of foreign investors (84%) have pointed out that the incoherent and unstable legal system was one of the most serious problems for their operations, followed by bureaucracy with 80%, limited purchasing power with 71%. Next came excessive taxation 57%, lack of infrastructure 55%, high investment risk with 32% and crime and corruption with 8%.

3.3.3.3 Considering legal framework as a barrier

In order to determine the incentives and barriers of inward FDI in Bulgaria and to divide them into several groups according to the FDI theory, a research was run using a questionnaire and the results were analyzed and studied with the help of statistics. The biggest obstacle that the investors had to deal with in the Bulgarian market was the unstable legal system (74%), followed by bureaucracy (58%) and corruption, crime and mafia (53%).

From the following Table 1, it can argue that the Bulgarian unstable legal framework which was profound from the above theoretical analysis, was also another important barrier for establishing an FDI project in Bulgaria. 47/64 MNEs (73.4%) informed the author that this barrier was also the most significant barrier (see Figure 4). Moreover, another significant finding of this thesis is that foreign MNEs, other than Greek MNEs, mentioned the above barrier with an extremely high percentage of 92.6% (25/27). At the same time, only 22/37 (59.5%) Greek MNEs investing in Bulgaria, have also made reference to this as a barrier. The reason behind this is that the western foreign investors are not familiar with constant changes in the legal framework. At the same time, Greek MNEs are used to living in such an environment with constant changes in the legal framework, inadequate enforcement of the laws which leave space for corruption, bribery and bureaucracy. Greek MNEs did not reject the above barrier, but referred to it at a significant lower percentage. From the statistical point of view, the p-value (continuity correction, 2x2 Table) is 0,007 and thus <0.01. Therefore, we accept the Ha hypothesis, implying that there is strong association between the two variables

(it is worth noticing the origin of MNEs if they consider the Bulgarian unstable legal environment as a significant barrier or not) at 1% level of significance.

Table 1: Unstable Legal System as a barrier for FDI and the origin of MNEs

			Origin of MNEs		
			Greece	Europe & Other	Total
Y62	No	Count	15	2	17
		%	88,2%	11,8%	100,0%
		%	40,5%	7,4%	26,6%
	Yes	Count	22	25	47
		%	46,8%	53,2%	100,0%
		%	59,5%	92,6%	73,4%
Total		Count	37	27	64
		%	57,8%	42,2%	100,0%
		%	100,0%	100,0%	100,0%

From the following Table 2 we can argue that MNEs which belong to the services sector or were banks were fully affected by the unstable legal environment (18/18, 100%). Moreover, MNEs belonging to the trade or food sector also mentioned (16/23, 69.6%) the above barrier as a significant one. The percentage was lower (13/23, 56.5%) in industrial and textile sectors compared to other sectors. It can be said that the unstable legal framework affects mostly MNEs which belong to the services sector. From the statistical point of view, according to the Pearson chi-square test, the p-value is 0.007 and thus <0.01. Therefore, we accept the Ha hypothesis, and so, there is strong association between the two variables (there is association between the sector that an MNE belongs to and the unstable legal environment) at 1% level of significance.

Table 2: Unstable Legal System as a barrier for FDI and the sector that an MNE belongs to

			Kind of business			
			Productive/Industry+ Textiles	Services/Banks	Trade/Food	Total
Y62	No	Count	10		7	17
		%	58,8%		41,2%	100,0%
		%	43,5%		30,4%	26,6%
	Yes	Count	13	18	16	47
		%	27,7%	38,3%	34,0%	100,0%
		%	56,5%	100,0%	69,6%	73,4%
Total		Count	23	18	23	64
		%	35,9%	28,1%	35,9%	100,0%
		%	100,0%	100,0%	100,0%	100,0%

Finally, it was not only the unstable legal environment in Bulgaria that created problems to foreign investors together with the constant changes in this legal framework, but also the inadequate enforcement of the laws which left space for corruption, bribery and bureaucracy (see Figure 3 and Table 5b).

3.4 Considering bureaucracy as a barrier

The high percentage of 37/64 (57,8%) of the interviewed companies which mentioned bureaucracy (Y72) as an important barrier for their FDI in Bulgaria was expected (Table 32).

Table 32: Bureaucracy as a barrier and the Origin of MNEs

			Origin of MNEs		
			Greece	Europe & Other	Total
Y72	No	Count	16	11	27
		%	59,3%	40,7%	100,0%
		%	43,2%	40,7%	42,2%
	Yes	Count	21	16	37
		%	56,8%	43,2%	100,0%
		%	56,8%	59,3%	57,8%
Total		Count	37	27	64
		%	57,8%	42,2%	100,0%
		%	100,0%	100,0%	100,0%

On the other hand, the high percentage of Greek MNEs (21/37 56,8%) that gave mention to bureaucracy as a decisive barrier for them was unanticipated. This outcome can be characterized as a surprise due to the fact that Greek entrepreneurs were familiar with Greek bureaucracy and many managers from other western MNEs have acknowledged the experience and the ability of Greek entrepreneurs to cope with great success in economic environments with a high percentage of bureaucracy. An explanation of the outcome may be that bureaucracy in Bulgaria is at higher levels than in Greece and that bureaucracy is an obstacle and a difficult task to cope with, even for experienced entrepreneurs. Finally, the origin of MNEs did not play any role at all in the consideration of bureaucracy as a barrier. From a statistical point of view, we can point out the same when the continuity correction (2X2 Table) was 1. Thus we concluded that there is no association between the origin of MNEs and the barrier of bureaucracy.

Although from Table 32 it was apparent that the origin of MNEs did not play any role in the consideration of bureaucracy as a barrier, on the other hand from Table 31 we can argue that the sector in which MNEs belong to, played a significant role.

Table 31: Bureaucracy as a barrier and the sector that an MNE belongs to

			Kind of business			
			Productive/Industry+Textiles	Services/Banks	Trade/Food	Total
Y72	No	Count	6	5	16	27
		%	22,2%	18,5%	59,3%	100,0%
		%	26,1%	27,8%	69,6%	42,2%
	Yes	Count	17	13	7	37
		%	45,9%	35,1%	18,9%	100,0%
		%	73,9%	72,2%	30,4%	57,8%
Total		Count	23	18	23	64
		%	35,9%	28,1%	35,9%	100,0%
		%	100,0%	100,0%	100,0%	100,0%

In other words, over 70% of MNEs which belong to industrial / textile or services sector considered bureaucracy as an important barrier, when at the same time only 30% (7/23) of MNEs which belong to the trade/food sector mentioned the above as a crucial barrier. From a statistical point of view, we assume the same, when the Pearson Chi-Square was 0,004 and thus at 1% level of significance we concluded that there is a strong association between the sector that an MNE belongs to and bureaucracy as a barrier.

3.5 Considering corruption as a barrier

All sources generally apply a definition of corruption such as the misuse of public power for private benefits, e.g., bribing of public officials, kickbacks in public procurement, or embezzlement of public funds. Each of the sources also assesses the "extent" of corruption among public officials and politicians in the countries in question. Corruption is, to an extent, an inevitable phenomenon during transition, but one that threatens to undermine market and democratic institutions before they have become self-sustainable. The international organisations lack a shared definition of corruption and a common understanding of why corruption is problematic. In particular, political corruption is often confused with organised crime. While there might be an overlap between the two, political corruption is more usefully defined as acts undertaken by public officials to further their personal rather than the public interest; a fact which may or may not be illegal. Organised crime, on the other hand, refers to illegal activities such as smuggling, trafficking and money laundering. The latter might, but does not necessarily rely on corrupting or bribing public officials in order to facilitate operations.

In a survey in 2001, the World Bank found that the most important means of corruption were: Stealing of Public Assets, Corrupt Privatization, Corruption in Procurement, Budget Leakages, Patronage and Nepotism, Bureaucratic/ administrative corruption, Elite bribes to shape laws /

policies and Corrupt Leadership.

Corruption is not outlined as the biggest obstacle to the foreign investors in Bulgaria[33]. According to independent foreign surveys, frequent changes to the statutory basis, the state administration's lack of flexibility, low purchasing power and the underdeveloped infrastructure present much greater problems to the investors. Corruption is a social phenomenon perceived by executives in state-owned and private entities as a problem currently existent in Bulgaria with far-reaching consequences.

In order to overcome corruption, there is a need for a Anti-corruption efforts which broadly fall into two categories: One approach is to put pressure on countries to introduce certain anti-corruption laws, such as OECD and Council of Europe conventions on bribery and corruption. In addition, state activities can be more tightly regulated and the policing of these regulations more effectively monitored. An alternative approach seeks to build integrity among public servants so as to engender better standards of public service, a will to perform in a non-corrupt manner and a capacity for self-limitation.

On the same line, the author's questionnaire analysis and its subsequent statistical analysis proved that with the help of Table 19, we can argue that 34/64 thus 53,1% of the total foreign MNEs mentioned corruption, bribery or other illegal actions from mafia as important obstacles for the operation of their FDI projects in Bulgaria. At this point, a surprise was the fact that barrier corruption, crime, bribery, mafia and illegal actions (Y67), had also been mentioned from 29/37 (78.4%) of the Greek companies (Table 19).

Table 19. Origin of MNEs and crime-corruption-bribery-illegal actions

			Y67		
			NO	YES	Total
RID	Greece	Count	8	29	37
		% RID	21,6%	78,4%	100,0%
		% Y67	26,7%	85,3%	57,8%
	Europe & Other	Count	22	5	27
		% RID	81,5%	18,5%	100,0%
		% Y67	73,3%	14,7%	42,2%
Total		Count	30	34	64
		% RID	46,9%	53,1%	100,0%
		% Y67	100,0%	100,0%	100,0%

*(RID) Origin of MNEs (in two groups) - Corruption, Bribery, Crime, Illegal actions, cost of protection from "mafia" (Y67)

The basis for this surprise is very profound when studying Table 20 where we can argue that the Greek corruption rate in 2002 was very similar with that of Bulgaria. This happened throughout the years (1998-2002) when Bulgaria improved its corruption rate from 2.9 to 4 and on the other hand, Greece deteriorated its corruption rate[34] from 4.9 to 4.2.

Table 5b: The Transparency International Corruption Perceptions Index: 10 (highly clean) and 0 (highly corrupt)

Rank	Country	CPI 2002 score	Surveys used
1	Finland	9.7	8
2	Denmark	9.5	8
	New Zealand	9.5	8
27	Slovenia	6.0	9
29	Estonia	5.6	8
31	Italy	5.2	11
33	Hungary	4.9	11
44	**Greece**	**4.2**	**8**
45	Brazil	4.0	10
	Bulgaria	**4.0**	**7**
	Poland	4.0	11
51	Croatia	3.8	4
52	Czech Republic	3.7	10
	Latvia	3.7	4
	Slovak Republic	3.7	8
81	Albania	2.5	3
101	Nigeria	1.6	6
102	Bangladesh	1.2	5

Country Rank	Country	2001 CPI Score	Surveys Used
1	Finland	9.9	7
2	Denmark	9.5	7
29	Italy	5.5	9
42	**Greece**	**4.2**	**8**
47	**Bulgaria**	**3.9**	**6**
	Croatia	3.9	3
	Czech Republic	3.9	10
90	Nigeria	1.0	4
91	Bangladesh	0.4	3

Country Rank	Country	2000 CPI	Surveys Used
1	Finland	10.0	8
2	Denmark	9.8	9
35	**Greece**	**4.9**	**8**
39	Italy	4.6	8
52	Argentina	3.5	8
	Bulgaria	**3.5**	**6**
	Ghana	3.5	4
	Senegal	3.5	3
	Slovak Republic	3.5	7
89	Yugoslavia	1.3	3
90	Nigeria	1.2	4

Country Rank	Country	1999 CPI Score
1	Denmark	10.0
2	Finland	9.8
3	New Zealand	9.4
	Sweden	9.4
36	**Greece**	**4.9**
38	Italy	4.7
63	**Bulgaria**	**3.3**
	Egypt	3.3
	Ghana	3.3
	FYROM	3.3
	Romania	3.3
98	Nigeria	1.6
99	Cameroon	1.5

Country Rank	Country	1998 CPI Score
1	Denmark	10.0
2	Finland	9.6
3	Sweden	9.5
36	**Greece**	**4.9**
39	Italy	4.6
66	**Bulgaria**	**2.9**
	Egypt	2.9
	India	2.9
84	Paraguay	1.5
85	Cameroon	1.4

Source: Transparency Index (TI)

The above-mentioned result (Table 19), that Greek MNEs considered corruption and mafia as an important barrier even more than the other foreign MNEs, can be partially explained from the fact that Greek companies were smaller in economic magnitude compared to the other foreign MNEs and thus it was easier for mafia to approach them. Furthermore, Bulgarians respected foreign MNEs (and especially large ones) that came from advanced western countries and this may be explained by their famous brand name and the Bulgarian tense to mimic western civilization. Moreover, as mentioned earlier as regards to bureaucracy, it is one thing to be familiar with corruption and another to consider corruption as a "necessary tool" in

every day economic and business transactions. However, it was not so much the origin of MNEs that played a significant role in the consideration of corruption, as the sector that an MNE belongs to (see following Table 2).

Table 2: Corruption and the sector that an MNE belongs to

			Y67		
			No	Yes	Total
Kind of business	Productive/Industry +Textiles	Count	10	13	23
		%	43,5%	56,5%	100,0%
		%	33,3%	38,2%	35,9%
	Services/Banks	Count	15	3	18
		%	83,3%	16,7%	100,0%
		%	50,0%	8,8%	28,1%
	Trade/Food	Count	5	18	23
		%	21,7%	78,3%	100,0%
		%	16,7%	52,9%	35,9%
Total		Count	30	34	64
		%	46,9%	53,1%	100,0%
		%	100,0%	100,0%	100,0%

It is apparent from the above Table 2 that foreign banks and other companies which belong to the services' sector, were the less affected MNEs (3/18 =16,7%) by this barrier. On the other hand, foreign MNEs from the trade/food sector with a percentage of 78,3% (18/23) and MNEs from the industrial/textile sector with a percentage of 13/23 (56,5%) mentioned the above as a strong barrier.

Using the same questionnaire survey, it can be emphasized that corruption affected mostly financial aspect hunters 9/11(81,8%), factor hunters with 29/40 (72,5%) and locational hunters 22/32 (68,8%). We can also conclude that MNEs which invested in Bulgaria using their ownership advantages (2/13, 15,4%) or for other strategic reasons (5/21, 23,8%) did not mention corruption as a significant barrier.

Table 10: Corruption and Privatisation as a foreign involvement entry way

			Y67		
			No	Yes	Total
Privatisation	No	Count	15	26	41
		%	36,6%	63,4%	100,0%
		%	50,0%	76,5%	64,1%
	Yes	Count	15	8	23
		%	65,2%	34,8%	100,0%
		%	50,0%	23,5%	35,9%
Total		Count	30	34	64
		%	46,9%	53,1%	100,0%
		%	100,0%	100,0%	100,0%

From the above Table 10, we can point out that only 8/23 (34,8%) MNEs, which invested in Bulgaria using a privatisation program, informed the author that corruption was a barrier. This result may be explained by the fact that although corruption is still a fact in Bulgaria, MNEs, which became higher bidders in privatisation deals and finally acquired the state-owned companies, did not consider corruption as a barrier perhaps due to the "happy end" of the

privatisation deal. However, the majority of other MNEs (26/41, 63.4%) mentioned corruption as a significant barrier possibly due to their failure to acquire a state-owned enterprise (SOE), through a privatisation program because of corruption, or due to their choice of other ways of foreign involvement, such as joint ventures or greenfield FDI, where corruption is strongly associated with other factors (corruption and green-field FDI 24/35 (68.6%), corruption and joint ventures 7/12 (58.3%)).

The high percentages of corruption in the above mentioned entry modes in Bulgaria such as green-field FDI and joint ventures can be explained by the fact that a foreign investor in order to acquire land, buildings or to construct a building, needed to co-operate with governmental agencies, to unclear property rights and to issue licenses. All those activities are quite enough to leave room for corruption.

Moreover, from the theoretical point of view, most of the joint ventures which exist in the SE European countries, had been established at the beginning of the transition period owing to the fact that their environment was not familiar and foreign MNEs needed (especially at the beginning) local partners in order to cope with bureaucracy and corruption.

Table 13: Corruption and Joint Ventures as a foreign involvement entry way

			Y67		
			No	Yes	Total
Joint Ventures	No	Count	25	27	52
		%	48,1%	51,9%	100,0%
		%	83,3%	79,4%	81,3%
	Yes	Count	5	7	12
		%	41,7%	58,3%	100,0%
		%	16,7%	20,6%	18,8%
Total		Count	30	34	64
		%	46,9%	53,1%	100,0%
		%	100,0%	100,0%	100,0%

Thus, the high percentage of 58.3% of foreign MNEs (Table 13) that have established joint ventures was unexpected, especially since they have also mentioned corruption (Y67) as a decisive barrier.

However, with the help of Table 12, it can be said that (7/12, 58.3%) MNEs, which followed joint ventures as a way of foreign entry, belong to the trade or food sector.

Table 12: Joint Ventures and the kind of Business that an MNE belongs to

			Joint Ventures		
			No	Yes	Total
Kind of business	Productive/Industry+ Textiles	Count	22	1	23
		%	95,7%	4,3%	100,0%
		%	42,3%	8,3%	35,9%
	Services/Banks	Count	14	4	18
		%	77,8%	22,2%	100,0%
		%	26,9%	33,3%	28,1%
	Trade/Food	Count	16	7	23
		%	69,6%	30,4%	100,0%
		%	30,8%	58,3%	35,9%
Total		Count	52	12	64
		%	81,3%	18,8%	100,0%
		%	100,0%	100,0%	100,0%

Therefore, as we mentioned above, that sector was mostly influenced by corruption (18/23, 78% - Table 2). Thus, we concluded that the high percentage of corruption (7/12, 58.3% - Table 13) is connected with joint ventures, is due to the fact that more than 50% of those joint ventures belong to the sector most affected by corruption, the trade/food sector.

3.6 Critical discussion of the survey results; Are the FDI inflows in the CEE countries and especially in Bulgaria a myth?

The changes observed in the last decades certainly have a significant growth rate, much larger than that of the past. Respective changes are likely to occur in much larger growth rate in the years to come. These changes will cause many static theories on FDI, and on other economic aspects, to become obsolete. For example consider how the theory of Aliber on FDI as a way of exploiting the differences in exchange rates, will apply after the monetary unification of the countries of the European Union.

This potential of the global market along with the consideration that each theory applies in a limited number of sectors, and that a given firm may be served by different theories in different time periods, the author proceeded in connecting the main aspects of the dominant theories in one Universal Model. This model hardly contains any new considerations, just another point of view of the existing theories. All the operations have one main purpose and that is profit. Profit can be either long term or short term, direct or indirect and may be achieved through many channels, but still remains the higher purpose behind the actions of all enterprises. Based on this notion all theories that analyze why companies undertake FDI or under what circumstances they should undertake FDI, have deep consideration of profit. This model connects all the FDI theories under the consideration of the way they assure profit for the company.[35]

As mentioned above, **there is no theory that dominates the decision making** process of FDI. After the consideration of the FDI theories the author made an attempt to present, in the simplest possible way, the incentives, motives, reasons, possibilities, opportunities, externalities, imperfections that an MNE considers before the decision of FDI. A company, when considering FDI, it tries to exploit or overcome any factor that has stimulated or motivated its management to proceed in investing in a foreign country. Moreover, the barriers, which discourage an FDI decision, are in fact, the other side of the same coin, meaning that the negative side of an incentive constitutes a barrier.

Some of the theories presented in chapter 2 may be viewed as static, while others may be considered dynamic. The static theories studied only the factors that lead to the decision of FDI, while the dynamic theories also consider the evolution of the foreign company and its interaction with the host industry and the host country. The dynamic models led the author to the presentation of the direct and indirect effects of FDI on the host country, on the transition process to a market economy and on the MNE. One must consider that **the market conditions are always changing** and the changing character of the boundaries, the globalization, the European Union etc. will definitely create new challenges and opportunities for a company to seek value-adding activities internationally in ways different from the ones studied up to now.

These considerations led to an additional conclusion. Since every country offers different motives and **incentives** for investment and has different **obstacles** and barriers that are all submitted to considerable changes through time, the MNEs choose the country that maximizes the possibility of success for their investment plan. Even when two countries hold the same properties, an MNE bases its investment decision on evaluation of all factors in relation with the corporate priorities and needs. The author succeeded in determining the most applicable theory for Bulgaria in the time period 1989-1999 by the statistical analysis of the results of the questionnaire answers and the interviews of almost a hundred foreign companies operating in Bulgaria.

The multinationals are interested in searching markets that fulfil their investment plans. They carry out extensive market research, before they reach a decision and focus their interest on the profitability of their decision. They are working towards finding countries, which fulfill their goals. A great deal of multinationals' decisions in making FDI depends on their willingness to participate in countries that exist in different geographical and strategic

positions. It is not possible that all countries around the world offer the same opportunities, the same conditions for a multinational to act, at the same time. Consequently, the interest of multinationals is not concentrated in one part of the world constantly, but follows opportunities in different places (Latin America, the UK and Ireland, Spain and Greece, Eastern Europe, CIS, SE Asia etc.) at different periods of time according to the circumstances. Each country offers its comparative, locational advantages, and its incentives for FDI. The multinationals evaluate these incentives and selects the most appropriate country for their investment. Derived from the worldwide statistical information there may be found countries with near to zero FDI inflows and simultaneously others that hold a great percentage of the total amount of FDI inflows. Since the 80% of the worldwide volume of FDI belongs to the multinationals their attitude towards it may reflect the nature of the world FDI.

Especially, for the case of Bulgaria and the CEE region, a simple analysis of the official data and of the results of the author's statistical analysis provided the author with certain conclusions, indicative for the FDI inflows in the region.

The western investment interest in the Central and Eastern Europe is very low considering that only a percentage between 2%-5% of the worldwide FDI outflows goes to CEE countries. This is apparent in the following tables, which show the low volume of FDI inflows that the whole Central and Eastern European region received compared to the global FDI inflows that other countries have received at the same time period (tables 6a, 6b, 6c).

Table 6a: FDI inflows, by host region, million US$, 1995-1999

Region	1995	1996	1997	1998	1999
Developed countries	205,693	219,789	275,229	480,638	636,449
Western Europe	119,012	114,940	138,986	259,924	315,123
North America	68,029	94,091	117,249	208,021	300,594
Other developed countries	18,652	10,758	18,994	12,693	20,732
Developing countries	111,884	145,030	178,789	179,481	207,619
Africa	4,699	5,522	6,896	7,519	8,949
Latin America and the Caribbean	32,816	45,890	69,172	73,767	90,485
Developing Europe	483	1,026	1,020	1,459	2,315
Asia	73,324	92,434	101,575	96,504	105,621
The pacific	583	158	126	231	248
Central and Eastern Europe	14,267	12,697	19,034	19,963	21,420

Source: World Investment Report 2000, UN

Table 6b: FDI Inflows and Outflows in a worldwide percentage by region

FDI	Inflows %			Outflows %	
	1994	1997		1994	1997
Western Europe	32.2	28.7		47	46.2
USA	18.6	22.7		25.8	27
Japan	0.4	0.8		6.4	6.1
Asia	25	21.7		12.9	14.4
CEE	2.4	4.6		0.1	0.8
Latin America & Caribbean	11.8	9.6		1.8	2.1
Other	9.6	11.9		6	3.4
TOTAL	100	100		100	100

Source: UNCTAD, *World Investment Report, 1998, Table 1.8*

Table 6c: Inflows of foreign direct investment in Eastern Europe, the Baltic states and the CIS, 1990-2000 (Million dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Eastern Europe [b]	479	2 332	3 124	4 165	3 575	9 230	7 974	9 399	15 268	18 615	21 502*
Baltic states	..	..	119	238	460	454	685	1 142	1 863	1 139	1 148
CIS	..	..	1 777	1 875	1 770	4 064	5 288	8 842	6 726	6 886*	5 363*
Total above [b]	..	..	5 020	6 278	5 806	13 748	13 947	19 383	23 857	26 640*	28 013*

145502

Source: National balance of payments statistics; IMF. [b] Excluding Bosnia and Herzegovina and Yugoslavia.

The data also shows that even the leading countries in foreign direct investment outflows, have a low interest in the CEE countries (and especially in Bulgaria) considering their total FDI outflows each year compared with their outflows directed to the CEE (tables 7 & 8).

Table 7: FDI INFLOWS IN THE BALKAN REGION

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Albania	–	–	20	58	53	70	90	48	45	41	100*	425
Bulgaria	4	56	42	40	105	90	109	505	537	819	975	3282
Romania	–	40	77	94	341	419	263	1 215	2 031	1 041	998	6519
FYROM	–	–	–	–	24	9	11	16	118	30	160*	208
Yugoslavia (FRY)	..	..	..	..	..	..	–	740	113	112	–*	965
TOTAL FDI INFLOWS IN THE ABOVE FIVE COUNTRIES OF THE BALKAN REGION												11399
Bosnia and Herzegovina	..	..	..	..	–	–	–	–	100	90	117	307
Croatia	–	–	16	120	117	115	506	530	898	1 408	1 000*	4710
Slovenia	4	65	111	113	128	177	194	375	248	181	181	1777
TOTAL FDI INFLOWS IN THE ABOVE EIGHT COUNTRIES OF THE BALKAN REGION												18193

Source: National balance of payments statistics; IMF.

Table 8: Outflows of FDI in 1993- 1996(billions of US dollars)

Country	1993	Country	1994	Country	1995	Country	1996
USA	78.2	USA	54.5	USA	95.5	USA	74.8
UK	25.5	UK	28.3	UK	40.3	UK	34.1
France	20.6	FRANCE	22.8	GERMANY	34.9	FRANCE	30.4
GERMANY	15.3	JAPAN	18.1	JAPAN	22.7	GERMANY	29.5
JAPAN	13.8	NETHERLANDS	16.7	FRANCE	18.7	HONG KONG, CHINA	26.4

Source: Balance of payments, International Financial Statistics, IMF, UNCTAD (1998) , *World Investment Report, 1998*, p.11

The FDI outflows from one country to another, is usually not an issue of national interest or a specific interest from one country to another. Derived from the worldwide statistical information there may be found countries with significant FDI inflows and simultaneously

these inflows to be from very few MNEs. This "isolated" interest of the multinationals is also clear from the example of the two Belgian multinationals, which have invested in Bulgaria. These two companies for strategic reasons (acquiring an existing Bulgarian firm producing similar products, having access to other neighboring countries, increasing their world-wide market-share) proceeded to FDI decisions in Bulgaria. Belgium was in the second place in FDI inflows to Bulgaria and 95% of these inflows belong to the above two companies (tables 9 & 10).

Table 9: BIGGEST FOREIGN INVESTMENTS IN BULGARIA over 1 million USD each (as of October 2000)

No	INVESTOR	COUNTRY	SECTOR	BULGARIAN COMPANY	YEAR	VOLUME IN USD million
1	UNICREDITO	ITALY	finance	BULBANK	2000	307.0
2	NATIONAL BANK OF GREECE	GREECE	finance	UNITED BULGARIAN BANK	2000	270.0
3	EBRD	International			94-99	261.2
4	SOLVAY	BELGIUM	chemical industry	SODI DEVNYA	97,98	206.0
5	UNION MINIERE	BELGIUM	copper smelter	MDK PIRDOP	97,98	190.3

Source: BFIA Catalogue

Table 10: FOREIGN DIRECT INVESTMENT IN BULGARIA BY COUNTRIES AND BY YEARS in millions of USD 1992-2001 (Jan – June 2001), 2000* preliminary

N	Country	1992	1993	1994	1995	1996	1997	1998	1999	2000*	2001	Total by countries preliminary
1	GERMANY	0.1	56.6	111.4	16.2	53.1	31.4	55.7	101.3	72.3	30.8	528.9
2	GREECE	0.2	5.1	3.0	29.8	14.6	16.1	3.3	14.9	241.1	142.6	470.7
3	ITALY	0.0	0.2	5.2	2.3	1.2	0.4	2.1	23.0	339.7	42.9	417
4	BELGIUM	0.0	0.1	0.3	10.0	0.8	264.4	31.2	66.2	39.8	-0.2	412.6
5	AUSTRIA	13	1	14.7	1.4	12.1	12.5	46.9	23.4	88.8	55.3	269.1
6	USA	0.0	10.5	16.2	16.1	20.7	46.6	38.6	49.8	37.1	33.4	269
7	CYPRUS	0.3	1.2	0.4	1.4	7.5	20.6	109.1	108.9	-11.3	17.8	255.9

Source: BFIA Catalogue

Thus, the author argues that there is an interest from MNEs to invest in a host country and not from specific home countries to give incentives or even provoke their home firms to invest in a specific host country. The interest is more company centered and that is evident in Central Eastern Europe by the fact that the bulk of the CEE FDI inflows come from approximately 40 multinationals from 5 advanced countries. Table 11 demonstrates that less than 40 large MNEs coming from the most advanced countries (the USA, the UK, Italy, France, Netherlands, Japan) have invested 43% of the total volume of foreign investment in Hungary, Bulgaria, the Czech Republic and Poland.

Table 11: Forty (40) MNEs have invested over 25000 million USD$ in 4 countries

	MNE (Invested capital in million USD$)	FDI	ORIGIN	HOST COUNTRY
1	Daewoo	1552.3	Korea	POLAND
2	Fiat	1545.9	Italy	POLAND
3	RAO Gazprom	1246.9	Russia	POLAND
4	Vivendi	1204.2	France	POLAND
5	United Pan-Europe Communications	1200.0	Netherlands	POLAND
6	UniCredito Italiano	1042.0	Italy	POLAND
7	Bayerische Hypo- und Vereinsbank AG	1000.0	Germany	POLAND
8	Citibank	986.6	USA	POLAND
9	Allied Irish Bank Plc	746.7	Ireland	POLAND
10	EBRD	703.4	international	POLAND
11	Shell	618.0	Great Britain	POLAND
12	Eureko B.V	601.4	international	POLAND
13	Metro AG	598.0	Germany	POLAND
14	Adam Opel AG	560.0	Germany	POLAND
15	Enterprise Investors	550.0	USA	POLAND
16	ING Group NV	520.0	Netherlands	POLAND
17	IPC	465.0	USA	POLAND
18	Reemtsma Cigarettenfabriken GmbH	465.0	Germany	POLAND
19	Saint-Gobain	440.0	France	POLAND
20	Coca-Cola Beverages Plc	400.0	Great Britain	POLAND
21	Ameritech (USA) and Deutsche Bundespost Telecom	$1.725 billion	(Germany, telecommunications)	HUNGARY
22	VW/Audi	US $420 m	(Germany, auto)	HUNGARY
23	US West International	US $330 m	(USA, cellular phones)	HUNGARY
24	General Electric	550 $ m	USA lighting	HUNGARY
25	General Motors	US $500 m	(USA, automotive maker)	HUNGARY
26	Suzuki Motor Co.	US $250 m	(Japan, auto)	HUNGARY
28	PTT NETHERLANDS, TELECOM DENMARK, & OTHER SCANDINAVIAN OPERATIONS	250 M $ USD	TELECOMMUNICATIONS	HUNGARY
27	Allianz	US $220 m invested	(Germany, insurance company)	HUNGARY
28	Volkswagen	USD 900 million +	Germany	CZECH REPUBLIC
29	T Mobil Deutsche Telekom Mobil, STET	USD 183million	Germany, Italy	CZECH REPUBLIC
30	Siemens AG	USD 170 million +	Germany	CZECH REPUBLIC
31	Continental AG	USD 150 million	Germany	CZECH REPUBLIC
32	IOC - Agip, DuPont-Conoco, Royal Dutch Shell	USD 629 million	The Netherlands USA, Italy	CZECH REPUBLIC
33	Phillip Morris	USD 420 million	USA	CZECH REPUBLIC
34	National Energy Corporation El Paso Energy, NRG Energy	USD 400 millon	USA	CZECH REPUBLIC
35	Pepsi-Cola International	USD 200 million	USA	CZECH REPUBLIC
36	Ford Motor Company	USD 115m	USA	CZECH REPUBLIC

37	UNICREDITO	307.0	ITALY	BULGARIA
38	NATIONAL BANK OF GREECE	270.0	GREECE	BULGARIA
39	EBRD	261.2	International	BULGARIA
40	SOLVAY	206.0	BELGIUM	BULGARIA
41	UNION MINIERE	190.3	BELGIUM	BULGARIA
42	LUCOIL PETROL	101.0	RUSSIA	BULGARIA
43	AMERICAN STANDARD	100.0	USA	BULGARIA
44	SHELL OVERSEAS HOLDINGS	92.9	UK	BULGARIA
45	HEIDELBERGER ZEMENT	70.2	GERMANY	BULGARIA
46	METRO	68.0	GERMANY	BULGARIA
47	3E – COCA COLA	124	GREECE	BULGARIA
	SUM	25647.6	Million USD$	
	Four countries (Hungary, Poland, Czech Republic, Bulgaria)	19822 $m 20402 $m 16546 $m 2778 $m	Hungary, Poland, Czech Republic, Bulgaria	
	TOTAL	59548 $m	43% of the total from 40 MNEs with an origin mainly from the USA, Japan, Germany, UK, Italy, Netherlands	

Source: Author's Research, various sources

The official data also demonstrates that although there are major investors (in FDI outflows), from the USA, the UK and Japan, in most CEE countries, they show no interest in Bulgaria (tables 10, 12 & 13). In Poland, the USA, Germany, France, the Netherlands, Italy, and the Great Britain, each one, has invested more than the total FDI inflows in Bulgaria. However, the lack of investment interest of the USA, France, Netherlands and the UK in investing in Bulgaria is not a surprise or it can be explained by the geographical distance, the strong Bulgarian dependence on the ex USSR and the ex CMEA trade organisation.

Table 12: Foreign Direct Investment in Poland – (at the first half of 2000)

NO.	Country of origin	Capital invested (millions of USD)	Planned investment (millions of USD)	Number of investors
1	USA	6396,5	2648,1	128
2	Germany	6234,4	2277,5	189
3	France	4091,1	1614	70
4	Netherlands	3714,7	692,8	58
5	Italy	3273,8	607,0	67
6	Great Britain	2646,1	259,0	36
16	Japan	361,6	137	12

Source: the Research Department of PAIZ, September 2000

Table 13: Central and Eastern Europe: geographical sources of inward FDI stock as a percentage, 1999

Central and Eastern Europe: geographical sources of inward FDI stock, 1999 (Percentage)	
Germany	18
United States	16
Netherlands	12
Austria	7
Other European Union	7
France	6
United Kingdom	6
Other Western Europe	6
Italy	4
Cyprus	4
Central and Eastern Europe	3
Other and not specified	11

Source: UNCTAD, FDI/TNC database, 3 October 2000, by the United Nations Conference on Trade and Development (UNCTAD)

Germany (or German MNEs) is in the first place in FDI inflows in Bulgaria, but having invested a small amount (half billion USD$) though is first in all the Central and Eastern Europe (tables 10 & 13). Furthermore, only three German MNEs in the Czech Republic have invested together over 1.3 billion according to CzechInvest, PBJ - March, 1999 (Volkwagen 900 million USD, Siemens AG 170 million and Continental AG 150 million USD) and even in Romania (a country that lags in transition, together with Bulgaria, behind the other CEE countries), German MNEs have invested 0.633 billion USD$ according to the Chamber of Commerce and Industry of Romania (October 2000). German MNEs have also invested 6.480 billion USD in **Russia** according to Russia's Goskomstat data as of July 1, 1999. Moreover, three German companies in **Hungary** have invested altogether 734$USD million (420 $USD VW/Audi, Allianz 220 $USD, Siemens 94 $USD), an amount that exceeds the total German FDI inflows in Bulgaria (Hungarian Investment and Trade Development Agency, HCSO, mid 1999). Finally, German MNEs have invested 6.234 billion of USD in **Poland** according to Research Department of PAIZ (Sep. 2000)

The choice of the companies on the direction of FDI is very much affected by any group of countries or a whole region, which may initiate a transition to a market economy, through privatization programs and their offers, or may go though other stages, which create opportunities for FDI. One may say that each time has its trends on developing economies that provide opportunities (Central America, South America, SE Asia, CEE region). One may also argue that the fact that the economy needs financial and technical support for the transition to a market economy is what generates the opportunities and interest for FDI

inflows.

The fact that strong Western economies are not in the first positions in the FDI lists of inflows in the CEE region is not surprising as much as the fact that Greek investments dominate the Bulgarian market (see table 10). However, this is happened mainly due to the geographical proximity, cultural closeness (at least closer compared to other EU or Western countries) and the lack of foreign investment interest. Greek domination in Bulgaria is not a unique case. The case of Greek FDI outflows in Bulgaria is similar with the cases of Austria and Nordic countries in Slovakia, Slovenia and Baltic countries respectively. Bulgaria has provided the opportunity for the Greek enterprises to become MNEs and use Bulgaria as an export base, since Greece is the most advanced country in the region of South East Europe and especially in the Balkans (being a member of the EU and NATO). Another advantage for Greek investors in the CEE region is that their knowledge of the market raise their possibilities to work with the difficulties of an "underground" or "grey" market, cope with the bureaucracy and overcome corruption, bribery etc.

3.7 CONCLUSIONS

This survey tried to specify the main incentives and barriers for a specific country case study, namely Bulgaria during its post communist period. More specifically, in our survey the findings regarding the significance of **geographical proximity** were in accordance with Pye (1998), Pitelis et al. (2000), OECD (1994), Meyer (1995-6) and SECI (1998)) and the **low labor cost** were in accordance with with Pitelis et al (2000), OECD (1994) Altzinger (1999).

On the other hand, the finding regarding the importance of low labour cost is against with Meyer's findings, who considered that for British and Germans MNEs were interested in low labour cost as a secondary incentive. Our survey in which Greek, Turkish and Russian MNEs prefer to invest in the neighbor Balkan region and in particular in Bulgaria, exploring low labour cost especially for labour intensive industries and export oriented industries. Geographical proximity and the importance of low labour cost for export- oriented companies were also in accordance with Lanks and Venables (1997) and Pitelis et al. (2000).

We agree with Lanks and Venables (1997) who argued that

The importance of factor costs seems to depend, not surprisingly, on the purpose of the investment. They found that export oriented firms place much greater importance on production costs and cheap skilled labour.

Our findings regarding the importance of **cultural closeness** together with the importance of **strong historical links and strong cultural ties** was in accordance with Andersen (OECD), SECI and Altzinger.

The absence of **political stability** as a major incentive for the case of Bulgaria can be explained by the fact that Bulgaria faced political instability from the start of its transition period and up to the year of 1997 (8 governments in 8 years). So, it was not evident the Bulgarian political stability at the time period when this survey was conducted.

Meyer (1995-96) found that the **qualified labour force** was an important reason for investment in Hungary together with its political and economic stability. Also Pye (1998) mentioned the importance of skilled labour force in Slovakia. However, sometimes the absence in consideration of the low labour cost as an significant incentive and the searching of the availability of qualified labour force is the key difference for foreign investors who prefer to invest in the Central European countries such as Hungary and Poland instead of investing in the Balkan region. This also clarifies the lack of western investment interest in the SEE region and the preference of British and German MNEs to invest in Hungary or Poland and not in the Balkan region or even more not in Bulgaria[36]. The Central European countries are neighbor countries to the advanced economies of Germany, the UK etc. and they provide more stable environment and they are more advanced economies with qualified labour force compared to the Balkan ones. On the other hand, the MNEs from advanced economies are less considering the low labour cost as the Greeks, Turkish and Russians are considering this.

We can also conclude in this chapter that there is a specific finding in the KPMG research which we believe that it is a biased one and not in accordance with our findings. This is regarding the above-mentioned incentive of skilled labour force which has been highly considered by the KPMG. In other words, the skilled labour force has been one of the driving considerations for more than a third (36%) in KPMG research. This author argues that this high percentage is biased and it depends on the sample. So, we can conclude that there was a participation of a large enough number of companies (in KPMG sample), which belong to a

sector which prefers/needs skilled labour force and not that the skilled labour force is a so significant factor for foreign MNEs which prefer to invest in Bulgaria.

We disagree with Lankes and Venables (1997) who found that almost half of the investors are positively influenced by similar investments by competitors in the same country (**following the competitors' theory**). The explanation behind our disagreement is the fact that our survey mentioned that only 12.5% mentioned the theory of following the competition theory because for the case of advanced economies such as German or British there are a lot of strong MNEs so the first movers are not the only MNEs interesting in investing in Central Europe. This is not the case of Greeks or Russian or Turkish MNEs which have only limited number of MNEs which prefer to invest in the Balkan region. Thus, it is difficult to have a lot of strong Greek or Turkish MNEs in order to follow each other in their investment paths.

The low importance of **financial incentives** is also in accordance with Buss[37], Brewer et al.[38] and OECD. We are against the finding of Pitelis et al, who find in a very high ranking place the investment incentives.

The finding of **market size and its prospects for growth** are in accordance with Lankes and Venables, Meyer, OECD. However, another unique finding of this survey was the high consideration of Bulgaria as a link to other neighbor and prospective countries. We agree with SECI regarding the finding that the investors are considering Bulgaria as an **investment link to other neighbour countries.**

The finding of KPMG regarding **limited purchasing power** which was scored with 71% we can argue that this high percentage it was an expected outcome for the KPMG research because of the chosen time period (April 1998) that the survey was conducted. In other words, we have to consider that in February 1997, Bulgaria experienced its third economic crisis in a row, after the 1994 and 1996 crises. In our survey we have also found a significant percentage of 50% and this difference in the importance from 71% to 50% can be partially explained by the later time period that our survey was conducted and the positive outcomes for the Bulgarian environment due to the introduction of the currency board.

Lack of competition was also a significant incentive and it was in accordance with Meyer's survey. At the same time, the importance of **following the clients'** theory as an incentive was also in accordance with OECD.

Furthermore, our finding regarding **corruption** and its consideration as an important barrier was in accordance with only the SECI survey and it was not followed by OECD and Pitelis et al. The finding of corruption ranking in such a high place of importance for an MNE project was a significant and unique outcome of this survey and it was revealed as an incentive from Greek entrepreneurs. However, our finding was in contrast with the KPMG research in which corruption ranked at the end with a very low percentage of only 8%.

The outcomes regarding the **unstable legal system and bureaucracy** in high levels in the ranking were a surprise. They were in accordance with OECD, Pitelis et al. and KPMG.

Moreover, **political and macroeconomic stability** were of minor importance for the MNEs because of the successful establishment of the currency board in mid 1997 and the political stability that has existed in Bulgaria from early 1997.

Finally, the fact that only half of the interviewed MNEs considered the Bulgarian environment as **a risky** one and not by all the MNEs (if you considered that the whole region is associated with the high risk consideration) is in accordance with all the surveys presented in the literature review with similar percentages and similar ranking places.

The significant sample used in this questionnaire survey consisted of sixty-four MNEs. These MNEs made a significant volume of investment, over one million $US dollar each one. According to the literature the present survey is a significant contribution to the field because was conducted for an ex-communist and isolated country from the western investment interest in the specific chosen time period, having a large enough sample, high response rate and a proportional distribution of the participants in all the sectors of the Bulgarian economy[39].

A problem arises when making comparisons using FDI data, owing to the various elements included in FDI and thus, for example many countries exclude one of the components of FDI, usually the re-investments of the foreign companies. Furthermore, comparisons are also inaccurate because each country follows a different method of calculating FDI. One country

followed the US model defining as FDI the acquisition of at least 10% of the total shares of a company, whilst another country followed the German model, which defines as FDI the acquisition of at least 25% of the total shares. Investments below those percentages are considered as portfolio investment.

This chapter also concludes that unstable legal framework, lack of adequate and efficient laws, constant changes in the legal framework, insufficient enforcement of laws and bureaucracy left space for corruption and briberies and thus discourages foreign investors in participating in such an environment.

Our results are in accordance with various surveys and reports presented in this chapter but they are in contrast with the KPMG's research in which corruption was of limited consideration and with Pitelis et al.'s survey where corruption was not taken into account.

3.8 APPENDICES

Difficulties in defining Foreign Direct Investment

Foreign direct investment (FDI) came from needs and opportunities presented in an imperfect market. There is a lot of literature, which analyzes the reasons that a firm or individual entrepreneur finds when directly investing in a foreign country. There is also a lot of literature about how to predict the outcome of such an investment and choose the best alternative. The generally accepted characteristics of FDI however coincide in the following definitions taken from several sources.

A definition of Foreign Direct Investment is:

> *"...FDI is defined in the IMF' Balance of Payments Manual (5th edition) as 'investment that involves a long-term relationship reflecting a* ***lasting interest*** *of a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor. The direct investor's purpose is to exert a significant* ***degree of influence on the management*** *of the enterprise resident in the other economy' (1993)"* [Dunning, 1993, p5][40]

"DFI is defined as investment in equity ***to influence management operations*** *in the partner company"* [Meyer, 1998, p125][41]

The IMF's definition emphasizes in "***lasting interest***", "***a significant degree of influence***" of the investor over the company outside the home country [Brewer, 1994, p117][42]

"There are many different operational definitions of FDI, but all aim to encompass the desire of a home country firm ***to obtain and manage an asset*** *in a host country"* [Barrell et al., 1997, p64][43]

"A Direct Foreign Investment is the amount invested by residents of a country in a foreign enterprise over which they have ***effective control.*** *"* [Ragazzi, 1973, p471][44]

The main points are investing / acquiring / obtaining a foreign firm or asset and influencing / controlling the management operations. The essence of FDI is clearly displayed in the 'objection' of MacManus[45] about the name of FDI:

"Foreign Direct Investment is a rather inappropriate name for the process by which productive activities in different countries come under the control of a single firm. The essence of this phenomenon is not foreign investment, which is an international transfer of capital, but the ***international extension of managerial control over certain activities.*** *"* [MacManus 1972, p66]

The issue of control and influence is very important in defining FDI, but does need some clarifications. The fact is that, depending on the host country, when an entrepreneur or a company acquires more than 10% or 20% or even 25% of a foreign company, it is considered FDI. But does such a small percentage ensure control for the investor? The ownership rights issue over a company is a very complicated subject nowadays. The person, which has control over the decisions affecting the company is determined by the elaborate enactment of each company that varies greatly; enough to forbid assumptions and generalizations. Sometimes a person can have management control owning 10% of the company (if for example the given company's shares are divided among many shareholders through the stock market) or have no management control even if s/he owns more than 50% of the company or have both management control and over 50% share and not be able to take important decisions (if the

agreement of all parties dictates that in order for a decision to be valid the 2/3 of the owners must agree). So, one must keep in mind that not all investments over 10% or 25% aim and lead to control.

Some definitions use "*lasting interest*" and "*significant amount of influence*". This is more accurate in explaining the current status of several FDIs, but still it is vague since it does not specify the target of the *"influence"*. *"Influence management operations"* is even more accurate, but not enough. In fact in order to clarify this issue one must first specify the amount of control the investing company needs over the company that receives the investment. This differs according to what the investing company expects from the investment.

Through the years, many theorists studied the concept of investing abroad, and foreign direct investment in particular. What FDI is, cannot be defined in a four-line definition, since it involves much more than a simple money transaction, which aims to profit. The complications begin with the very first step economists might take; measuring and comparing FDI flows among several countries. This is because each country may have **different standards for a foreign investment to be considered direct**. The OECD has recommended that the minimum equity stake for an investment to qualify as direct should be 10%. The differences, though, among countries are distinct. For example in the US, Canada, and Australia the minimum is 10%, in France and Germany 20% (or 25% according to Brewer (1994) p.117) and in New Zealand 25%. It is obvious that any comparison among the state records of these countries on FDI would be unequal. [Dunning, 1993, p12][46]

Another difficulty is to specify **the components included in FDI measurement**. The following components should be used in FDI, when reporting to the IMF.

- Equity Capital: the value of the initial investment
- Reinvested earnings: all earnings of the affiliate company that are reinvested on the initial investment.
- Other capital: the transfer pricing between the mother company and the affiliate, (short and long-term capital)

[Barrell et al., 1997, p64][47]

The problem arises because many countries leave out in the reports at least one if not two of those components [Brewer 1994, p117][48]. *"The reinvested earnings component of FDI is particularly problematic. It is the most difficult component to measure because the data are*

not collected from foreign exchange records, but are based on surveys of the firm" [Brewer 1994, p117][49]. That is one of the reasons why this component is left out in many national FDI records. This problem is also distinct in Bulgaria, in which the Bulgarian Foreign Investment Agency (BFIA) includes in its official catalogues the reinvested earnings, while the Balance of Payments (BP) of the Bulgarian state, which is the source of data used by official institutes, does not. Although the BP is projecting the obvious foreign capital flows, it excludes the reinvested earnings and also investments applied in gray/black/unofficial ways (shadow economy) or even individual investments (not derived from a registered company). The clear capital inflows, or individual acquisitions appearing in BP is the minimum FDI volume, which the country may have, but still the actual investment is usually much higher. The Bulgarian official catalogues (National Statistical Institute -NSI) generally present distinct problems, since they often present different data for the same variables for the same time period and they are usually not updated them properly and in time. Also, some of the companies, which have invested in Bulgaria do not appear in the catalogues (BFIA) or appear with smaller amounts (see chapter 5). The author's questionnaire research has revealed at least 20 companies, which have invested large amounts of money (over 1 million USD), but do not appear in the Bulgarian official lists. Another problem is the manipulation of the economic facts, either because of incompetence or with intent, so that companies, which have withdrawn their investments through the years, still appear in the catalogues. An example of this problem is Rover, which withdrew an investment made in the end of 1994 almost immediately and still appears in the official catalogues of Privatisation Agency.

Inaccuracies and statistical problems regarding FDI

The **sources** from which one may find data on FDI are several. The primary sources of information are the company itself and the government of the home and the host country; the secondary sources are the international and regional economic agents. Some of them are United Nations on Trade and Development (UNCTAD), United Nations (UN), International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), European Bank for Reconstruction and Development (EBRD), The Economist Intelligence Unit (EIU), the World Bank, EUROSTAT, industrial and commercial trade associations and academic scholars. In general, one should be careful when using statistical data because of **several inaccuracies**. Dunning (1993) has presented some of them[50].

- The book value of the capital assets of the MNEs is noticeably underestimated compared to the replacement value estimated with current market price.
- The way home governments deal with foreign currency translation adjustments, regarding outward FDI, differs from country to country, so the affiliated firm's capital gains and losses are included or not in the parent firm's reports.
- The accounting techniques concerning depreciation are different from country to country.
- Some countries base the data on FDI intentions (passive and active) while others that are in progress (active only). An interesting example regarding Bulgaria is that from 1989 and onwards more than 1500 Greek investors registered. At present time, less than half are active.
- The collection of data by governments is derived in different ways and at different time periods. There are also many variations of the quality and accuracy of the research depending on the level of confidentiality and how willing the firms are to produce all the data the government asks for.
- Because of cross border transfer pricing, some of the economic data of a company may be inaccurate.

Besides the above, there are also some less general, but with high occurrence rate, especially for the case of Bulgaria.

- When investigating the origin of an FDI one may be mislead if the investment is contacted through a offshore company, which is directed by a third country firm.
- Companies may overestimate their capital assets in order to be able to repatriate more profits. This was a usual tactic with Greek entrepreneurs in Bulgaria, until both governments ratified (late 2000) the agreement for double taxation avoidance.
- Many of the entrepreneurs choose not to take the legal way of transferring/repatriating money, and move great quantities illegally through the borders. This is easier if the countries are neighbors, and this was also a common practice for Greek entrepreneurs in Bulgaria (mainly small Greek firms). This, results to underestimation of the total FDI inflows, since a lot of money capital is invested in a foreign country without being declared anywhere.

Sometimes the deviations are so significant that the FDI outwards are not so close when measured as inwards (e.g. according to Greek sources- the Greek FDI outflows in Bulgaria is

not so close in figures when compared with the Bulgarian FDI inflows derived from Greek MNEs – according to Bulgarian sources). Such deviations also exist when the data is derived from two different sources regarding the same variable. According to the Polish research department of PAIZ, (until September 2000), Poland had received 43,017 billion USD$, while at the same time (until the end of 2000 – table 14) according to UN, Poland had received less than 30 billion USD$.

Table 14: FDI Inflows in Poland

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	TOTAL
10	117	284	580	542	1132	2768	3077	5129	6471	9461	29571

Source: UN

Since, there is little, anyone can do about those inaccuracies a researcher should always "*...reminds himself that all estimates are only as good as the data on which they are based*"[51]

Statistical problems and information gaps at the beginning of the transition

At the beginning of transition, the general view, among the policy makers in all the transition economies, was that the information tools were inadequate to help them in taking significant decisions and using the analysis of the past trends as an indicator to improve policy design. Balcerowicz et al. (1995) argued that *"Even in established market economies **standard statistical data** provide only an incomplete description of economic reality, but in countries in transition data deficiencies and biases are much more serious".*[52]

Most of those statistical problems are presented in this thesis:

- During the transition years, there was a need for replacement of the material product system with the system of national accounts, because the former did not measure all the parts of GDP (particularly the service sector)[53]

- The statistical offices of the planned economies were adequate to keep under control the statistical information regarding state-owned enterprises with strong governmental control of the bookkeeping system. In the post-communist era, the introduction of a significant number of private firms, created problems to these statistical agencies, which did not expect and were not ready to prepare and measure economic facts of a market economy with quickly increasing private sector.

- The introduction of the private sector created the underground economy, which exists in all the economies, even in the Western ones. Thus, there is no experience in the Central and Eastern statistical agencies to deal with such as calculations.

- Different methodologies create inaccurate data, and comparisons with data derived from other countries are impossible. There is a need for a revision of all these data, which belongs to the pre-transition period. Nowadays, it is believed that a significant progress has been made, and many of the sources obtained have finalized the macro-economic data for both periods (pre/ post communist period).

- All the countries suffer from heavily distorted relative prices. Energy and household necessities were heavily subsidized

- Under the planned- economy there was a continuous attitude for an increase in output. This was apparent in the figures, but at the same time does not mean economic growth. There was an exaggeration of the data.

- The exchange rate was overvalued, and as a consequence in many countries and especially in Bulgaria, there was a significant black market exchange rate in the pre-transition period (1985 and onwards). This black market rate was heavily depreciated in relation to the official rate.

- Balcerowicz[54](1995, p.257) has argued that *"even in the established market economies statistical indicators do not provide a fully adequate description of the economic reality, because, for example, of well known problems of statistical representation of changes in produce quality, or the inadequacy of comparing data on unemployment in various countries. Even in these countries there are many instances of the poor interpretation of statistics"* The newly emerging output in Central and Eastern Economies is more closely geared to the consumers' welfare than the planned economy's output.

- Martha de Melo et al. (1996, p.399) have pointed out that[55] *"Under central planning the output of state enterprises was often exaggerated, whereas during the transition, output of the private sector has tended to be underreported, sometimes by large margins."* During the transition period to a market economy, there were strong tax incentives for the output

to be underreported by the private entrepreneurs.

- Lipton et al. (1990, p.79) have argued that[56] *"Real growth has been routinely overstated and inflation routinely understated in the data of Eastern Europe and the Soviet Union".*

- Lipton et al. (1990, p.79) have also argued[57] that *"in a market economy, a fall in real wages usually means a drop in living standards. But in a shortage economy (in which goods are not available at official prices), a fall in real wages can simply mean the elimination of queues, and therefore a rise of living standards".*

- There was also an underreported unemployment rate at the beginning of the transition period in most of the Central and Eastern economies.

- Furthermore, the fiscal deficits were understated due to the fact that central bank supported state-owned enterprises with cheap loans

- Finally, cross-border transactions were poorly reported, giving significant errors in the trade volume.

Questionnaire - Survey of the Determinants of FDI inflows
Reasons/ Incentives and Obstacles/ Barriers for Foreign Direct Investment Inflows in Bulgaria (1989-1999)

The purpose of this questionnaire is to extract valuable information regarding the determination of Foreign Direct Investment in Bulgaria during the post-communist period 1989-1999. The developer of this questionnaire is a Ph.D. student at the Department of Russian and East European Studies at the University of Glasgow and his name is Aristidis BITZENIS. Its purpose is to identify the kind and the type of reasons for foreign direct investment (inward) that the foreign firms (home country) have considered in order to invest or not in Bulgaria (host country).

The results will be included in his thesis for the Ph.D. degree.

It is necessary for the validity of this survey to inform us your name and the name of the company that you represent (both names will not appear in the results) for the purposes of this questionnaire.

FIRST PART

(a) How did you complete this questionnaire? (Please tick)

By FAX ☐	By WEBSITE ☐
By E-MAIL ☐	By INTERVIEW ☐
By POST LETTER ☐	By TELEPHONE ☐

(b) Could you please give us some general information? Please, complete the following background Information:

Company's Name: ..... Core:
Your Name: ..... Core:
Do you have an E-mail? ○ Yes ☐ ○ No ☐
Your E-Mail Address:
Do you have fax number? ○ Yes ☐ ○ No ☐
Your fax number:
Enter your Company's Web Site Address:
(c) Your Home Country:
(d) Kind of Business:
(e) Year of Investment in Bulgaria:
(f) Amount of Investment in $ US:

(g) Which of the following ways have your company used in order to invest in Bulgaria? (Please tick any appropriate)

- ☐ Acquisition opportunities through Bulgarian Privatisation Program ☐

- ☐ Investment opportunities through PHARE or other EU Programs, grants and subsidies ☐
- ☐ Has your company made EXPORTS in Bulgaria in previous years and then proceeded to an FDI project? ☐
- ☐ Has your company used Licensing or Franchising together with FDI? ☐
- ☐ Acquisitions ☐
- ☐ Foreign Direct Investment (FDI) - Greenfield Site / Wholly Owned Subsidiary ☐
- ☐ Joint Ventures / Strategic Alliances / M & A ☐
- ☐ Portfolio Investment ☐
- ☐ Representative Office / Branch ☐
- ☐ **Other, Please specify** _____ ☐

(h) Is your company planning on making additional investments in Bulgaria? ◦ Yes ☐ ◦ No ☐

SECOND PART

In this part of the questionnaire there are SEVEN groups of incentives that might have attracted your company to invest in Bulgaria. Please tick where appropriate and then after studying all the seven groups, please specify the three (3) most important groups of incentives for investing in Bulgaria

1. Locational hunters

☐ Economic Stability ☐

☐ Political Stability ☐

☐ Social Stability ☐

☐ New currency board after June 1997 ☐

☐ The attraction of the East European market - to have a link to other members of CMEA ☐

☐ Geographic Proximity - Low transportation costs ☐

☐ Historical Links between home and host country ☐

☐ Lack of Infrastructure (services, telecom etc.) as an incentive/opportunity for investment ☐

☐ Cultural Closeness – Consumption of Goods and Services based on their country-origin ☐

☐ Cultural distance - Consumption of Goods and Services based on the Western life style ☐

☐ Climate for Tourism ☐

☐ Other, Please specify _____ ☐

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2. Factor hunters

- ☐ **Skilled Low-cost Labour Force** ☐
- ☐ **Semi/Un-skilled Low-cost Labour Force** ☐
- ☐ **Low cost Labour-intensive production for exports (textiles)** ☐
- ☐ **Low cost of Raw Material (energy, oil, gas, etc.)** ☐
- ☐ **Searching for resources, availability of Raw Material** ☐
- ☐ **Inexpensive Land** ☐
- ☐ **Low-cost Production and Creation of an export base** ☐
- ☐ **Access to High Technology** ☐
- ☐ **Other, Please specify _____** ☐

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3. Market hunters

- ☐ **The size of the Bulgarian market (Customer base)** ☐
- ☐ **Prospects for market growth** ☐
- ☐ **New market – expand the operation - Increasing the profits (Market Share)** ☐
- ☐ **Other, Please specify _____** ☐

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4. Market hunters from a strategic point of view

- ☐ **First mover advantages** ☐
- ☐ **International Pressures from Competition - Physical Presence in different countries** ☐
- ☐ **Acquiring the assets of an existing foreign corporation – Globalisation** ☐
- ☐ **Lack of Local Competition in the Host Country** ☐
- ☐ **Pressures of Competition in the Home Country** ☐
- ☐ **A Way to Survive (Market Share)** ☐
- ☐ **The Product Cycle Theory** ☐
- ☐ **Follow the Competition (counter-attack, ATTACK, offensive/defensive, follow the leader)** ☐
- ☐ **The market in Home country is saturated** ☐

- ☐ **Follow the clients** ☐
- ☐ **Follow the suppliers** ☐

- ☐ **To avoid trade barriers (tariffs, quotas, currency constraints, etc.) - FDI is substitute or supplement to trade** ☐
- ☐ **Local Unsatisfied demand for products** ☐
- ☐ **Other, Please specify** _____ ☐

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5. Efficiency hunters

- ☐ **Economies of scale** ☐
- ☐ **Economies of scope** ☐
- ☐ **Risk Diversification (product, location sites)** ☐
- ☐ **Other, Please specify** _____ ☐

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6. Exploiting the Ownership advantages

☐ Existing Business Links ☐

☐ Brand Name, know-how, and innovation ☐

☐ Past experience of Business contacts in Bulgaria (representative office, exports) ☐

☐ Ability of adopting the local tastes, needs, customs, language, (Familiarity, Multinationality) ☐

☐ Other, Please specify _____ ☐

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7. Hunters of Financial aspects

- ☐ **Favourable Investment Law Framework (Liberal Character)** ☐
- ☐ **Any favourable regional trade agreements for surrounding countries (Setting up an export base)** ☐
- ☐ **Tax Holiday Regulation** ☐
- ☐ **Corporate Tax Relief on Profits for 3 plus 2 years (acquisition of 67% and over of the total shares)** ☐
- ☐ **Corporation Tax Rate** ☐
- ☐ **50% Corporate Tax Relief for 10 years** ☐
- ☐ **Avoidance of Double Taxation** ☐
- ☐ **Profits re-invested in certain sectors are tax-deductible** ☐

- ☐ **Discounts through debt swaps (Bradies/Zunk)** ☐
- ☐ **Technology-based investment project** ☐
- ☐ **Subsidies (Financial Assistance) for infrastructure through PHARE Program or other** ☐
- ☐ **Special incentives in regions with high unemployment or special subsidised zones** ☐
- ☐ **Exception from VAT, customs duties and taxes for the import of machines, technological equipment** ☐
- ☐ **Loss carry forward mechanism (next 5 years or 10 for banks)** ☐
- ☐ **Free Trade Zones** ☐
- ☐ **Availability of financing** ☐
- ☐ **Strong Currency of the home country** ☐
- ☐ **Other, Please specify** _____ ☐

Please <u>tick up to three (3) groups of incentives</u> that are considered to be the most important for your company in undertaking an FDI project:

☐ Locational hunters ☐

☐ Factor hunters ☐

☐ Market hunters ☐

☐ Market hunters from a strategic point of view ☐

☐ Efficiency hunters ☐

☐ Exploiting the Ownership advantages ☐

☐ Hunters of Financial aspects ☐

THIRD PART

Please tick <u>the most important barriers - up to five (5) in total</u>, which you would consider as discouraging your company to invest in Bulgaria or was hard to cope with them in the operation of the FDI project

1. ☐ **Low Progress in Privatisation, in Banking Reform, in Liberalisation, in Transition Process, etc.** ☐
2. ☐ **Unstable Legal System, Lack of appropriate laws, insufficient enforcement of the laws** ☐

3. ☐ **Exchange rate volatility, macroeconomic instability (inflation)** ☐
4. ☐ **Political instability** ☐
5. ☐ **Lack of managerial skills** ☐
6. ☐ **Lack of natural resources** ☐
7. ☐ **Corruption, Crime - Insufficient protection of the investors from illegal actions, organisations – cost of protection from 'mafia'** ☐
8. ☐ **Unstable Banking system, lack of financial intermediaries** ☐
9. ☐ **Lack of favourable bilateral treaties** ☐
10. ☐ **Culture, local behaviour regarding consumption, labour** ☐
11. ☐ **Low income per capita, consumers' consumption patterns (low tendency in consumption)** ☐
12. ☐ **Bureaucracy** ☐
13. ☐ **Tax System - Repatriation of the profits** ☐
14. ☐ **Stage of development of technology in Bulgarian Industry** ☐
15. ☐ **High Investment Risk** ☐
16. ☐ **Lack of infrastructure** ☐
17. ☐ **High Level of Strikes** ☐
18. ☐ **Difficulties in securing financing** ☐
19. ☐ **High V.A.T. (22%) – High taxation Rates** ☐
20. ☐ **Other, Please specify** _____ ☐

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[2] **MEYER, K** (1996), "Direct Foreign Investment in Eastern Europe: The role of labour costs", *Research paper*. This survey also appeared in **MEYER, K.,** 1998, *Direct Investment in Economies in transition*, Edward Elgar Publishing Ltd., UK

[3] the companies were from the following sectors: food and beverages, chemicals and petroleum, and machinery, including electronic and transport equipment

[4] **MEYER, K** (1996). "Business operation of British and German companies with the Economies in Transition", CIS Middle Europe Center, London Business School Department Series No.19.

[5] **ARTHUR ANDERSEN,** *Assessing Investment Opportunities in Economies in Transition*, OECD, 1994

[6] In the paper: "Assessing Investment Opportunities in Economies in Transition", 162 managers of multinational firms were interviewed (34 from Austria, 34 from France, 20 from Germany, 7 from Japan, 26 from UK, 41 from USA)

[7] Foreign Direct Investment in Eastern Europe and the former Soviet Union: results from a survey of investors", Chapter 5 in Zecchini S, ed., *Lessons from the economic transition in Central and Eastern Europe*, 1997

[8] **LANKES, H P AND A J VENABLES** (1997), "Foreign direct investment in Eastern Europe and the former Soviet Union: results from a survey of investors", in Zecchini S, ed., *Lessons From The Economic Transition: Central And Eastern Europe In The 1990s* (OECD and Kluwer Academic Publishers).

[9] **Pitelis et al** (2000) carried out in 1995-96, as a part of an ACE Project supported by the European Commission on the economic integration through FDI in the less favoured CEECs, a study titled "FOREIGN DIRECT INVESTMENT AND "LESS FAVOURED REGIONS": GREEK FDI IN BULGARIA AND ROMANIA" (also presented in Dublin Conference, August 1999). The original database from which the sample was drawn included 220 Greek and Portuguese investors (The database included 120 Greek and the remaining were Portuguese investors) in Bulgaria, Romania and the Slovak Republic and the response rate for that initial project is not known to us. The EU investing countries considered in the ACE Project (No 94-0719-R) were Greece and Portugal and the survey addressed also to their subsidiaries in CEECs, allowing a database of 220 firms in total. In this paper Pitelis et al. considered only the results for Greek parents which invested in Bulgaria and Romania. Only 96 Greek firms responded to the questionnaire. 76 firms were used with 85 direct investments in the two CEECs (Bulgaria and Romania) as the remaining Greek firms had invested in Slovak Republic.

[10] **PITELIS, C AND S IAMMARINO**, 2000, "Foreign Direct Investment and Less Favoured Regions: Greek FDI in Bulgaria, and Romania", *Global Business Review*, 1, 2

[11] **PYE, R B K** (1998), "Foreign Direct Investment in Central Europe: The Experiences of Major Western Investors", *European Management Journal*, Special Issue, *Russia and Central and Eastern Europe*.

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[13] **ALTZINGER, W** (1999), "Austria's Foreign Direct Investment in Central and Eastern Europe: 'Supply Based' or 'Market Driven'", presented at the 47th International Atlantic Economic Conference, Vienna.

[14] The survey "Research into the Disincentives that Greek Companies face in their Business Activities in Southeast European Cooperative Initiative (SECI) countries, Yugoslavia, and Russia, December 1998" was conducted by the Federation of Industries of Northern Greece within the framework of its involvement in **Southeast European Cooperative Initiative (SECI)**. The field of investigation were companies active in the SECI countries, namely Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Moldova, Romania, Slovenia, the former Yugoslav Republic of Macedonia (FYROM). The survey did not include one SECI country, Turkey, but did include Yugoslavia, which is not included in SECI. The survey also included the Russian Federation, which supports SECI. In total, questionnaires were sent to a total of three hundred and eighty (380) companies and organizations. Two hundred and seventy (270) questionnaires were returned for processing from 92 companies and organizations. The last completed questionnaires were received on November 17, 1998.

[15] Approximately 200 foreign investors have been addressed, including the top 50 foreign direct investors identified by the BFIA. These investors have received questionnaires of 20 multiple-choice questions, focusing on company data and managers' opinions of the Bulgarian business environment. The response rate was 35.4%. 88% of the respondent companies were considering further investment. Origin of foreign investors were American (26%), German (20%), Austrian 9% and Swiss (8%), Greek (6%), and from Netherlands (6%). About 38% of the respondent companies have invested less than 250 thousand dollars.Another 13% of the respondent companies have invested less 1 million US$ (large part of the sample-companies had limited in amount investment interest!! More than 50% of the total sample companies were invested less than 1 million USD$).

[16] The usual way of replying questionnaires, the post way, in any research study, failed (i.e. only 4.7% of the companies replied in this way). Hence, it seems that the best replying rate came from one to one interviews (35,9% of the total response rate, followed by e-mail or www with 29.7%). The fax and telephone methods had success in about 30% cases together. Due to the above bad response rate by post (despite the fact that the questionnaire was sent to all the companies) and the possibility of a failure to collect the sufficient data, a multiple approach of the target group was decided by applying some pressure with various methods of contacting and getting their attention.

[17] From the questionnaire survey the services sector accounts 28% and the FDI inflows in Bulgaria in the same sector were 18% (Finance 11,4% + Tourism 5,1% + Telecommunications 1,8% =18.3%). Trade in the questionnaire survey accounts 36% and the FDI inflows in Bulgaria in the same sector were 19,2%. Finally, the answers from the industrial sector were 22% and textiles 14% (total 36%) and at the same time the FDI inflows in Bulgaria in the industrial sector were 55% of the total.

[18] BITZENIS ARISTIDIS, 2002, "The Determinants of FDI in Transition Countries; Incentives and Barriers Based on a Questionnaire Research: the Case of Bulgaria, 1989-2000", *International and Monetary Aspects of Transition in Southeastern Europe*, D. Chionis and G. Petrakos (eds.), p. 89-144

[19] *[Published in the Official Gazette Issue No 109 of December 27th, 1996]* and article 3 on the Right to Make Investments (Title amended, Official Gazette issue No 109 of 1996) (Amended, Official Gazette issue No 109 of 1996)

[20] [The Act was adopted by the 36th National Assembly on 16 January 1992 repeals the act published in the State Gazette No. 47/1991; amended in No. 48/1991]

[21] {Published in the Official Gazette issue No 97, of 1997; supplemented, Official Gazette issue No 29 of 1998; No 153 of 1998, No 110 of 1999 amended and supplemented. [This law also repealed the Law on Promotion and Protection of Foreign Investments (published, State Gazette, issue 8 of 1992; amended, issues 92 and 102 of 1995, issue 109 of 1996; corrigendum, issue 110 of 1996; amended, issues 55 and 58 of 1997).]}

[22] [according to the IMF Balance of Payments Manual, Fifth Edition, 1993 and OECD's issue Benchmark Definition of Foreign Direct Investment, OECD, 3rd Edition, 1996 and appeared in the Balance of Payments Manual.]

[23] In accordance with the standard presentation of the balance of payments, the **Direct investment** in the country item **comprises**:

A. Equity capital – acquisition/disposal of shares and equities (in cash and in kind) by non-residents in/from the share or equity capital of Bulgarian enterprises. The acquisition of equities and shares in the capital is reported as increase in the direct investment in the country, and the disposal – as decrease.

B. Other capital – principal received and paid on loans (both on short- and long-term ones) between the direct investor and the direct investment enterprise. The receipt of a principal is treated as an increase of the direct investment abroad, and the repayment of the loan – as a decrease.

C. Reinvested earnings – the share of non-residents in the undistributed earnings/ loss of the enterprise for the reporting period. The share in the undistributed earnings is reported as increase of the direct investment in the country, and the share in the loss – as decrease.

In the compilation of the balance of payments, the BNB uses data from the following **sources**:

- Privatisation authorities

- Agency for Privatisation and branch ministries

- Insurance Supervision Directorate at the Ministry of Finance

- Central Depository

- Financial sector enterprises

- Foreign investment enterprises from the non-financial sector

- National Statistical Institute

[24] ([Promulgated State Gazette No. 83/21.09.1999], which Law repealed the Law on Transactions with Foreign Exchange and Foreign Exchange Control, in the additional provisions

[25] '**Direct investment**' shall be:
a) the establishment or acquisition of a commercial enterprise;
b) the acquisition in a company, of the rights of unlimited liability partner, or
of an equity stake giving the right to **over 20 percent of the votes** at a general meeting;
c) granting a loan for a period not less than 5 years for the purpose of direct investment under 'a' or 'b', or related to an agreement for participation in the profit distribution;
d) additional investment to the investment under 'a' or 'b'.

According to Foreign Exchange Law (Adopted by the 38th National Assembly on 8 September 1999; published in the State Gazette, issue 83 of **21 September 1999**)

[26] SURVEY METHODOLOGY: Sample: National representative survey of the population aged 18+ of each country. Sample Size: Albania 1002, Bulgaria 1144, FYROM 1007. Survey method: The survey used the method of the face-to-face interview. Field work: Field work was conducted between January 15 - January 25, 2000. CORRUPTION INDEXES: Corruption assessment index numbers assume values from 0-10. The closer the value of the indexes is to 10, the more negative are the assessments of the evaluated aspect of corruption in Bulgaria. Index numbers closer to 0 indicate approximation to the ideal of a "corruption-free" society. Corruption indexes have been grouped into several categories: - Attitudes towards corruption; - Corrupt practices; - Assessment of the spread of corruption; - Corruption-related expectations.

[27] It was conducted in the capitals of Albania, Bulgaria, Belarus, Ukraine, Russia, Romania, Hungary and Lithuania. The results of the survey show that victimization by conventional offences. This survey was a part of an international project of the United Nations Interregional Crime and Justice Research Institute (UNICRI) and was coordinated by Gallup-Hungary. UNICRI's extended research project consisted of: (1) International Crime Victim Survey, based on public opinion polls, and (2) International Crime Business Survey, based on interviews with business' persons. This initiative made it possible to analyze victimization by comparing two overlapping periods, 1993-97 and 1996-2000.

[28] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, the former Yugoslav Republic of Macedonia, Malta, Romania, Turkey, the Federal Republic of Yugoslavia (Serbia and Montenegro)

[29] The survey "Research into the Disincentives that Greek Companies face in their Business Activities in Southeast European Cooperative Initiative (SECI) countries, Yugoslavia, and Russia, December 1998" was conducted by the Federation of Industries of Northern Greece within the framework of its involvement in **Southeast European Cooperative Initiative (SECI)**. The field of investigation were companies active in the SECI countries, namely Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Moldova, Romania, Slovenia, the former Yugoslav Republic of Macedonia (FYROM). The survey did not include one SECI country, Turkey, but did include Yugoslavia, which is not included in SECI. The survey also included the Russian Federation, which supports SECI. In total, questionnaires were sent to a total of three hundred and eighty (380) companies and organizations. Two hundred and seventy (270) questionnaires were returned for processing from 92 companies and organizations. The last completed questionnaires were received on November 17, 1998.

[30] **Pitelis et al** (2000) carried out in 1995-96, as a part of an ACE Project supported by the European Commission on the economic integration through FDI in the less favoured CEECs, a study titled "FOREIGN DIRECT INVESTMENT AND "LESS FAVOURED REGIONS": GREEK FDI IN BULGARIA AND ROMANIA" (also

presented in Dublin Conference, August 1999). The original database from which the sample was drawn included 220 Greek and Portuguese investors (The database included 120 Greek and the remaining were Portuguese investors) in Bulgaria, Romania and the Slovak Republic and the response rate for that initial project is not known to us. The EU investing countries considered in the ACE Project (No 94-0719-R) were Greece and Portugal and the survey addressed also to their subsidiaries in CEECs, allowing a database of 220 firms in total. In this paper Pitelis et al. considered only the results for Greek parents which invested in Bulgaria and Romania. Only 96 Greek firms responded to the questionnaire. 76 firms were used with 85 direct investments in the two CEECs (Bulgaria and Romania) as the remaining Greek firms had invested in Slovak Republic.

[31] **PITELIS, C. and S. IAMMARINO**, 2000, "Foreign Direct Investment and Less Favoured Regions: Greek FDI in Bulgaria, and Romania", *Global Business Review*, 1, 2

[32] Approximately 200 foreign investors have been addressed, including the top 50 foreign direct investors identified by the BFIA. These investors have received questionnaires of 20 multiple-choice questions, focusing on company data and managers' opinions of the Bulgarian business environment. The response rate was 35.4%. 88% of the respondent companies were considering further investment. Origin of foreign investors were American (26%), German (20%), Austrian 9% and Swiss (8%), Greek (6%), and from Netherlands (6%). About 38% of the respondent companies have invested less than 250 thousand dollars. Another 13% of the respondent companies have invested less 1 million US$ (large part of the sample-companies had limited in amount investment interest!! More than 50% of the total sample companies were invested less than 1 million USD$).

[33] According to the Vitosha research (February 2000 – a sociological program) in a sample survey of 1144 face-to-face interviews with agencies, international organizations, financial institutions, SMEs, trade organizations, ministries and state agency officials we found the following results: unemployment rate (65,3%), low incomes (50,6%), poverty (41,2%), corruption (37,5%) and crime (27,9%)

[34] The Corruption Perceptions Index, which Transparency International (TI) first launched in 1995, ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The surveys embrace the perceptions of business people, the general public and country analysts. The surveys were undertaken over the last three years and no country is included in the CPI unless there are results from a minimum of three surveys (a perfect 10.00 would be a totally corruption-free country). Standard Deviation indicates differences in the values of the sources for the index: the greater the variance, the greater the differences of perceptions of a country among the sources. The number of surveys used had to be at least 3 for a country to be included in the CPI. High-Low Range provides the highest and lowest values of the sources.

[35] The author must note that the profit the parties are seeking for in FDI is not necessarily financial profit. Some of the groups of incentives or individual incentives lead to non-money benefits that may eventually lead to financial profit.

[36] **BITZENIS ARISTIDIS**, 2003, "Universal Model of Theories Determining FDI; Is there any dominant theory? Are the FDI inflows in CEE countries and especially in Bulgaria a myth?", *European Business Review, 2003, No2, Forthcoming*

[37] **TERRY F. BUSS,** 2001, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature", *Economic Development Quarterly*, Vol. 15, No.1, pp. 90-105

[38] **THOMAS L. BREWER AND STEPHEN YOUNG,** 1997, "Investment Incentives and the International Agenda", *The World Economy*, Vol. 20, No.2, pp. 175-198

[39] for more see endnotes: 18-21

[40] **DUNNING H. JOHN,** 1993, *Multinational Enterprises and the Global Economy*, chapter 1, "The activities of Multinational Enterprises: Some Introductory Remarks", p5, Addison Wesley publishers Ltd., UK.

[41] **MEYER KLAUS**, 1998, *Direct Investment in Economies in transition*, chapter 5, p125, Edward Elgar Publishing Ltd., UK

[42] **BREWER L. THOMAS**, 1994, "Indicators of foreign direct investment in the countries of Central and Eastern Europe: a comparison of data sources", *Transnational Corporations*, Vol. 3, no.2, pp.115-126

[43] **BARRELL RAY** and **NIGEL PAIN**, 1997, "The growth of Foreign Direct Investment in Europe", *National Institute Economic Review*, pp. 63-75

[44] **RAGAZZI GIORGIO**, 1973, "Theories of the Determinants of Direct Foreign Investment", *International Monetary Fund Staff Papers*, volume 20, p471

[45] **MCMANUS C. JOHN**, 1990, "The Theory of the International Firm", chapter 2, *Multinational Corporations*, Mark Casson, Edward Elgar Publishing Limited, UK, p32

[46] **DUNNING H. JOHN**, 1993, *Multinational Enterprises and the Global Economy*, chapter 1, "The activities of Multinational Enterprises: Some Introductory Remarks", p12, Addison Wesley publishers Ltd., UK.

[47] **BARRELL RAY** and **NIGEL PAIN**, 1997, "The growth of Foreign Direct Investment in Europe", *National*

Institute Economic Review, pp. 63-75

[48] **BREWER L. THOMAS**, 1994, "Indicators of foreign direct investment in the countries of Central and Eastern Europe: a comparison of data sources", *Transnational Corporations*, Vol. 3, no.2, pp.115-126

[49] Ibid

[50] **DUNNING H. JOHN**, 1993, *Multinational Enterprises and the Global Economy*, chapter 1, "The activities of Multinational Enterprises: Some Introductory Remarks", p10, Addison Wesley publishers Ltd., UK.

[51] Ibid

[52] **LESZEK BALCEROWICZ** and **ALAN GELB**, 1995, "Macropolicies in transition to a Market Economy: A Three-Year Perspective", *Proceedings of the World Bank for Reconstruction and Development, World Bank*, p23.

[53] **SALVATORE ZECCHINI**, 1997, "Transition approaches in retrospect", *Lessons from the economic transition: Central and Eastern Europe in the 1990s*, Part I, Chapter 1, pp. 1-35, OECD, Kluwer Academic Publishers, USA.

[54] **LESZEK BALCEROWICZ**, 1995, "Common Fallacies in the Debate on the Economic Transition in Central and Eastern Europe", Chapter 13, in *Socialism, Capitalism, Transformation*, in Balcerowicz (eds), p.257, Central European University Press, Hungary.

[55] **MARTHA DE MELO, CEVDET DENIZER** and **ALAN GELB**, 1996, "Patterns of Transition from Plan to Market", *The World Bank Economic Review*, Vol. 10, No.3, p.399

[56] **DAVID LIPTON** and **JEFFREY SACHS**, 1990, "Creating a Market Economy in Eastern Europe: the case of Poland", *Brookings Papers on Economic Activity*, 1:1990, p.79.

[57] Ibid

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CHAPTER FOUR

4.1 Introduction

This chapter examined topics such as the privatisation and restructuring process in Bulgaria as a part of foreign direct investment. Incentives and barriers regarding the whole privatisation process have been considered. Moreover, topics such as foreign financial reform in general, cleaning up of the balances of the banks, their debt cancellation and the problem of bad loans have been discussed. The role of financial institutions and commercial banks in the privatisation process (if any) together with the stock market development, legal framework and the presence of foreign banks in Bulgaria are also examined. There is also a criticism about the slow privatisation process in Bulgaria, and its choice of different methods of privatisation.

In addition, there is a discussion about the development of small and medium enterprises, property rights, and corporate governance, ownership and private sector development. All the laws are presented together with graphs and examples of all the privatisation and FDI deals and the progress from the beginning until now are presented in this chapter.

Case studies with foreign MNEs that participated in the privatisation process, together with all the BCC deals taking part in the Bulgarian privatisation of the banking system, are also presented in this chapter.

4.2 WHAT WAS BEHIND The Delay IN The BULGARIAN Privatisation Process? DETERMINING INCENTIVES AND BARRIERS OF Privatisation As a Way Of Foreign Entry

"The word "privatisation"... is used in two senses. In the narrower sense, it means the transfer of assets hitherto owned by the state into private hands. The broader interpretation covers the property relations in the economy as a whole, so that privatisation of the economy must be understood to mean that the share of the private sector grows until it ultimately becomes the dominant economic sector."[Kornai 1995, p32] An extension of the broad definition provides more insight in the process of privatisation. Besides the selling or leasing of public property, the term implies the abandonment of any government control over all units

of the economy, as well as the state monopoly in certain sectors. It also includes the return of property, which had been illegally confiscated to it rightful owners, the promotion of private enterprises and the effort to attract foreign investors[1].

Under, the broad definition, privatisation may also be called "*the restructuring of the independent and private sectors.*" [Hare 1994, p34-35] The creation of small private firms may, eventually, achieve the revival of the private sector, even without the help of Privatisation of state firms, [Koves, 1992, p40] or in other words privatisation represents the transfer of state-owned assets to private ownership, alongside the creation and fostering of "de novo" private business. Privatisation is an alternative way of distributing and choosing means of generating wealth so it may also be considered as a distribution of political and economic power over the long run.

Especially in the context of former communist countries, Estrin S. (1995) views privatisation as a *"reversal of communism"*, considering the restoration of the private property rights which are essential to a free market economy. In the same sense, the emergence of "de novo" private sector using the fixed assets of former state owned firms purchased after bankruptcy or liquidation, can lead to industry-level supply responses to demand changes even in the absence of supply responses from current and state owned firms. [Estrin, S. p5 (1994)]

In contrast with the Western economies, where privatisation represented only "*a transfer ownership of few state-owned enterprises, functioning in a fundamentally market economy, dominated by private property*" [Frydman, R. et al., 1992], and do not command an entire restructure of the national economy, in the planned economies of Central and Eastern Europe, privatisation plays an invaluable role in the transition process toward a free market economy. The privatisation process and the emergence of de novo private entities in Eastern economies require institutional reform that relies on an effective property system, together with economic stabilisation (at a macroeconomic level) and price liberalization.

Since the question of whether privatisation should preside or follow restructuring emerges, a definition of restructuring is needed. Restructuring is a "*...multidimensional, encompassing: "reactive" policies brought about by the hardening of firms' budget constrains (e.g. labour-shedding, wage reductions, plant closures); strategic aspects, including export reorientation, changes in the mix of products and changes in management structures; and "deeper*

restructuring", generally involving substantial new investment, that can deliver large improvements in enterprise performance and growth over the long run."[EBRD Transition Report 1995, p128]

Restructuring may also be viewed from a macroeconomic perspective. As companies restructure by adopting policies and strategies, which increase their efficiency, governments restructure by adopting laws, regulations and policies in the same direction, meaning to increase the efficiency of the state economy. From the macro economic point of view, the adaptation of companies to new market standards can also be called restructuring.[2]

If the state decides to undertake restructuring before privatizing a firm, it needs to spend additional capital time and effort for state-owned companies for the sake of higher revenues derived from the sale. On the other hand, if it avoids restructuring, the state achieves quick privatisation and relieves the burden of financing the loss-making company. Restructuring before privatisation holds another, hidden, drawback. The managers and employees of the company, which is under restructuring procedures, (in order to be privatised in the future) will probably not be motivated to participate in a specific restructuring program, given that privatisation may result, in the long run, in the loss of their position in the company. What governments may fail to consider is that the restructuring they intend to apply on the company may be far from what the potential investors expect.[3] A close inspection of the company should determine the path that is more profitable for the state. Sometimes, governments use restructuring prior to privatisation as an excuse for delaying the process in order to avoid the political burden of mass dismissals of employees and generally postpone hard restructuring methods imposed by the new owners. A long restructuring period allows space for corruption and increases the possibilities that the nomenklatura will profit by wild privatisation.

4.3 Privatisation and Restructuring in an ex-communist country: the case of Bulgaria

The sequence, path or the pace of the adaptation of each policy is very important in the transition process. Rapid changes are favoured by most countries, but have been sometimes criticized by theorists. Stanley Fischer et al. [2000, p.1] mentioned that *"the faster is the speed of reforms, the quicker is the recovery and the higher is growth"*. Stanley Fischer (1992, p.227) has also concluded that

"small firms should be privatised by sale almost immediately... larger industrial firms should be corporatized as soon as possible...plans envisage the corporatization phase being completed within a year or two... the key to the long-run transformation of the formerly socialist economies may lie less in the privatisation of the very large industrial firms ... than in the development of new firms and the growth of existing smaller firms... for that reason, rapid progress in other areas, such as the creation of a suitable legal environment, price decontrol ... is as important to the development of a vibrant private sector as privatisation of large firms".

The supporters of the big-bang approach argue that the level of poverty and income inequality is higher in countries following the gradualist method, which is a method that provides more space for the satisfaction of personal interests and corruption.[4] The characteristics of 'big bang' sequencing favour fast privatisation techniques including mass privatisation plans, leaving the task of restructuring to the owners of the privatised firms.

On the other hand, others object on the premise that the shock-therapy approach leads to drastic increases in the level of poverty and income inequality. Especially in the case of privatisation of state owned firms, the rushed moves have often led to the disorganization of valuable operational enterprises, a fact assisting the drop of the output level.[5]

Although early analysts have seen Bulgaria as a country, which undertook a 'big bang' transition, a transition study of eleven years of Bulgaria indicates otherwise. The instant price liberalization of more than 70% of commodities in 1989 was the only sign to point toward a 'big bang' strategy. On the other hand there was a delay in the liberalization of prices in remaining commodities, preservation of the big state monopolies, late introduction of bankruptcy laws and hard budget constraints as well as accumulation of bad loans and inability to stop inflation before the introduction of the currency board, which them all resulted in the reinforcement of the nomenklatura, development of wild privatisation, and in overall a very slow progress of the privatisation and restructuring process.

The developments in Bulgarian privatisation are not only far from a 'big bang' path, but also raise doubts on whether it falls under gradualism. It can be argued that political constraints impose a gradual approach to restructuring, which has implications on the speed and

sequencing of privatisation.

Lipton et al.(1991, p.231) in an article argued that "*In Eastern Europe, privatisation is a very difficult task, involving nothing less than the complete redefinition of property rights for literally thousands of enterprises ...Advocates of rapid privatisation are typically confident that even if quick Privatisation initially leads to an inappropriate distribution of ownership with, for example, too diffuse ownership, or firms in the wrong hands, then the capital markets will encourage a reshuffling of ownership through takeovers, mergers and buy-outs so that there is a proper matching of owners and firms....* "

The situation in Bulgaria showed that the Bulgarian government tried to promote restructuring prior to privatisation, continued to finance state companies and erased some of the old debts. This resulted in an accumulation of debt and the creation of the so-called 'bad loans' problems. The problem of accumulation of debt was enforced because the country was borrowing in foreign currency and because the national currency was devaluated. The postponement of privatisation in hopes of a higher return proved to be an illusion, because the debt that the government undertook during the time of the restructuring was not covered by the alleged higher price, not to mention that during the years of the 'restructuring' the country suffered great economic instability and lacked the revenues to cover its deficits. The question that arises is whether a country should privatise before or after restructuring or should both proceed simultaneously. Another question is whether there is a need for sequencing in privatisation or not and if so what principles should underline it

4.4 General Aspects on Privatisation in Bulgaria

At the beginning of the transition, Bulgaria had more than 80% state-ownership, one of the highest percentages among the former communist countries, and co-operative ownership had been turned into a variety of state ownership. In the 1970s, state and co-operative ownership covered 99.9 per cent of the national economy. A steady policy of restriction and liquidation of private ownership, and a merger of co-operative and state ownership, was pursued even until the mid 1970s. In the 1980s, shifts in the ownership pattern were observed, mainly in two directions (to provide autonomy to state-owned enterprises or to pass the management of state enterprises to employees). The attempt to share the ownership rights between the state

and the employees failed due to the preserved and centralised character of the economy and the minimal opportunities for workers' self-initiatives.

Although, Bulgaria started its transition and liberalization of prices earlier than most of the other CEE countries, the actual privatisation process started later. This could have been an advantage if Bulgaria had studied and tried not to repeat other's mistakes. The Bulgarian economy went through institutional and economic change after the attempts towards decentralization, de-monopolization and liberalization in the early 1990s. The SOEs were allowed full legal autonomy and were transformed into joint stock or public limited companies, aimed at encouraging a sense of managerial responsibility and corporate competitiveness.[6]

Privatisation in Bulgaria, as in many countries, included the privatisation of small, medium, and large enterprises (SMEs, SOEs, agriculture, housing and mass privatisation), which were either owned by the state, or by municipalities or even were co-operative firms. The distinction of the size of the enterprises is determined by the nominal value reported in their balance sheet. According to the Bulgarian Law of 1999 [7], small and medium enterprises are characterized as micro-enterprises when the maximum average number of employees is 10. In small enterprises the maximum average annual number of employees is 50 and their annual turnover do not exceed the BGN 1 million or their fixed tangible assets do not exceed BGN 800.000 and in medium enterprises the maximum average annual number of employees is 100 and their annual turnover do not exceed the BGN 3 million or their fixed tangible assets do not exceed BGN 2.4 million.

The Law on Incorporating Single-Owned Firms provided guidelines for the management of the converted firms and was, in turn, covered by the Privatisation Law issued in April 1992 regulating the corporatization and privatisation of state owned firms.[8]

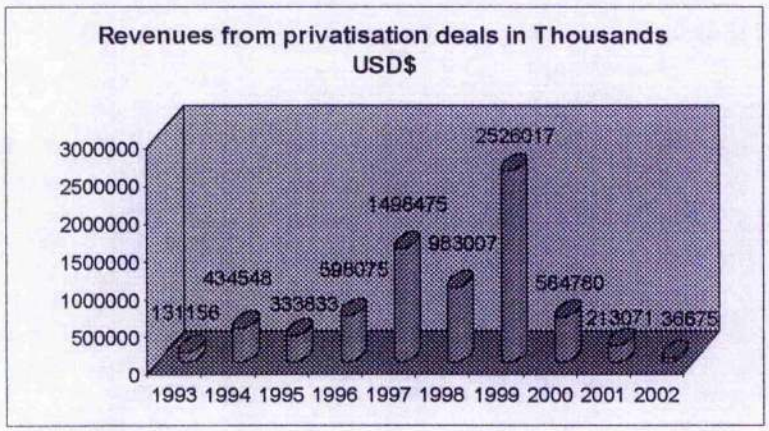
The party competent to undertake the privatisation of an enterprise is determined by the book value of the fixed assets of the enterprise. According to the initial law[9] of 1992, enterprises worth under 10 million [*old*] leva (BGL), were handled by one of the five branch ministries and enterprises worth between 10 and 200 million BGL by the Privatisation Agency (PA)[10]. Decisions for enterprises worth over 200 million BGL were undertaken by the PA and had to be endorsed by the Council of Ministers.

Although, in 1992 Bulgaria chosen a rapid road toward privatisation (at least there was such a belief from each government) the results for the time period 1993-2002 showed very little progress (figures 1 & 2).

Figure 1: Privatisation Deals, Total Number, By Year, Feb. 2002

total 9590 * Privatisation deals (enterprises + separate parts)
Source: PA

Figure 2: Total Revenues from Privatisation Deals in Bulgaria, Feb. 2002



Source: PA

Especially in the time period 1993 - end 1997, there was a significant low progress. This limited number of completed privatisation deals and the low accumulation of revenues can be explained either by the weak Bulgarian privatisation authorities, or by the general instability of the Bulgarian economic environment, together with the political instability or inability of the Bulgarian governments and the limited western investment interest. Actually, the gap between the annual goals of the PA's and the other privatisation authorities' programs, and the concluded privatisation deals, led to frequent changes at the executive director level of the Privatisation Agency (see table 1a).

Table 1a: The Executive Directors of the PA from 1991-2001

1.	Alexander Boshkov	First executive director, then Deputy Prime Minister
2.	Reneta Indzhova	She worked under Berov's government. She became the next Prime minister
3.	Vesselin Koev	Became popular by several sales of small units
4.	Ivan Sabotinov	Left his position shortly afterwards
5.	Sahari Zhelyazkov	An Executive Director of PA from Haskovo.
6.	Levon Hampartsoumyan	On 04.09.2001, the government released Levon Hampartsoumyan from the position of Executive Director of the Privatisation Agency
7.	Apostol Apostolov	Ex Executive Director of the Bulgarian Stock Exchange

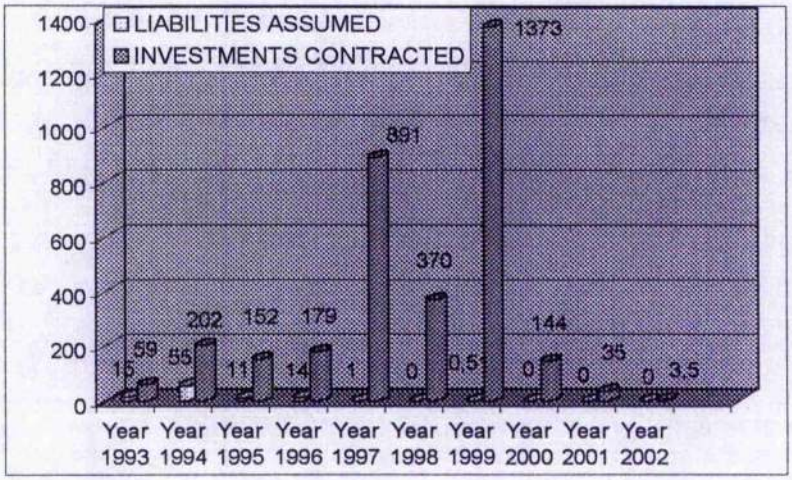
Source: Various Sources, Author's Research

The issue of restructuring before privatisation or leaving the restructuring process for new investors should have been considered more carefully by the Bulgarian authorities. However, the bad loans accumulation and the debts recorded in the balance sheets of the majority of state-owned enterprises made it necessary for the Bulgarian governments to proceed into a general restructuring program, especially after the second general economic crisis occurred in Bulgaria in 1996 (the first was in 1994 and the third was in 1997).

The first privatisation program (approved in the autumn of 1992) planned the initiation of the privatisation procedures for 92 enterprises. The program did not totally meet its goal. No privatisation deal was achieved in 1992, initiating the first in a line of many, unfulfilled privatisation plans, so the privatisation process actually started in 1993.

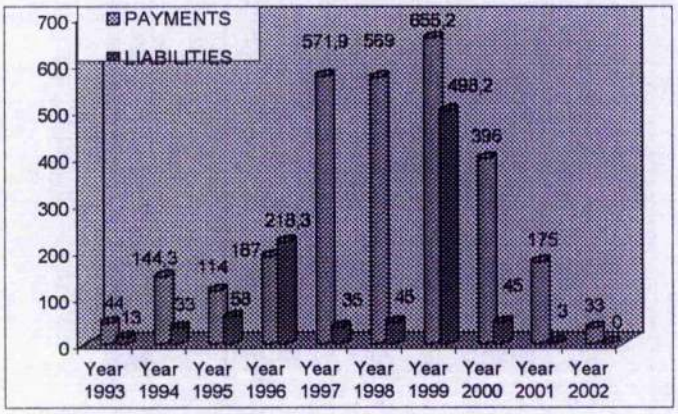
The 1999 privatisation forecast was the only one that was met. The estimated number of privatisation transactions was 1083 and over 2400 transactions were concluded by all state bodies. This was the only year that the PA met its annual privatisation program forecast and the other state bodies have managed to meet their goals. The year 1999 also fostered some major privatisation deals in the banking sector. This year was the zenith of Bulgarian Privatisation when there were 1373 million USD$ investments contracted (figure 3), 655 million USD$ payments and 498 million USD$ liabilities paid (figure 4) and only half million USD$ liabilities assumed. In other words, at that year a percentage of 34.4% of the total privatisation revenues has been fulfilled. Furthermore, 60% of all the privatisation deals were made in the three-year time period 1998-2000 (figure 1). Finally, 55% of the total privatisation revenues were collected in the same three-year period (figure 2).

Figure 3: Liabilities Assumed + Investments contracted -from Privatisation Deals in Bulgaria (up to Feb 2002)



Source: PA

Figure 4: Total Revenues (Payments) + Liabilities Paid from Privatisation Deals in Bulgaria (up to Feb 2002)



Total payments: 2887 million USD$, liabilities undertaken 947 USD$, liabilities paid 97 USD$, investments contracted 3408 USD$
Source: PA

The data also indicates the significant delay that the privatisation process experienced until June 1997, a fact that is also be demonstrated by the yearly progress, which shows that yearly goals were rarely met. Despite the delay and the constant reconsideration of the facts, the amount of Privatisation deals offered and completed surpasses the initial target and indicates a wide range of enterprises offered for Privatisation and a serious attempt to totally privatise state assets, thus encouraging the operation of an open market.

Most of the privatisation deals have been carried out by all state bodies (2605 enterprises + 2190 separate parts), followed by all ministries (2082 enterprises + 1765 separate parts) and by the Privatisation Agency (PA) (523 enterprises + 425 separate parts).

The percentages of the contracts concluded are quite deceptive regarding the PA's performance considering that the PA only handles the privatisation of large companies (over BGL70 million according to the law of 1997). The Privatisation Agency has often been accused of not performing its tasks efficiently and playing a key role in the delay of privatisation. Nevertheless this author, based on statistical data and qualitative facts, insists that the privatisation agency has been moving on the same levels as the other privatisation authorities and demonstrated no additional disadvantages. There were many rumours in the Bulgarian press about the termination of the PA or the drastic reduction of its duties by increasing the minimum value of the companies handled by the PA. The 1994-7 minimum was BGL70 million; in 1998 it was increase to BGL350 million, and finally reached BGN1 million in 1999. The rumour was that in March 1998 Bozhkov, the Deputy Prime Minister, demanded that the minimum would be raised to BGL 4-5 billion an amount met at the time only by approximately 10 companies. These rumours have been proven wrong by the present situation since the PA is operational and the possibility of its termination is close to zero since Bulgaria is so close to the completion of the entire privatisation program.

Considering that December 2002 could be the deadline for Industrial Privatisation, one understands that the plan of the Privatisation Agency is ambitious and difficult to meet. By the end of 2003, privatisation procedures in industry, construction, transport, agriculture and service sectors should be completed and all liquidation procedures should be concluded.

The control functions of the Privatisation Agency over the privatised groups is to be increased. Nevertheless, the performance of post-privatisation commitments is not considered as one of the main priorities. The transparency of transactions considered to be increased through the regulation of the negotiations with potential buyers, if the declared intentions are to be trusted.

4.5 The main reasons for the delay in the Bulgarian Privatisation process

Privatisation in Bulgaria in the transition years was very slow and difficult both for reasons of insufficient planning and implementation of Privatisation schemes resulting from uncontrolled circumstances. The delays in Bulgarian Privatisation were sometimes so striking that they affected (very negatively) the trustworthiness of the Bulgarian government. For example the Privatisation of 51% of Balkan Airlines was announced in the Wall Street Journal in 1993, after an already failed attempt to sell 49% of the company in June of the same year. [11] The

company was loss making and the agreement contained several unclear elements, although it was first privatised in June 1999. On the other hand, in 2000 there were rumors that the license will be revoked from the owner Israel's Zeevi Group. This finally happened due to the inability of the Group to invest 20 million USD$, which was included in the privatisation deal as an obligation, and in the end, a bankruptcy procedure was launched early in 2001 due to the poor financial position of the airline.

The obstacles for privatisation are generated by the considerations each government has to make before, and during, the privatisation process. The issues a government should consider in order to efficiently start the privatisation process are:

- The selection of the companies to be privatised in different time periods,
- The specific methods to be used in each company, the use or not of a mass privatisation method,
- The speed and sequence of the entire privatisation process (restructuring of companies before privatisation or passing of this task to the new owners),
- The selection of the percentage that the state will maintain, and the time limit for the abolition of all monopolies.

However, two of the most important adverse initial conditions, which were very strong in Bulgaria and affected the privatisation process, were the state bureaucracy and the unstable business environment. A striking example was the case of Rover. In November 1994, Rover acquired a manufacturing company in Bulgaria investing $1.4 million. Some time later the company withdrew the investment, because of the problems faced regarding state bureaucracy and certain "bridges" in the agreements already signed with the Bulgarian government.[12]

Another two obstacles responsible for the slow Bulgarian privatisation process were the political instability (and the conflicts of interest among politically strong parties) and the fact that Bulgarians are either indifferent or negative towards privatisation. [Mladenova et al. (1997), p.505] A report prepared by the Centre for the Study of Democracy revealed that in 1992, 74,6% of the population had no intention in participating in the privatisation process.

Until the end of 1997, the above underlying factors responsible for the delay proved 'lethal' for the Privatisation process. The unstable political environment and the inability of the acting

governments to plan and coordinate the economic restructuring had a direct effect on the Privatisation process. The negative attitude of the Bulgarian people, especially toward Privatisation when there was participation of foreign investors, worsened the situation and led many government plans to failure. There were also some functional problems, which undermined the Privatisation procedure. The first was the widely discussed valuation problem. The former communist countries had an enormous problem firstly in defining the assets owned by each company, and then in attributing the proper value on each asset, mainly because of the shared use of assets by companies and insufficient accounting records. Bulgaria had a large valuation problem, which was underlined by the fact that the so-called 'valuation experts' used in the early years by the Privatisation Agency were Bulgarian citizens that were trained in a one or two week seminar and hardly gaining the expertise needed.

The second problem was that after any valuation of the respective companies, the competent authorities failed to realize that the price of the company should not merely represent the value of the company. In order for the Privatisation deals offered to be attractive to foreign investors the potential risk they would undertake by investing, given the unstable and high risky business environment and the political and economic instability should be reflected on the price in the form of a price reduction. Since it is next to impossible to incorporate all the potential risks in a given situation, the instruments, which better approximate financial risk are inflation and exchange rates, which, if incorporated in the price accounting for a 5-year estimation, may make the price more attractive. This did not happen in Bulgaria so the privatised companies were offered at prices much higher than what the investors could consider an opportunity.[13] Actually, the situation after the introduction of the currency board in mid 1997 and especially in 1998-99, accelerated the whole privatisation process, as mentioned above, when Bulgaria faced moderate inflation rates and stable exchange rates.

In general, the parties authorized to conduct Privatisation deals, and especially the Privatisation Agency have often been accused of improper judgment in important decisions and insufficient planning and control of the procedures.

Another factor, which played an important, negative, role in the Privatisation procedure in Bulgaria was the extensive power of the nomenklatura, which was heavily involved in informal, or illegal Privatisation. An indicative reference appears in research by Bulgarian economists, which suggests that in the time period 1991-1996, assets worth about 100 billion

leva, and profits of several tens of billion lev were acquired or 'privatised' under suspicious circumstances (either illegally or by 'side methods').[14]

The problem of inconsistent data is apparent in the official citations and reports of the Privatisation Agency. Most of the updated data retrieved from yearly reports include changes throughout the years. Given the fact that evidence on Privatisation deals appears different in separate reports and in different time periods, this research will present the latest data from official PA reports after the modifications and calculations done by the author for the purpose of higher credibility. Another important note is that according to the Article 1[15] the Bulgarian lev shall be re-denominated whereby 1,000 old levs (BGL) shall be exchanged for one new lev (BGN). In the data presented in this chapter 1 BGN is equivalent to 1DM while 1000BGL is equivalent to 1DM. However, there are different results when comparing statistical data using different sources such as the Bulgarian Foreign Investment Agency (BFIA) and that from the PA (see table 2a and figures 2 & 4)[16].

Table 2a: FOREIGN DIRECT INVESTMENT INFLOWS IN BULGARIA BY YEARS 1992-2001* (June 2001)

YEAR	VOLUME IN $USD million				
	Privatisation	*Capital market*	*Greenfield+*	*Total by years*	*Number*
1992			34,4	34,4	1271
1993	22,0		80,4	102,4	2261
1994	134,2		76,7	210,9	3163
1995	26,0		136,6	162,6	4183
1996	76,4		180,0	256,4	4570
1997	421,4	29,7	185,1	636,2	4077
1998	155,8	64,2	400,0	620,0	4613
1999	226,7	53,1	539	818,8	3590
2000	366	20,0	615,5	1001,5	5300
*2001 (Jan-June)**	19		390.6	409,6	2500
*Total 1992-2001**	**1447,5**	**167**	**2638,3**	**4252,8**	**35528**

"GREENFIELD+" - Greenfield investment + additional foreign investment in companies with foreign participation + reinvested earnings + joint ventures + credits by direct investor

Source: BFIA AGENCY

Except for the above, the following reasons resulted in the slow speed and low effectiveness of the Bulgarian Privatisation process.

- The lack of transparency and the existence of corruption and bribery in the Privatisation progress discouraged both investors, who had dealt with Bulgarian

bureaucracy, and potential investors who were informed about the situation by the experience of others.

- The macroeconomic environment of Bulgaria that was highly unstable in the time period 1989-1997, until the introduction of the currency board, discouraged investors, which in any case are heavily affected by the macroeconomic environment of a country in investment decisions. After 1997 the Privatisation process was accelerated, a fact that resulted from several changes, but was mainly predicated on the initiating macroeconomic stabilization.
- The inadequate legal framework and its constant changes did not provide investors with any security; instead, it made the trustworthiness of Bulgarian deals rather questionable, thus increasing the risk of the investment.
- The effort of Bulgaria to get the highest proceeds possible for the larger and more significant state companies, led the government to decide on restructuring before Privatisation. Besides the extra financial burden on the state budget, this resulted in companies that constituted greater investment opportunities to either be offered at unreasonably high prices or not to be offered at all for long time periods until they were restructured. Moreover, the delay in offering significant SOEs resulted in low value added projects for privatisation offered by the Bulgarian state, and thus resulted in low western investment interest.
- Most of the SOEs had high accumulated debts that the Bulgarian state did not restructure rapidly. The restructuring of debt through the restructuring of the company, through isolation, or through debt swap operations, either delayed the companies' offering for Privatisation or diminished the value of the companies that were offered without settlement of their debts.
- The geographical situation of Bulgaria, which places the country far from the advanced western economies, was one of the factors that affected investors in their decision to seek Privatisation opportunities in transition economies closer to their own countries or to economically developed countries.
- The implementation of methods such as spontaneous Privatisation, MEBO etc., which were not efficiently supervised, allowed the insiders and the nomenklatura to exploit inside information for acquiring state property through informal ways. The interest was personal profit rather than the effective and prosperous development of the firms.

- The complex criteria of selecting the buyers, a process that was in many cases anyway corrupted by the insiders and the nomenklatura, and the barriers of state bureaucracy, delayed the Privatisation process and discouraged potential investors.
- The Kosovo war and the embargo that the Western countries imposed in the area cut Bulgaria off from its main export channels. This resulted not only in a drastic increase in transportation costs, but also a decrease in the export potential of the area and the possibility of expanding markets. The turmoil of war and its economic consequences on the wide area hardly indicated a period suitable for investments in a country so much affected by the situation as Bulgaria was.
- The economic crises of both Asia and the former USSR discouraged investors from investing in Eastern emerging markets, because they indicated that the risk of the investment was high compared to the potential return or, despite any return, they were not capable of undertaking such high risk.
- The lack of experience in Bulgaria, which led to decisions that negatively affected Privatisation, such as the choice of inexperience valuation 'experts', as well as the state bureaucracy that was inherited from the communist years, created an insecure environment for investors. The positive changes that occurred after 1997, such as the introduction of international consultants in the Privatisation deals, were a product of the experience acquired as well as the response to external pressures.
- Until 1997, the inability and unwillingness of the changing governments to facilitate Privatisation led to decisions that stalled both the process of Privatisation and the process of restructuring. The political instability was both a cause and an effect of the delay in the transition to a market economy.
- The problem of the correct valuation of the state owned firms brought about significant delays and inefficiencies in the Privatisation process. Initially, the lack of proper and accurate accounting records and the missing documents that clarified property rights and other information about the firm, made the valuation of separate firms very difficult.
- There was a lack of information regarding the companies, which were offered for privatisation. The information was based on misleading data from the former management and different accounting rules and techniques, which should have been resolved through a proper evaluation of past performance together with the value of the assets. Specifically the data provided lacks evidence of profitability, because the

state was not profit oriented and the intermediate goods were discriminatorily priced through either internal means or through the Council for Mutual Economic Assistance (CMEA) trade, a fact restricting predictions on the future profits of the company. Many companies were missing evidence on purchasing prices, and those which had all of the papers needed, appeared to have been purchased again at discriminatory prices.

- According to Bulgarian law, a Privatisation deal is consummated with the sale of more than 50% of the state company to a private investor. The 49% which belongs to the state may be sold later to other investors or remain in the ownership of the state. Nevertheless, Bulgarian Corporate law allows a shareholder, or a group of shareholders, which own more than 33% of the shares, to block strategic decisions concerning the company. Thus, the IMF and other institutions put pressure on the Bulgarian government to offer more than 67% of the total shares of each state-owned company. The investors are discouraged by the fact that the government may offer more than 33% of the state-owned company in MEBO, Mass, or other kinds of Privatisation, since this will create problems in corporate governance and may restrict foreign investor's strategic moves if the decisions are blocked by employees or other investors.
- The late abolishment of monopolies, or the delay of this abolishment, the absence of an adequate competitive environment together with the lack of strong structural reforms, the lack of sound stock market and financial intermediaries and the high risk Bulgarian environment led again to the absence of significant western foreign investment interest.
- The limited savings of people led to limited participation in mass privatisation programs and in the inadequate creation and establishment of new private firms

4.6 Privatisation as a way of foreign entry in Bulgaria; Questionnaire Results

Examining table 3a, we can argue that from 64 companies, only 23 of them (35,9%) participated in the Bulgarian privatisation procedure.

Table 3a: Statistical Analysis – Questionnaire Survey

Privatisation as an entry way of foreign Involvement and the sector that an MNE belongs to

			Kind of business			
			Productive/Industry +Textiles	Services/Banks	Trade/Food	Total
Privatisation	No	Count	11	11	19	41
		%	26,8%	26,8%	46,3%	100,0%
		%	47,8%	61,1%	82,6%	64,1%
	Yes	Count	12	7	4	23
		%	52,2%	30,4%	17,4%	100,0%
		%	52,2%	38,9%	17,4%	35,9%
Total		Count	23	18	23	64
		%	35,9%	28,1%	35,9%	100,0%
		%	100,0%	100,0%	100,0%	100,0%

Privatisation as an entry way of foreign involvement and the origin of MNEs

			Origin of MNEs		
			Greece	Europe & Other	Total
Privatisation	No	Count	30	11	41
		%	73,2%	26,8%	100,0%
		%	81,1%	40,7%	64,1%
	Yes	Count	7	16	23
		%	30,4%	69,6%	100,0%
		%	18,9%	59,3%	35,9%
Total		Count	37	27	64
		%	57,8%	42,2%	100,0%
		%	100,0%	100,0%	100,0%

Low progress in transition process (privatisation, banking reform, etc.) [Y61] and the sector that an MNE belongs to

			Y61		
			0	1	Total
Kind of business	Productive/Industry+ Textiles	Count	23		23
		%	100,0%		100,0%
		%	42,6%		35,9%
	Services/Banks	Count	8	10	18
		%	44,4%	55,6%	100,0%
		%	14,8%	100,0%	28,1%
	Trade/Food	Count	23		23
		%	100,0%		100,0%
		%	42,6%		35,9%
Total		Count	54	10	64
		%	84,4%	15,6%	100,0%
		%	100,0%	100,0%	100,0%

Bureaucracy [Y72] as a barrier and privatisation as a way of foreign entry

			Y72		
			No	Yes	Total
Privatisation	No	Count	18	23	41
		%	43,9%	56,1%	100,0%
		%	66,7%	62,2%	64,1%
	Yes	Count	9	14	23
		%	39,1%	60,9%	100,0%
		%	33,3%	37,8%	35,9%
Total		Count	27	37	64
		%	42,2%	57,8%	100,0%
		%	100,0%	100,0%	100,0%

Crime, Corruption, illegal actions (Y67) and Privatisation as a way of foreign entry

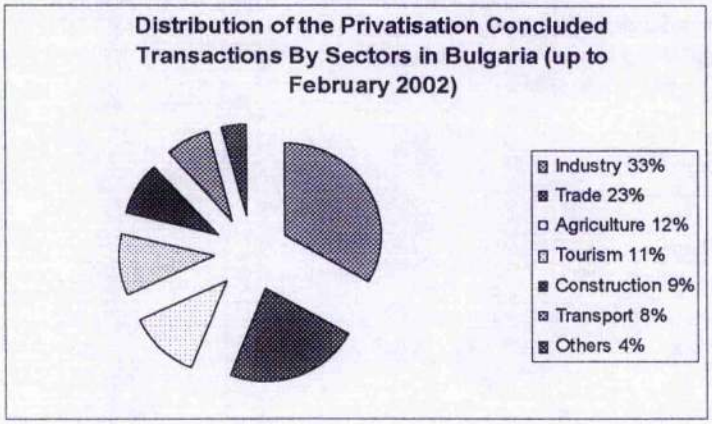
			Privatisation		
			No	Yes	Total
Y67	No	Count	15	15	30
		%	50,0%	50,0%	100,0%
		%	36,6%	65,2%	46,9%
	Yes	Count	26	8	34
		%	76,5%	23,5%	100,0%
		%	63,4%	34,8%	53,1%
Total		Count	41	23	64
		%	64,1%	35,9%	100,0%
		%	100,0%	100,0%	100,0%

High Investment risk (Y75) and Privatisation as a way of foreign entry

			Privatisation		
			No	Yes	Total
Y75	No	Count	19	12	31
		%	61,3%	38,7%	100,0%
		%	46,3%	52,2%	48,4%
	Yes	Count	22	11	33
		%	66,7%	33,3%	100,0%
		%	53,7%	47,8%	51,6%
Total		Count	41	23	64
		%	64,1%	35,9%	100,0%
		%	100,0%	100,0%	100,0%

Privatisation deals (from MNEs which participated in the questionnaire research) in Bulgaria have been taken place mostly in industrial or textile sector (12/23 with 52.2%), followed by the services sector (7/18 with 38.9%). At the same time, 17.4% (4/23) of the companies, which belong to the trade/food sector have invested in Bulgaria using a privatisation programme. We can argue that MNEs participated in the Bulgarian privatisation process preferred to invest mostly in the above sectors, mainly because the Bulgarian governments privatised the specific SOEs[17] from these sectors.

Figure 5: Privatisation Concluded Transaction by Sectors (up to Feb. 2002)



Source: PA

The later is also apparent, when observing the official data provided until February of 2002 (figure 5), in which it is pointed out that 42% of the concluded privatisation deals belong to the industrial sector (industry and construction), followed by the trade sector with 23% and the services sector with 19% (tourism and transport).

Examining table 3a, we can conclude that only 18.9% of the responding Greek companies (7/37) participated in the Bulgarian privatisation programs, while at the same time 59.3% (16/23) of foreign MNEs (other than Greek MNEs) have also invested in Bulgaria using a privatisation program. In other words, geographical proximity played a significant role for Greek companies to choose other ways to establish an FDI project in a neighbour country, such as Bulgaria. Most Greek MNEs preferred greenfield FDI. It is quite easy and most probable for a company, which is about to invest in a neighbour country, to proceed with market research searching for a bargain acquisition of land, or a building and/or moving its machinery from the home country in order to establish a greenfield investment. Thus, the origin of MNEs was found to be significant in the consideration of participation in a privatisation program or choosing other ways of foreign entry. With the help of statistics we underpinned the above results, and we found that the p-value (continuity correction, 2x2 table) is 0.002 and thus <0.01. Therefore, we accept the Ha hypothesis, and so, there **is strong association** between the two variables (entry modes of foreign involvement and the origin of MNEs) at a 1% level of significance.

Examining table 3a, we found only ten responding MNEs (a small percentage of 15,6%

(10/64)), who had invested in Bulgaria using a privatisation programme and mentioned that the delay in the privatisation process and the whole transition process was a barrier for considering an FDI project in Bulgaria. The most interesting thing was the fact that all such companies belong to the services sector, primary banks. In other words, it can be concluded that foreign MNEs, which have invested in Bulgaria, did not consider the above barrier as a significant one, with the exemption of the majority of MNEs, which belong to the services sector (10/18 equals to 55.6%). This can be partially explained by the fact that banks being financial intermediaries, are concerned with the whole privatisation process upon which their progress depends. At the same time, an MNE, which belongs to other sectors, is interested in the completion of a privatisation deal rather than in considering the whole delay in the privatisation or in the transition process of a country as a significant barrier. From a statistical point of view we can conclude that **according to the Pearson chi-square test** the p-value is 0 and thus <0.01. Therefore, we accept the Ha hypothesis, and suggest that there **is strong association** between the two variables (low privatisation and transition process and the sector that an MNE belongs to) at the 1% level of significance.

Examining table 3a, we can argue that 37/64 (57.8%) of the sampled MNEs mentioned bureaucracy as an important barrier when considering FDI. However, 14/23 (60,9%) companies, which have been involved in Bulgaria with a privatisation deal, have also mentioned that bureaucracy was a barrier for their investment plan. At the same time, 23 out of 41 (56,1%) companies, which used other ways of foreign entry in Bulgaria, have argued that bureaucracy was a barrier for an FDI project. Thus, the research suggests that bureaucracy affected all the ways of foreign involvement and all the levels of foreign investment. The statistics also underpin the above argument. The p-value (continuity correction, 2x2 table) is 0,915 and thus >0.1. Therefore, we reject the Ha hypothesis, and we accept the null (Ho) hypothesis and suggest, there is **no association** between the two variables (bureaucracy as a barrier and privatisation as an entry mode of foreign involvement).

Examining table 3a, we can point out that 34/64 (53,1%) MNEs have also considered corruption and the lack of transparency together with other illegal actions (crime, bribery etc.) as a barrier for an FDI project in Bulgaria. However, corruption has not been considered as a significant barrier from MNEs, which invested in Bulgaria using a privatisation programme (8/23, 34,8%). On the other hand, corruption was an important barrier for other forms of foreign involvement in Bulgaria, such as green-field FDI or joint ventures. In other words,

68% of MNEs, which used a green-field FDI entry mode and 58% of MNEs, which established joint ventures in Bulgaria have also considered corruption as a barrier for their FDI projects. However, MNEs did not consider corruption as a barrier when investing in Bulgaria through acquisitions. This result may be explained by the fact that although corruption is still a fact in Bulgaria, companies, which became higher bidders in the privatisation deals and finally acquired the state-owned companies, did not mention corruption as a barrier (because of the "happy end" of the privatisation deal). However, the majority of other MNEs (not participating in privatisation programme, mentioned corruption as a barrier - 26/41 thus 63.4%) may failed to acquire a State Owned Enterprise (SOE), through a privatisation program, due to corruption, or have chosen other ways of foreign involvement, such as joint ventures or green-field FDI, in which corruption is strongly associated. The high percentage of 53.1% (34/64) sampled companies, which considered corruption as a barrier for an FDI in Bulgaria, is not a surprise. In fact, during the first years of transition, when clear property rights did not exist, the unstable legal system and the inappropriate/inadequate enforcement of the law, left space for corruption. Thus, corruption did not affect privatisation, when corruption significantly affected other foreign entry modes in Bulgaria. The statistics underpin this argument. The p-value (continuity correction, 2x2 table) is 0,052 and thus <0.1. Therefore, we accept the Ha hypothesis, and so, there **is association** between the two variables (corruption and ways of foreign entry) **at the 10% level of** significance.

Examining table 3a, we can point out that 33/64 (51,6%) MNEs mentioned the high investment risk as a barrier for establishing an FDI project in Bulgaria. Moreover, 47.8% (11/23) of the companies who participated in the research, which used Bulgarian privatisation program, have also considered Bulgaria as a high risk environment. However, there is a similar percentage of 53.7% (22/41) of the companies, which chose other ways of foreign involvement in Bulgaria, and which, at the same time, have also considered Bulgaria as a high risk environment. Thus, this questionnaire research concluded that the chosen way of foreign involvement was indifferent when considering risk as an FDI barrier. Foreign MNEs, which successfully participated in privatisation program, did not mention that the risky environment was a barrier for them, due to the fact that they acquired SOEs in lower prices and thus it was supposed that the risk has been embodied in the price. On the other hand, the consideration of risk as a barrier is connected with other elements such as the sector that an MNE belongs to, the idiosyncrasy of the entrepreneur, the existence of prior trade relations etc. The statistics underpins the above argument. The p-value (continuity correction, 2x2 table) is 0,851 and thus

>0.1. Therefore, we reject the Ha hypothesis, and we accept the Ho hypothesis and so, there is **no association** between the two variables (high risk environment as a barrier and privatisation as an entry way of foreign involvement).

4.7 Foreign Participation in the Bulgarian Banking System during its transition period (1989-2001)

4.7.1 Introduction

This section outlines most of the aspects, which seem to have a more direct impact on the functioning of the financial system and on the process of its transformation. The role of financial intermediaries such as banks, and investment funds and stock market exchange is significant in the privatisation process. A stable and developed banking system helps the economic stabilisation and development in general, and it is also a factor, which encourages foreign investors in their decisions for undertaking FDI projects. A sound banking system, which helps the companies in their investment plans through financing their projects, as well as a functioning stock market exchange, which is a basic tool for mass or market privatisation, are essential parts of a stable economy.

The banking environment of an ex-communist country was difficult to change in order to provide a competitive and efficient banking system and to facilitate the different banking activities of investors. There was a need to encourage foreign investors to participate in the general privatisation process, and also in the specific privatisation, restructuring, and corporatization of the state-owned banks, which process was very slow and inefficient for the case of Bulgaria. The history of the banking system in the communist years clarifies the significant delay in the establishment of a sound banking system and the difficulty of privatising it.

One of the main difficulties was the establishment of an adequate legal framework, which could support and control the banking sector. Moreover, the delay of adopting laws regarding the bad loans, liquidation and bankruptcy led to the instability of the sector and the delay of the transition to a market economy.

The creation and the increase of private sector is precondition for the market economy, thus, the establishment of new private banks, the establishment of foreign branches and the participation of the foreign banks through privatisation of whole or part of state owned banks, help the transition to a market economy, and it is actually a form of FDI. The creation of BCC (Bulgarian Consolidation Company) helped the privatisation process, through the mergers of 59 banks into 4 big banks and their subsequent privatisation. The significant economic development and the inflow of significant FDI amounts in Bulgaria coincided with the development of an efficient banking system and the entrance of foreign banks either with new branches or with privatisation and acquisition of state-owned banks. Foreign bank can participate in a host country:

- with a **branch** (e.g. Pireus Group (ex Xios Bank), Alpha bank of Greece (ex Ionian Bank), National Bank of Greece, HypoVereinsBank, ING, and Ziraat Bankasi in Bulgaria),
- or creating a **new private bank** (e.g. Demirbank-Bulgaria and Raiffeisenbank in Bulgaria)
- or making **direct acquisition** (e.g. Commercial Bank of Greece in Bulgaria)
- or through the **BCC's privatisation programme** (e.g. Eurobank + Alico and Societe Generale in Bulgaria),
- or with a **joint venture** (e.g. BNP + Dresdner Bank in Bulgaria),
- or with **limited (minority) participation** (e.g. EBRD in Bulgaria).

4.7.2 Bank Consolidation Company (BCC)

The **Bank Consolidation Company (BCC)** was established by the Bulgarian government with the purpose of reorganising the banking system by consolidating the small weak banks and creating strong large banks to be offered for privatization. Hunter (1993)[18] has argued "*the Bulgarian government has established the BCC - similar in some respects to the Resolution Trust Corporation in the United States, which is charged with liquidating financially failed savings and private risk capital and the absence of established markets for asset liquidation. Thus, unlike the United States in recent cases, Bulgaria can not rely on the formation of private companies to purchase and liquidate the failed companies*". The BCC was established in order to deal with the large number of stated-owned banks that decreased the efficiency of the banking system. Established on 4, January, 1992, the BCC is a share-holding company

owned jointly by the Ministry of Finance, the BNB and the BFTB. The initial capital of BCC was BGL933 million; 20 % from the BFTB and 80% from the BNB.[19] The BCC represented the state's interest in approximately 70 small state-owned banks[20].

The first consolidation project started in the second half of 1992 when the BCC encouraged the merger between Doverie Commercial Bank and 21 other smaller banks. This consolidation led to the establishment of the **United Bulgarian Bank** at the end of 1992, which was firstly privatised in August 1997 [for more details see section 4.7].[21]

Table 4a: Consolidation of the UBB

Doverie Bank	Construction Bank	Rousse	Pleven	Vratza
Shoumen	Haskovo	Gabrovo	Karjali	Lovech
Montana	Pazardzik	Peshtera	Sliven	Nova Zagora
Iskar	Elhovo	Botevgrad	Samokov	Targovishte
Pernik	Popovo			

Source: Dobrinsky (1994), Chapter 14, p. 343

In April 1993, the BalkanBank received permission from the BNB and the BCC to acquire three small regional banks. This project completed in 1994, and then BalkanBank was closed.

Table 5a: Consolidation of the Balkanbank

Balkanbank	Vidin	Lyaskotetz	Gorna Oriahovitza

Source: Dobrinsky (1994), Chapter 14, p. 343

During the second-half of 1993, BCC created **ExpressBank**, by a merger of 12 state banks (one sectoral and 11 regional), which was privatised in September 1999,

Table 6a: Consolidation of the Expressbank

Transport Bank	Varna	Vazrazhdane Bank	Kyustendil	Silistra
Razgrad	Smolian	Cherven Briag	Rila Bank	Gotze Delchev
Provadija	Devin			

Source: Dobrinsky (1994), Chapter 14, p. 343

and **Hebrosbank**, by a merger of 8 state banks (one sectoral and seven regional).

Table 7a: Consolidation of Hebrobank

Agrocooperative Bank	Plovdiv	Veliko Tarnovo	Blagoevgrad
Vitosha Bank	Mezdra	Troian	Chepelare

Source: Dobrinsky (1994), Chapter 14, p. 343

In 1994, the BCC encouraged the merger of Hemus Commercial Bank, Sofia Commercial Bank, Electronika Commercial Bank and Kazanlik Commercial Bank to create Sofiabank (one sectoral and three regional). In September 1995, the BCC forced another merger between the Sofiabank (1993), Commercial Bank Biochim (1987), Commercial Bank Serdika (1995) and several smaller banks (Sredetz Bank, Burgas, Stara Zagora, Karlovo, Trakia Bank, Asenovgrad, Parvomai, Elin Pelin). This was the basis for establishing the **BiochimBank**. Within two years of its establishment, the BCC facilitated the mergers of approximately 50 commercial banks into 5 large organisations.[22]

Consolidations were envisaged to produce stronger banks, but the consolidation of weak banks without restructuring, is bound to lead to bigger, but equally weak banks. The situation of BalkanBank that experienced liquidity problems and loan collection problems (in 1995, and especially in 1996) that brought the bank close to insolvency, prove this point. BalkanBank was eventually bankrupted in 1997, 1st of August.

Maybe, this was one of the reasons that the privatisation of the large banks was delayed and no deals were achieved until 1997. The privatisation of the state banks begun gradually and the BCC sold most of the minority shares in several private banks, like First International Bank, Commercial and Savings Bank and Crystalbank. During the second half of 1995, and in 1996, the BCC played a significant role in the development of the program for the restructuring of the banking sector in Bulgaria. In the second half of 1997, and after the government had clarified the banking sector development strategy the BCC was authorised to accelerate the privatisation of the state-owned banks and to promote the expansion of activities of foreign banks in Bulgaria. The first bank privatisation project that had started in 1994 was completed in August 1997, soon after the announcement of the strategy. The United Bulgarian bank, one of the six largest state owned banks, was firstly privatised by the EBRD (35% of the shares) and Oppenheimer & Co. Incorporation (30% of the shares). This privatisation was followed by the initiation, in September 1997, of extensive efforts for the sale of the Bulgarian Post Bank. The bank received three very competitive offers and was finally sold to the strategic investing consortium of the American Life Insurance Company (ALICO, AIG) with the Consolidated Eurofinance Holdings (Greek Eurobank) in November 1998. The BCC's strategy preferred a strong well-managed financial institution as a strategic investor for each of the banks because although the price is a important issue of the offer, the investors ability to

invest additional capital (if necessary) and management expertise into the Bulgarian banking system is a major factor in evaluating prospective offers (spillover effects from FDI inflows).

In any case the BCC was relatively successful since "... *by mid-1994 the BCC has succeeded in merging most of the 59 banks into 6, whilst 6 others were left unmerged and 2 were put under BNB administration for possible liquidation.*" [Wyzan (1996)][23]

BCC has managed to sell five of the six state-owned banks (four created from the consolidation, together with Postbank and Bulbank) and only Biochim is remaining. Although BCC's task was very close to its conclusion, in a general meeting held in end-July 2000 the state decided to extend the BCC's life until February 2004, thus keeping on function BCC for another three years. The BCC has also a new mandate to compile, a strategy for the sale of a 25-percent stake of Banka DSK's shares (former State Savings Bank), the privatisation of a minority stake of the state-owned Central Co-operative Bank (CCB). Under IMF's requirement the state-owned share in the CCB should drop under 33 percent. As the CCB is a public company the privatisation deal may be completed through the stock exchange.

4.7.3 Bulgarian Banking Privatisation deals (up to the end 2001)

4.7.3.1 UNITED BULGARIAN BANK (UBB)

The first trial for a privatisation deal for the United Bulgarian Bank (UBB) was concluded two months after the election of Ivan Kostov's Government in **(June) 1997**, after years of preparation. The European Bank for Reconstruction and Development (EBRD) and the Bulbank bought 35% of UBB's capital each, and the remaining 30 per cent was sold to the Oppenheimer & Co. from the United States. **In 1999**, the latter (under the name CIBC Oppenheimer & Co., Inc.) sold part of its stake (17.19 per cent of the total) to the AIG New Europe Fund, a subsidiary of the American International Group (AIG) of New York. In **July 1999**, in the "third part" of the privatisation of the UBB, the **National Bank of Greece (NBG)** acquired 90 per cent of UBB for 215 million dollars from Bulbank and the other shareholders. The EBRD retained a 10 per cent stake.

4.7.3.2 BULGARIAN POST BANK

The bitterest experience of the BCC was probably the sale of the Bulgarian Post Bank, which was one of the most controversial **deals of 1998**, although it was declared the best deal of the year among all privatisation deals. The problem started when the deadline for submitting

offers was extended, regardless of the fact that only two investors had made their bid. One of the bidders was the National Bank of Greece, backed by the EBRD. Following its investment policy, the EBRD was planning to buy a minority stake in the Post Bank (in case the National Bank of Greece would win in the bidding) with the intention to sell it years later. The other bidder was ALICO/CEH Balkan Holdings Ltd, a joint venture set up by the American Life Insurance Co. (ALICO) (an AIG subsidiary), and the Consolidated Eurofinance Holdings S.A. (CEH S.A., a Greek subsidiary of the European Financial Group Eurobank based in Geneva, Switzerland). After the extension, the European branch of Japan's Nomura bank and Bulgaria's Eurobank also joined in the bidding. The latter dropped out in the initial stage of selection. Then, Nomura was selected as exclusive buyer, though the other bidders were not rejected either. After nearly half a year of negotiations with Nomura, the BCC invited all three bidders to review their offers. Then Nomura withdrew, and ALICO/CEH took possession of a 78.23% stake in Post Bank for USD$38 million in cash. Following an increase of the bank's capital from BGN12 million to BGN51 million, **ALICO/CEH** currently owns an 86.24% stake in Post Bank. The remaining is distributed among Bulgarian Posts, the Bulgarian Telecommunications Company, the State Insurance Institute, DSK Bank and the National Palace of Culture. The Post Bank now holds 6.85 per cent of the national banking market, and its capital adequacy is 35%.

4.7.3.3 EXPRESSBANK

The approved buyer of the Varna-based Expressbank, which was established in 1993, was the French bank Societe Generale with a payment of USD39.1 million for the 97.95% of the capital of Expressbank, previously held by the Bank Consolidation Company. The other bidders for Expressbank (now SG Expressbank) included the Regent Pacific Group, Bulgaria's First Investment Bank, and a consortium of two Turkish companies. In their offers the bidders were required, among other things, to state which of the three proposed methods they would choose to settle the USD23.5 million debt of the Varna Shipyard to the bank. The options were: a USD15.5 million government guarantee, the BCC repaying the debt, or the buyer assuming the liability. The negotiations between **Societe Generale** and the BCC started on August 9, 1999 after the French bank had been chosen as exclusive buyer by the company on July 27, 1999. Under an agreement, which entered into force on **November 30, 1999** all loans and guarantees extended by the bank to the shipyard were transferred to the BCC. The fixing of the bank's price was depended mostly on the settlement of the debts of its biggest debtor under ZUNK - the bankrupt Varna Shipyard. The deal was finalized on November 30, 1999

when the whole sum (39.1 million USD) was transferred and the shares were endorsed. Thus, Bulgaria complied with IMF's requirement to privatise Expressbank by the end of 1999.

4.7.3.4 Hebrosbank

Regent Pacific Group became the owner of a 97.75 stake in Plovdiv-based Hebrosbank by paying USD 23.5$ million in cash and undertaking investment obligations of USD5$ million in the year 2000, USD3 million in 2001, and USD2$ million in 2002. Regent prevailed over two other bidders, a consortium formed by Kentbank and Finansbank of Turkey, and a consortium formed by the Turkish Municipal Bank, the Bulgarian Holding Company and St. Sofia Holding. On the day of signing the contract (**December 10, 1999**), Regent Pacific Group's Director predicted that soon Hebrosbank would become Bulgaria's second largest financial institution in terms of capital volume, a promise that never became true.

4.7.3.5 BULBANK

Bulbank is the largest Bulgarian bank with total assets of BGN2.26 billion as of September 30, 1999. Before the privatisation deal in 2000, Bulbank was 98% owned by the Banking Consolidation Company, while afterwards it was offered for privatisation, preferably by a strategic investor, which would bring fresh technical expertise in Bulbank. After many postponements, three bidders presented their offers by April 19, 2000; a consortium of Unicredito Italiano and Germany's Allianz; the Canovas S.A. consortium controlled by interests of the Greek tycoon Vardinoiannis and the Credit Agricole of France; and Belgium's KBC Bank. None of the three bidders wanted to buy less than a 67% share, that the BCC offered aiming at to registering the remaining shares at the stock exchange, and to keeping a percentage for the managers. On **May 10, 2000 Unicredito/Allianz** was selected as a preferred buyer. Canovas's offer was ranked second best. In case the negotiations with Unicredito/Allianz failed, the BCC would proceed with at least one of the other bidders. Bulbank was finally acquired by the UniCredito/Allianz consortium that paid EUR360 million for 98% of the bank. The price was EUR10 million higher from the initial offer by Unicredito and Allianz. The Italian Unicredito will get 93% of the bank and Allianz will get 5%. The consortium members have undertaken the obligation not to sell their shares for at least three years.

Bulbank was also rated as the best local institution trading in securities and owns 27% of the assets of the Bulgarian banking system. Bulbank was credited by a Single B long-tern and

short-term rating by Standard & Poors, at the beginning of 2000. The rating takes into consideration the economic and banking environment of Bulgaria, which is still considerably risky, but at the same time assesses the banks' high commercial position, its steady liquidity, and its relatively low-risk asset profile, especially compared with the other financial institutions in the emerging economies.

Bulbank has also been rated as the best local bank by the Euromoney magazine in 1999. The data for the rating is based on the annual reports of the central banks of Central and Eastern European countries, and the prize is awarded to institutions whose majority stake is owned by local persons. This means that from next year Bulbank will no longer participate in the rating under this indicator since it is 98% owned by foreign investors. The sale of Bulbank, Bulgaria's most profitable bank with a market share of about 30% is the biggest privatization deal in the Balkan region in 2000.

Table 8a: Evaluation of the Bulgarian Banks

Ranked by 1997 & 1998 Revenues in US$ Millions (from the TOP 100 Ranking Table – Best Banks)				
1997				
1st place	Komercnv Banka a.s	Czech Republic	Assets billion 14,704	29 million net profits
36th place	Bulbank Bulgaria	Bulgaria	Assets Billion USD 1,358	USD $ million 97 net profits
80th place	State Savings Bank	Bulgaria	Assets Million USD 496	USD $ million 36 net profits
86th place	United Bulgarian Bank	Bulgaria	Assets Million USD 457	USD $ million 72 net profits
1998				
1st place	Komercnv Banka a.s.	Czech Republic	Assets billion 14,888	-304 million losses
45th place	Bulbank	Bulgaria	Assets Billion USD 1,2	USD $ million 42 net profits
80th place	State Savings Bank	Bulgaria	Assets Million USD 580	USD $ million 3,6 net profits
92th place	United Bulgarian Bank	Bulgaria	Assets Million USD 512	USD $ million 321 net profits
Source: Deloitte & Touche 1997 & 1998, Ranked by 1997 & 1998 Revenues in US$ Millions				

Table 9a: Top Five Bulgarian Banks (the Banker)

Bulgarian Banks	Tier One Capital	Total assets
1. BULBANK (31/12/1998)	407,612 million Leva	2.196.595
2. UNITED BULGARIAN BANK (31/12/1998)	198,076 million Leva	867.703
3. STATE SAVINGS BANK (31/12/1998)	72,134 million Leva	881.224
4. EXPRESSBANK (31/12/1998)	61,524 million Leva	364.584

5. BULGARIAN POST BANK (31/12/1998)	29,537 million Leva	397.780

Source: the Banker, June 1999.

Table 10a: Top 100 Central Europeans Banks (The Banker April 1999 + May 1998)

PLACE (END 1997)	COUNTRY	CAPITAL	PLACE (END 1996)	COUNTRY	CAPITAL
KOMERCNI BANKA 1st	CZECH REPUBLIC	970 mil US$	KOMERCNI BANKA 1st	CZECH REPUBLIC	1084 mil US$
BANK HANDLOWY W WARSZAWIE 2ND	POLAND	718 mil US$	BANK HANDLOWY W WARSZAWIE 2ND	POLAND	787 mil US$
Bulbank 21st	Bulgaria	235 mil US$	Bulbank 27th	Bulgaria	140 mil US$
United Bulgarian Bank 64th	Bulgaria	42 mil US$	United Bulgarian Bank 66th	Bulgaria	44 mil US$
State Savings Bank 68th	Bulgaria	40 mil US$	State Savings Bank -	Bulgaria	
Bulgarian Post Bank 73th	Bulgaria	38 mil US$	Bulgarian Post Bank -	Bulgaria	
Expressbank 100th	Bulgaria	25 mil US$	Expressbank 64th	Bulgaria	64 mil US$

Source: The Banker (1998, 1999)

Author's Comment: From the above three tables it is clear that Bulbank, UBB, SSB, Postbank and Expressbank are the strongest five Bulgarian Banks, which also appeared in the TOP 100 Central & Eastern European Banks. Four out of five of them have been privatised (except the state-owned SSB).

4.7.3.6 BIOCHIM

Biochim is another bank owned by the BCC, and the latest deadline for its privatisation, set by the IMF and the World Bank, is the May of the year 2002. The case of Biochim is maybe the most complicated privatisation deal in the Bulgarian banking system. During the second trial of the privatisation of Biochim, the BCC was supposed to signed confidentiality agreements with the Austrian Bank Austria Creditanstalt International, the Raiffeisen Zentralbank AG, the Commercial Bank of Greece, the Italian Banko Nazionale del Lavoro, the HebrosBank and the French BNP-Paribas. Experts in Bulgaria believed that the battle for Biochim would have been only between Bulgaria's Hebrosbank and the Commercial Bank of Greece. The reality was even worst. The bid of the only candidate buyer was opened on January 24 2001. For Bulgarian officials it was much more important to find a strategic buyer for Biochim rather than rush the sale of the bank. On the other hand, it was the first deadline of IMF (end March 2001), which push the government to "finalize" the privatisation of Biochim with the sole tender, **Hebrosbank**, which offer to the BCC board of directors about USD$20 million for the state interest in **Biochim (99.3%)**. Since no other offer was submitted, the Bulgarian officials compared the previous uncompleted trial of Hebrosbank's bid to Neftinvestbank one of last year. At that time, **Neftinvestbank was also chosen** as an exclusive buyer through a tender. It offered $10 million for **67 percent stake in Biochim** (plus 27 million levs to be used for

capital increase). The officials also figured out that if Neftinvestbank had bidden for the entire state-owned stake, for which now Hebrosbank bids, the price would have risen to around $15 million, together with an amount of another $6 million - the worth of the capital increase, which the state completed last year. Though, the calculations prove that if Neftinvestbanks participated in that tender, it would offer $20-$22 million (exactly as much as Hebrosbank offers) or even a little more. The fact is that nothing has been finalized after the above trials (two privatisation failures for the case of Biochim) and the Bulgarian government is very worried for the completion of this deal before the latest deadline of the IMF. At the beginning of 2002, the BCC has announced that signed confidentiality agreements (under the third privatisation trial of Biochim) with the Roseximbank, Hebrosbank, the Commercial Bank of Greece. However, there are a few more candidates such as the Bank Austria, the Societe Generale, Bulbank and the TBI Holding.

4.8 Foreign banks and financial intermediaries in Bulgaria; Incentives and Barriers for their FDI projects

The establishment of the currency board in July 1997 brought a significant increase in foreign participation in the privatisation of the Bulgarian Banking system, which also holds a significant part in the FDI inflows' statistics. Author's research in Bulgaria has shown that foreign investors, especially from Greece, have participated in most of the 41 Bulgarian banks, braches or representative offices (tables 11a & 11b).

Table 11a: Total Banks Operating in Bulgaria

License Type	Number
Commercial banks with an international banking license	27
Commercial banks with domestic and limited license	1
Branches of foreign banks in Bulgaria	8
Representative offices	4
Bulgarian National Bank	1
TOTAL	41

Source: *Bitzenis' Research*

Bulgaria, like all Central & Eastern European countries experienced many difficulties in establishing a stable banking system, and is still far from reaching the level of a western-type banking system in terms of broadness of activities and quality of infrastructure. Few domestic banks, which play an important role in the sector, are willing to make efforts to that extent, but the presence of foreign banks will help their efforts in broadening their services as well as the efforts of the Bulgarian government in attracting further foreign direct investment inflows.

The presence of the foreign banks that offer western style services, assist the local banks to work better and adopt the western banking approach more quickly, since the co-existence of foreign and domestic banks, will not only establish competitive trends, but encourage the development of current investments and invite potential investment decisions. The introduction of the currency board greatly assisted the development of the banking system since it stabilised the lev, thus provided a less risky environment for the foreign investors both in banking and in other fields.

The presence of many private banks and several foreign banks or foreign bank branches, have assisted in the development of relatively competitive environment. Tsantis A. (1997)[24] has argued "*that the evolution of the banking system reflects on one hand the achievements of BCC to consolidate the state-owned banks and, on the other, the entry of private banks. The number of commercial banks is declining because of the consolidation.... There is still very little foreign banking presence. Greek banks are particularly active, as much of Bulgaria's trade activities are with its southern neighbour.*"

According to official statistics, seven foreign banks (5 branches of foreign banks) were established in Bulgaria between 1994-1996. Before 1997, there was no legal constraint for the foreign banks to provide all services permitted by the Law on Credit Activities, but none of them performed the full range of their banking activities. None of the foreign banks accepted deposits from the household sector nor provided consumer credit. Given their comparative advantages with respect to prestige, reliability, international contacts and experience, they were in a position to exert substantial competitive pressure on Bulgarian banks, but they limited their own activities to specialised services mainly for international business firms.

Table 11b: Foreign Banks and Foreign participation in the Bulgarian Banking system

No.	Bank Name [Previous Names – Ownership]	Country	Type
1	**PIREUS GROUP** (Previous name of XIOSBANK S.A). – SOFIA BRANCH (M&A OF PIREUS, XIOS, MACEDONIA & THRACE)	GREECE	BRANCH
2	**ING N.V.** – Sofia Branch	NETHERLANDS	BRANCH
3	**ALPHA BANK OF GREECE** (Previous Ionian and Popular Bank of Greece S.A). - Sofia Branch (changed its name to Credit Bank of Greece, because of the M&A of Credit Bank of Greece and Ionian and Popular Bank of Greece S.A. in 1999.	GREECE	BRANCH
4	**NATIONAL BANK OF GREECE** – Sofia Branch	GREECE	BRANCH
5	**HYPOVEREINSBANK BULGARIA** – Sofia Branch (Bayerische Hypotheken-und-Wechsel Bank and Bayersiche Vereinsbank were merged)	GERMANY	BRANCH
6	**SOCIETE GENERALE** - Sofia Branch	FRANCE	BRANCH

7	**CITIBANK**	USA	BRANCH
8	**T.C. ZIRAAT BANKASI** – Sofia Branch	TURKEY	BRANCH
9.	**BNB – PARIBAS** (ex BNP-Dresdnerbank, Sofia)	GERMANY, FRANCE and EBRD	Joint Venture
10	**RAIFFEISENBANK** (Bulgaria), Sofia	AUSTRIA	Private
11	**COMMERCIAL BANK OF GREECE** [ex International Commercial Bank (ICB), (ex Bulgarian Investment Bank), Sofia 90% the Greek Investor (COMMERCIAL BANK OF GREECE) + EBRD 10 %]	GREECE and EBRD	Acquisition + Joint Venture
12	**BULGARIAN POST BANK**, Sofia - 84% (50% Greek Investor (EFG EUROBANK) + 50% from USA (AIG))(CYPRUS)	GREECE	BCC Privatisation + Joint Venture
13	**ECONOMIC AND INVESTMENT BANK AD** [ex BRIBANK (former Bulgarian-Russian Investment Bank)]	RUSSIA	Joint Venture
14	**ROSSEXIMBANK** (ex Trakiya bank)	RUSSIA	Acquisition
15	**EUROBANK**, Sofia	SLOVAKIA	Acquisition
16	**UNITED BULGARIAN BANK** (UBB), Sofia (In first Privatisation Oppenheimer & Co.Inc.and EBRD), (Nowadays, the owner is the National Bank of Greece)	GREECE	BCC Privatisation + Joint Venture
17	**DEMIRBANK** (Bulgaria), Sofia [after its bankruptcy the UK financial group HSBC has acquired the Turkish Demirbank. However, HBSC has sold Demirbank (Bulgaria), Sofia to a Turkish Consortium (end 2001)]	TURKEY	Private
18	**UNIONBANK**, Sofia (London Investment Partners Ltd)	UK	Acquisition
19	**NEFTINVESTBANK**, Sofia (ex St Nicholas International Orthodox Bank)	RUSSIA	Acquisition
20	**INTERNATIONAL BANK OF (FOR) TRADE AND DEVELOPMENT**, Sofia	SWITZERLAND and USA	Acquisition
21	**TOKUDA CREDIT EXPRESS BANK**, Sofia (ex Credit Express Bank) **Commercial Banks with Domestic and Limited License**	JAPAN	Limited Participation
22	**FIRST INVESTMENT BANK**, Sofia (Austrian Investor – Vienna based EPIK)	AUSTRIA and EBRD	Acquisition
23	**EXPRESSBANK** (French Investor – Societe Generale)	FRANCE	BCC Privatisation
24	**CAIB INVESTMENT BANK** (ex Creditanstalt Investment Bank AG and Creditanstalt Bank, Sofia)(Bank Austria and Creditinstalt were merged)	AUSTRIA	Representative Office
25	**CORPORATE COMMERCIAL BANK PLC** (by Vneshekonombank)	RUSSIA	Acquisition
26	**BULBANK** (Unicredito 93% + Allianz 5% Consortium) [ex Bulgarian Foreign Trade Bank]	Italy / German	BCC Privatisation
27	**HEBROSBANK** (Regent Pacific Group)	RUSSIA	
28	**BIOCHIM**	STATE OWNED	BCC ???? Privatisation
29	**BULGARIAN-AMERICAN CREDIT BANK LTD.**, Sofia (by Bulgarian American Enterprises Fund)	USA	Joint Venture
30	**EBRD** (UK based)	International	Representative Office
31	**World Bank**	International	Representative Office
32	**BLACK SEA TRADE AND DEVELOPMENT BANK** (Greece based)	International	Representative Office
33	**PROCREDIT BANK** [EBRD + IFC (World Bank) 20% + consortium of German funds and banks]	German	Joint Venture
34	**BANKA DSK** [Former ssb – State savings bank]	STATE OWNED	BCC ???? Privatisation

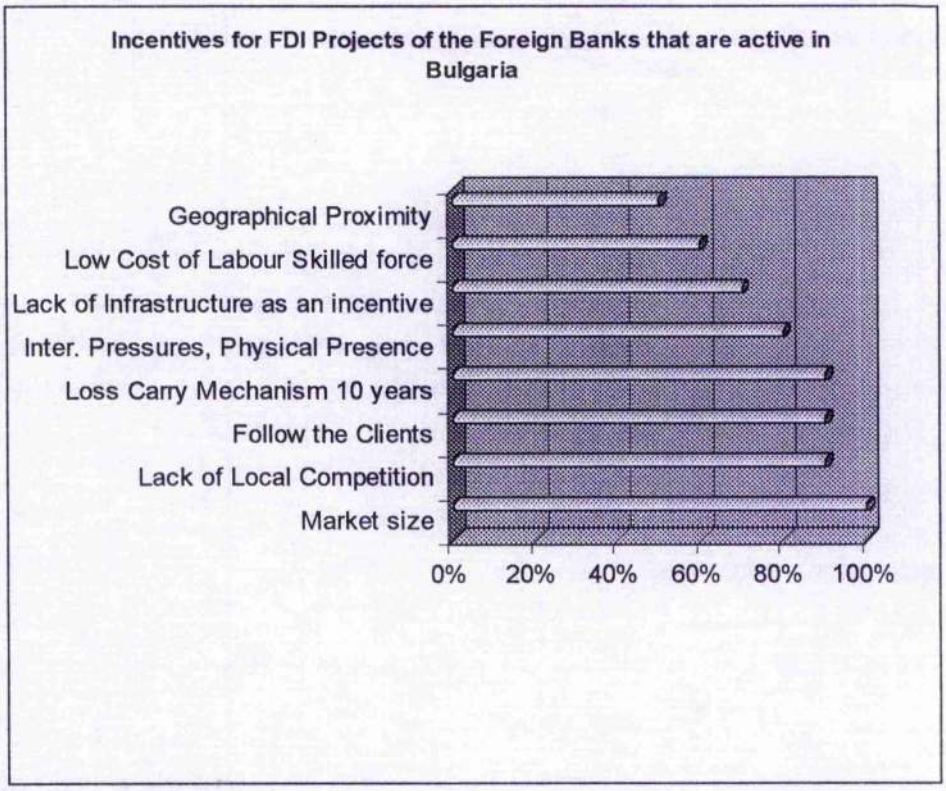
35	**CCB** [Central Cooperative Bank] [32.77% by the BCC and 24% by the corporate bank]	STATE OWNED	BCC ???? Privatisation
36.	PROMOTIONAL BANK OR ENCOURAGEMENT BANK	STATE OWNED	Ministry of Finance 99%
37	BULGARIAN NATIONAL BANK	STATE OWNED	
38	PRIVATE ENTREPRENEURIAL BANK TEXIM		
39	MUNICIPAL BANK	STATE OWNED	Sofia Municipality + others
40	FIRST EAST INTERNATIONAL BANK		
41	CB BULGARIA-INVEST OR BULGARIAN-INVEST BANK		

Source: *Bitzenis' Research*

The first banking permissions were given in 1994 to the Greek Xios Bank and to the Dutch ING Bank. After those pioneer banks, three more were licensed: the Raiffesenbank- Bulgaria (Austrian), the BNP- DRESDNER Bank (French- German) and the Ionian Bank (Greek). Nowadays, (2/2002) in Bulgaria there are 8 foreign branches, 3 from Greece, and 1 from the USA, Turkey, France, Germany and the Netherlands. There are also 27 banks with an international licence for banking activity, four representative offices and one, the Tokuda Bank, with a domestic and limited banking license. [The author's research presents the foreign participation in the above banks in the Bulgarian territory in table 11b].

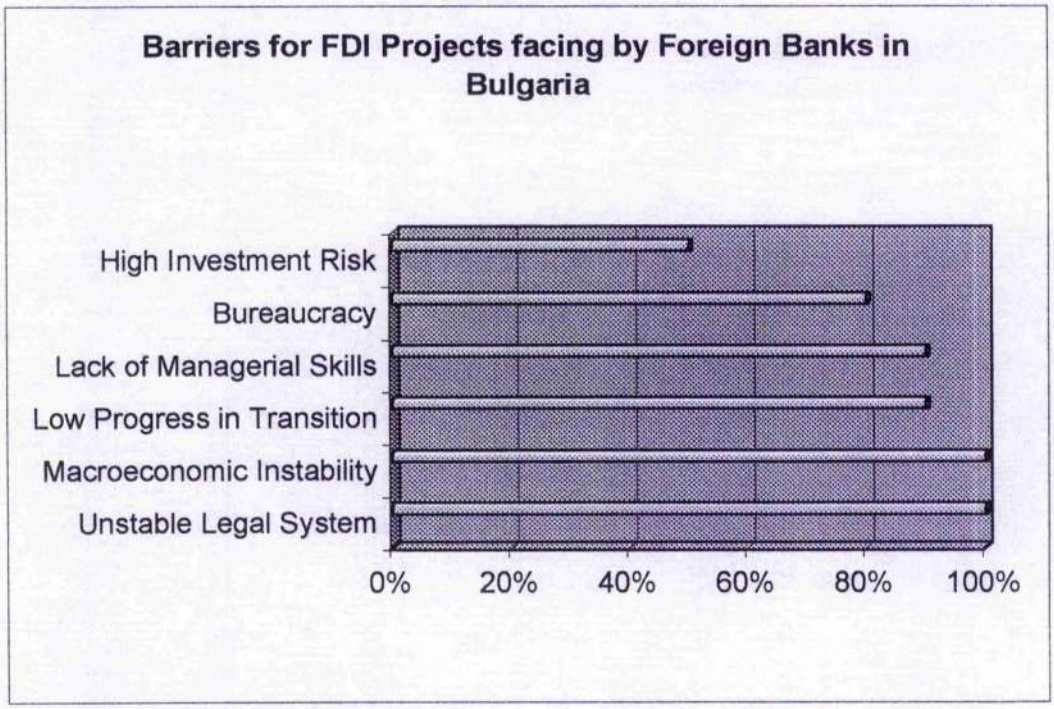
The first Greek banks, which opened branches in Bulgaria, aimed at the promotion of Greek enterprises into the Bulgarian market (follow the clients). These Greek banks also developed in the corporate banking sector as well as in the management of the disposable. Another three Greek banks have tried to expand their operations in Bulgaria, Egnatia Bank, Macedonia & Thrace and Agricultural bank of Greece, which, for several reasons, closed their representative offices. Nowadays, five Greek banks (National Bank of Greece, Commercial Bank of Greece, Eurobank, Pireus Group (Xios Bank), and Alpha Bank (Ionian & Popular Bank)) have active participation in the Bulgarian banking system due to several reasons such as the large participation of Greek enterprises, geographic proximity, lack of foreign competition, etc. [see also figures 6, 7, 8]

Figure 6: Incentives for the Bulgarian Privatisation Process in the Banking system



Source: Bitzenis' Questionnaire Results

Figure 7: Barriers for the Bulgarian Privatisation Process in the Banking system



Source: Bitzenis' Questionnaire Results

Figure 8: Factors that influence Foreign Investors in participating in the Privatisation Process in the Bulgarian Banking system

Source: Bitzenis' Questionnaire Results

As it is with other sectors foreign involvement brought spillover effects in the Bulgarian Banking Sector. What is special about the banking sector is that its development greatly affects the other aspects of the economy. The establishment of foreign banks required intensive efforts of organisation, but the results, after the first years of operation, were encouraging. The foreign banks have well trained managers, which provide very good services not only to the foreign enterprises, but also to the Bulgarian ones. The foreign banks brought new technology, management systems and an advanced contact network. Overall, they introduced different and more competitive conditions into the sector. Nevertheless, the foreign banks' activity in the Bulgarian market and their co-operation with other banks is mostly conservative, in order to avoid their involvement in lending, which is still a risky field.

Ten foreign banks, which are active in Bulgaria and have participated in the questionnaire analysis of this author have underpinned that the major incentives for their FDI decision were: the market size, the lack of local competition, the theory of follow the clients, the financial incentive of the loss carry mechanism for the following ten years, the international pressures from competition and their physical presence in many countries [figures 6-8]. The major obstacles that they had faced in the Bulgarian environment were: the unstable legal framework, the macroeconomic instability, the low progress in the transition, the lack of managerial skills, bureaucracy and the high risky environment. It must be considered that the author's research ran in the period Jan 1998-June 1999, and most of the questionnaires have been completed at the end of 1998. Thus, it is not a surprise this ranking of barriers such as the

macroeconomic instability (2nd) and the low progress in the transition (3rd), since the positive signs of the currency board were obvious in mid 1999.

The significant Greek presence of 3 banks and 3 branches must be explained mainly by the geographical proximity.

Table 12: NUMBER OF FOREIGN BANKS IN SELECTED EAST EUROPEAN COUNTRIES (the Banker)

ALBANIA	BULGARIA	CZECH R.	HUNGARY	ESTONIA	POLAND	CROATIA	ROMANIA
3 Greek Banks	3 Greek Banks	4 from Italy	16 from Germany	3 from Finland	7 from the USA	6 from Austria	2 from France
1 from the USA	2 from Germany	10 from Austria	3 from Italy	1 from Germany	14 from Germany	4 from Germany	3 from Greece
1 from Bahrain	1 from France	16 from Germany	2 from the USA	1 from Sweden	7 from France	2 from Italy	2 from the USA
1 from Italy	2 from Austria	7 from France	3 from France		4 from Austria	1 from France	2 from Turkey
1 from Malaysia	1 from Turkey	4 from the USA	5 from Austria		3 from Italy		2 from Netherlands
	1 from Netherlands	3 from the UK	3 from Netherlands				2 from Austria

Source: From the Banker, April 1999

From the table 12 it is argued that in Poland most of the banks come from the neighbour Germany, in Croatia most come from neighbour Austria, in Estonia most come from the neighbour Finland, and in Albania and Bulgaria most come from neighbour Greece etc. The extreme interest of Greek banks not only in Bulgaria, but also in the whole region of Balkans can be explained by the following: "*...firm's preferences for near, similar markets was a function of lack of international experience. Firms with broader international operating experience were more ready to extend their operations to less familiar markets than were firms with less experience.*"[25]

In tables 11a and 11b appeared all the Bulgarian Banks active up to the end of 2001. The banks with foreign participation have under their control over 80% of the Bulgarian Financial Capital. The Greek participation in the banking system is over than 35%. In comparison to other CEE countries, like the Czech Republic and Hungary, the development of foreign banks in Bulgaria until 1998, was delayed. The limited number of foreign banks in Bulgaria until the mid 1997 is mainly attributed to six major reasons. Firstly, Bulgaria was insufficiently developed, compared to the international banking system, the needs of multinational enterprises and the economies of the other CEE countries. Secondly, the investments' risks in Bulgaria were considered very high. This was also the case for investments in the banking

sector since the inflation was in very high levels. Thirdly, the institutional framework of businesses' operations was very unbalanced and this did not attract multinational enterprises, which are usually followed by international banks. Fourthly, the central authorities did not help the broad privatisation of enterprises and the significant foreign participation in the state banks. Fifthly, the distrust to foreign investors and a kind of unjustified alertness limited the operations permissions granted to foreign banks so as to limit their broad expansion over the public banks that were facing many problems. That alertness, though, had no basis since all the foreign banks that went in Bulgaria just wanted to be represented rather than expanded in an economic and banking environment with serious problems. Sixthly, the delay in the corporatization, privatisation and restructuring of state banks and the delay in the political and economic stability that came only after the establishment of the currency board, in the mid 1997 affected the foreign participation in the banking sector as it has affected the foreign participation in all other sectors. In general, all the factors, which have affected the total FDI inflows in Bulgaria like the inadequate legal framework, the delay of adoption of significant laws, the cultural distance from the western investors, the lack of managerial skills, the limited consumer power, the limited establishment of foreign companies, affected also the whole banking system as well. It was inevitable for the new banks that entered Bulgaria to face negative economic results due to their volume of investments and the limited number of customers, which they initially have. However, this is a normal phenomenon even for banks that opened their branches into international advanced economic centres.

4.9 STATISTICAL ANALYSIS

Examining Table A1, we observe that 50% of the foreign banks in Bulgaria (that participated in the questionnaire research) have considered risk as a barrier for their investment projects. At the same time 28 out of 54 (51.9%) foreign companies (other than banks) have also considered risk as a barrier for their investment projects in Bulgaria, as well. It can be pointed out that there is no difference in the way of considering the Bulgarian business environment and its level of risk if we are interviewing foreign banks or other MNEs. Thus, the majority of both of them characterized the Bulgarian economy as a risky one. Each bank or any enterprise from a different sector have more or less the same reasons for considering or not the risk as a barrier for its investment plans. From a statistical point of view, we can conclude that according to the continuity correction test (because we have 2X2 Table), the p-value is 1 and thus >0.1. Therefore, we neglect the Ha hypothesis, and we accept the Ho hypothesis,

concluding that there is no association between the two variables (high risk environment as a barrier and the sector which a MNE belongs to).

Considering Table A2, we observe that 80% of the foreign banks in Bulgaria and 54% of the other foreign companies have considered bureaucracy as a barrier for their investment project. Although bureaucracy was a significant barrier for the majority of MNEs, on the other hand, foreign banks mentioned burcaucracy as a crucial barrier for making foreign direct investments in Bulgaria and found coping with the Bulgarian business environment under bureaucracy a hard job. Moreover, from the statistical point of view we can support the above result. According to the continuity correction test (2X2 Table), the p-value is 0,231 and thus >0.1. Therefore, we neglect the Ha hypothesis, and we accept the Ho hypothesis, concluding that there is no association between the two variables (bureaucracy as a barrier and the sector which an MNE belongs to).

Examining Table A3, we discover that all the foreign banks (100%) which participated in the questionnaire research have considered the Bulgarian unstable legal system as a significant barrier. At the same time, 68.5% of the other 54 companies have considered the above as a barrier. The unstable legal system has been considered as an extremely significant barrier for all the banks when only the majority of other MNEs considered it as an important barrier. This means that the unstable legal framework negatively affects specific sectors of the economy and it has been considered differently by all MNEs regarding its importance/significance. It also constitutes a unique barrier for foreign banks which strongly prefer to avoid it. We can also point out the same conclusion from statistics. The p-value (continuity correction, 2x2 table) is 0,093 and thus <0.1. Consequently, we accept the Ha hypothesis, concluding that there is an association between the two variables (unstable legal system as a barrier and the sector that an MNE belongs to) at 10% level of significance.

Examining Table A4, we can mark that 90% of the foreign banks that participated in the questionnaire research have considered the lack of managerial skills as a significant barrier, while at the same time only 7.4% from the other 54 companies have considered the lack of managerial skills as a barrier. It is very important, especially for the banks, to consider the managerial skills of the labour force. The lack of such skills creates significant problems to the establishment of foreign banks in a host country. With the help of statistics the author underpinned the above results, and found that the p-value (continuity correction, 2x2 Table) is

0 and thus <0.01. Therefore, we accept the Ha hypothesis, concluding that there is strong association between the two variables (lack of managerial skills and the sector that an MNE belongs to) at 1% level of significance.

Considering Table A5, we can show that 90% of the foreign banks that participated in the questionnaire research have considered the low progress in banking reform, privatisation progress, liberalisation reform and the low whole transition reform from a plan to a market economy, as a significant barrier, while at the same time only 1.9% of the other 54 companies have done the same. The liberalisation in most of the economic aspects (prices, trade, exchange rates, interest rates) of a country together with various structural reforms and the privatisation of state-owned companies are basic elements of a market economy. It is also necessary for a host country to proceed to the above reforms in order to have the attraction and establishment of foreign banks. The statistics confirms the above. The p-value (continuity correction, 2x2 Table) is 0, thus <0.01. Therefore, we accept the Ha hypothesis, implying that there is strong association between the two variables (low progress in banking reform, privatisation, liberalisation and transition as a barrier and the kind of business for a company) at 1% level of significance.

Looking at Table A6, we can denote that none of the foreign banks that participated in the questionnaire research have considered corruption, crime or mafia and illegal actions as a barrier, when at the same time an important percentage of 63% from the other 54 companies had significantly considered this as a barrier. From the statistical point of view we found that the p-value (continuity correction, 2x2 table) is 0,001 and thus <0.01. Therefore, we accept the Ha hypothesis, concluding that there is strong association between the two variables (corruption, mafia, crime, illegal protection from suspicious people, insufficient protection of their investment projects etc. and the possibility of being a bank or another kind of enterprise) at 1% level of significance

Examining Table A7, we can point out that 90% of the foreign banks that participated in the questionnaire research have considered the lack of local competition in Bulgaria as a barrier, when at the same time only 31.5% from the other 54 companies have significantly considered this as such. The significant lack of local competition in the Bulgarian banking sector left space for an extremely high percentage of foreign banks to enter the Bulgarian market, using this as a major incentive. From the statistics we have the p-value (continuity correction, 2x2

Table) to be equal to 0,002 and thus <0.01. Therefore, we accept the Ha hypothesis, implying that there is strong association between the two variables (the lack of local competition in Bulgaria and the sector that an MNE belongs to) at 1% level of significance.

As it was expected, examining Table A8, we can prove that almost all the companies (both the banks and other enterprises) have considered the Bulgarian market as an incentive for their investment project, although Bulgaria is not such a big market as Germany, France or the United Kingdom. There is a high percentage of MNEs (100% of the banks and 92.6% of the other MNEs) which is considering Bulgaria for an FDI project due to its market size. This was not a surprise for the author. Firstly, this happened because 37 out of 64 interviewed companies were Greek (5 out of 10 banks were also Greek). Thus, these companies considered Bulgaria as an important market with a population of over 8,000,000 people (which is "another Greece" for them). Secondly, for companies such as Coca Cola, McDonalds or even for banks such the Banque Nationale de Paris from France or the Dresdner Bank from Germany, every country and every market is significant and their policy is to participate in almost every country (market hunters) in the world (even in Bulgaria). Thirdly, in a host country in which there is a lack of local competition there is an expected high market share and thus a large enough number of possible customers. From the statistical point of view and according to the continuity correction test (2X2 Table), the p-value is 0,859 and thus >0.1, so we confirm the above. Therefore, we neglect the Ha hypothesis, and we accept the Ho hypothesis, implying that there is no association between the two variables (market size as an incentive is indifferent to the sector which a MNE belongs to).

Examining Table A9, we observe that 90% of the foreign banks that participated in the questionnaire research considered the theory of "following the clients" as an incentive, when at the same time only 11% of the other 54 companies have significantly considered this as an incentive. Foreign banks have many customers, especially from the industrial sector in their home country. When most of these companies (customers of a bank) move part of their activities to the host country, then it is obvious that there is a need for the bank to proceed to an FDI project in the same host country, in order to continuously support the business activities of the existing customers ("following the clients" theory). The statistics supports the above argument, when the p-value (continuity correction, 2x2 table) is 0 and thus <0.01. Therefore, we accept the Ha hypothesis, implying that there is strong association between the

two variables (following the clients as an incentive and the sector that each MNE belongs to) at 1% level of significance.

As it was also expected (Table A10), geographical proximity has been considered as a strong incentive for an investment project in the Bulgarian market only by MNEs which have their origin in neighbouring countries such as the example of Greek and Turkish banks. However, we concluded that geographical proximity is not an incentive which supported or positively affected specifically the foreign banks or the other MNEs or a specific sector of the Bulgarian economy. Thus, this incentive has been considered indifferent from the sector that each foreign MNE belongs to (foreign banks 50%, other foreign MNEs 59,3%). Looking closely at Table 10 and with the help of statistics, we can conclude that according to the continuity correction test (2X2 Table), the p-value is 0,845 and thus >0.1. Therefore, we neglect the Ha hypothesis and we accept the Ho hypothesis, implying that there is no association between the two variables (geographical proximity as an incentive is indifferent with the sector that an MNE belongs to).

Examining Table A11, we can see that 80% of the foreign banks in Bulgaria, which have participated in the questionnaire research, have considered the international pressures from competition and/or physical presence in many countries as a significant incentive for their FDI decision, when at the same time only 38.9% from the other 54 companies have considered the above as an incentive. The statistics also underpin this argument. The p-value (continuity correction, 2x2 table) is 0,04 and thus <0.05. Therefore, we accept the Ha hypothesis, implying that there is association between the two variables (international pressures from competition and/or physical presence in many countries and the sector in which an MNE belongs to) at 5% level of significance.

Observing Table A12, we can point out that 60% of the foreign banks in Bulgaria, which have participated in the questionnaire research, have considered the low cost of skilled labour cost as a significant incentive for their FDI decision, when at the same time only 28% from the other 54 companies have considered the above as an incentive. It is necessary for the banks to pursue a skilled labour force. It is also important for them to search for a low – cost skilled labour force. We come to the same conclusion using statistics. The p-value (continuity correction, 2x2 Table) is 0,04 and thus <0.05. Once again, we accept the Ha hypothesis,

concluding that there is association between the two variables (low cost of skilled labour as an incentive and the sector that an MNE belongs to) at 5% level of significance.

Table A: Statistical Analysis – Questionnaire Survey

Table 1: Banks and Risk as a barrier

			High Investment Risk (Y75)		
			No	Yes	Total
banks	other sectors	Count Observations	26	28	54
		%	48,1%	51,9%	100,0%
		% Y75	83,9%	84,8%	84,4%
	banks	Count Observations	5	5	10
		%	50,0%	50,0%	100,0%
		% Y75	16,1%	15,2%	15,6%
Total		Count Observations	31	33	64
		%	48,4%	51,6%	100,0%
		% Y75	100,0%	100,0%	100,0%

Table 2: Banks and Bureaucracy as a barrier

			Bureaucracy (Y72)		
			No	Yes	Total
banks	other sectors	Count	25	29	54
		%	46,3%	53,7%	100,0%
		% Y72	92,6%	78,4%	84,4%
	banks	Count	2	8	10
		%	20,0%	80,0%	100,0%
		% Y72	7,4%	21,6%	15,6%
Total		Count	27	37	64
		%	42,2%	57,8%	100,0%
		% Y72	100,0%	100,0%	100,0%

Table 3: Banks and unstable legal system as a barrier

			Unstable Legal System (Y62)		
			No	Yes	Total
banks	other sectors	Count	17	37	54
		%	31,5%	68,5%	100,0%
		% Y62	100,0%	78,7%	84,4%
	banks	Count		10	10
		%		100,0%	100,0%
		% Y62		21,3%	15,6%
Total		Count	17	47	64
		%	26,6%	73,4%	100,0%
		% Y62	100,0%	100,0%	100,0%

Table 4: Banks and lack of managerial skills as a barrier

			Lack of Managerial Skills (Y65)		
			No	Yes	Total
banks	other sectors	Count	50	4	54
		%	92,6%	7,4%	100,0%
		% Y65	98,0%	30,8%	84,4%
	banks	Count	1	9	10
		%	10,0%	90,0%	100,0%
		% Y65	2,0%	69,2%	15,6%
Total		Count	51	13	64
		%	79,7%	20,3%	100,0%
		% Y65	100,0%	100,0%	100,0%

Table 5: Banks and the low progress in privatisation, in banking reform, in transition process, in liberalisation as a barrier

			Low Progress in ... (Y61)		
			No	Yes	Total
banks	other sectors	Count	53	1	54
		%	98,1%	1,9%	100,0%
		% Y61	98,1%	10,0%	84,4%
	banks	Count	1	9	10
		%	10,0%	90,0%	100,0%
		% Y61	1,9%	90,0%	15,6%
Total		Count	54	10	64
		%	84,4%	15,6%	100,0%
		% Y61	100,0%	100,0%	100,0%

Table 6: Banks and crime, corruption etc. as a barrier

			Crime, Corruption ... (Y67)		
			No	Yes	Total
banks	other sectors	Count	20	34	54
		%	37,0%	63,0%	100,0%
		% Y67	66,7%	100,0%	84,4%
	banks	Count	10		10
		%	100,0%		100,0%
		% Y67	33,3%		15,6%
Total		Count	30	34	64
		%	46,9%	53,1%	100,0%
		% Y67	100,0%	100,0%	100,0%

Table 7: Banks and the lack of local competition in the host country as an incentive

			Lack of Local Competition (CX23)		
			No	Yes	Total
banks	other sectors	Count	37	17	54
		%	68,5%	31,5%	100,0%
		% CX23	97,4%	65,4%	84,4%
	banks	Count	1	9	10
		%	10,0%	90,0%	100,0%
		% CX23	2,6%	34,6%	15,6%
Total		Count	38	26	64
		%	59,4%	40,6%	100,0%
		% CX23	100,0%	100,0%	100,0%

Table 8: Banks and the size of the Bulgarian market (customer base) as an incentive

			Customer Base (CX21)		
			No	Yes	Total
banks	other sectors	Count	4	50	54
		%	7,4%	92,6%	100,0%
		% CX21	100,0%	83,3%	84,4%
	banks	Count		10	10
		%		100,0%	100,0%
		% CX21		16,7%	15,6%
Total		Count	4	60	64
		%	6,3%	93,8%	100,0%
		% CX21	100,0%	100,0%	100,0%

Table 9: Banks and "follow the clients" as an incentive

			Follow the Clients (CX34)		
			No	Yes	Total
banks	other sectors	Count	48	6	54
		%	88,9%	11,1%	100,0%
		% CX34	98,0%	40,0%	84,4%
	banks	Count	1	9	10
		%	10,0%	90,0%	100,0%
		% CX34	2,0%	60,0%	15,6%
Total		Count	49	15	64
		%	76,6%	23,4%	100,0%
		% CX34	100,0%	100,0%	100,0%

Table 10: Banks and geographical proximity as an incentive

			Geographical Proximity (AX8)		
			No	Yes	Total
banks	other sectors	Count	22	32	54
		%	40,7%	59,3%	100,0%
		% AX8	81,5%	86,5%	84,4%
	banks	Count	5	5	10
		%	50,0%	50,0%	100,0%
		% AX8	18,5%	13,5%	15,6%
Total		Count	27	37	64
		%	42,2%	57,8%	100,0%
		% AX8	100,0%	100,0%	100,0%

Table 11: Banks and international pressures from competition or physical presence in many countries as an incentive

			International Pressures (DX41)		
			No	Yes	Total
banks	other sectors	Count	33	21	54
		%	61,1%	38,9%	100,0%
		% DX41	94,3%	72,4%	84,4%
	banks	Count	2	8	10
		%	20,0%	80,0%	100,0%
		% DX41	5,7%	27,6%	15,6%
Total		Count	35	29	64
		%	54,7%	45,3%	100,0%
		% DX41	100,0%	100,0%	100,0%

Table 12: Banks and skilled low-cost labour cost as an incentive

			Skilled Low-cost labour cost (BX15)		
			No	Yes	Total
banks	other sectors	Count	42	12	54
		%	77,8%	22,2%	100,0%
		% BX15	91,3%	66,7%	84,4%
	banks	Count	4	6	10
		%	40,0%	60,0%	100,0%
		% BX15	8,7%	33,3%	15,6%
Total		Count	46	18	64
		%	71,9%	28,1%	100,0%
		% BX15	100,0%	100,0%	100,0%

Source: Bitzenis' Questionnaire Survey; Statistical Results

4.10 Conclusion

Privatisation in Bulgaria proceeded very slowly, despite the motives provided by the World Bank and IMF in the form of aid packages. The delay in Bulgarian Privatisation is attributed to the political instability of the country and governmental inability or unwillingness during the years of the transition, the social dislike towards Privatisation as well as to several economic factors. The public reaction was studied by a sociological investigation, which indicated that Bulgarians are indifferent, and some times negative, towards privatisation[26]. Another social factor is the fact that any substantial private capital in Bulgaria in the first years was obtained illegally and thus was unlikely to be used for Privatisation purposes given that the Privatisation Law requires that all owners of any Bulgarian capital, which enters the Privatisation process, must explain its origin.

Considering the economic factors contributing to the delay, one must pay much attention to the collapse of COMECON, which also contributed to other factors like the prolonged recession, decrease in real income, and the very low internal demand. The political uncertainty, underdeveloped infrastructure and communications, delay in structural reforms and delay in the establishment of a legal background, resulted in reluctant foreign investors.

Both domestic and foreign investors were further discouraged by the low net present value of the enterprises offered for Privatisation.

One of the most difficult tasks in a privatisation process in a transition country is to determine the market value of public enterprises. Thus, in Bulgaria, an administrative rather than a market approach to valuation was adopted. The problem was intensified not only by the inexperience of evaluators, but also by the high inflation that often necessitated re-evaluation. The valuation of the company was made even more difficult because of difficulties in allocating the appropriate assets to each company (the legal analysis of enterprises). Since in the communist years ownership was always considered public, the enterprises' assets were not clearly defined since many companies might use the same asset, so the documents identifying their assets, including land and physical plant, usually, are not available or non-existent. The asset allocation problem becomes even more complicated if the claims for restitution are considered. Delays in the privatisation process became even more complicated, when disagreements led the cases to courts. The valuation problems were often solved by artificial valuations of enterprises, resulting in abuses of authority and corruption by the agents in charge of the process.

Corruption is another significant factor responsible for the delay of Privatisation. The former Bulgarian authorities were determined to obtain ownership of state-owned property for themselves (or friends) at preferential prices and without public auction. This kind of ownership transfer is considered "quiet" if the information concerning the sale is not made public, or "illegal" if working rules are violated.

From this research we can conclude that the delay in the privatisation process affected multinationals' FDI decisions (MNEs, which belong to the banking sector). Moreover, the way of privatisation as an entry mode has been chosen mainly from MNEs other than Greek ones. Privatisation deals mostly took part in the industrial sector, because most of the Bulgarian SOEs, which were offered to the privatisation programs, belonged to this sector.

In addition, although bureaucracy and corruption were important barriers for establishing an FDI project in Bulgaria, only about 1/3 of MNEs who participated in the research suggested that bureaucracy or/and corruption was an important barrier for them, when taking part in a Bulgarian privatisation program. Finally, Risk was also an important barrier in the decision of

making an investment in an environment such as Bulgaria. However, risk was considered indifferently by MNEs, when it came to choose either privatisation as a way of foreign entry or other ways of entry mode.

The most important determinants for economic stabilization and development in Bulgaria continue to include further acceleration of privatisation and abolishment of monopolies, thus providing a well-functioning market economy in order to attract further foreign investments. All the authorized Privatisation agents, including the Privatisation Agency, should target their efforts on the improvement of the country's image in the eyes of foreign investors, the real improvement of the entrepreneurial environment and the marketing of Bulgarian enterprises abroad.

The transition to a market economy needs a sound banking system, which is a crucial factor in attracting foreign investors. Foreign direct investment in the banking sector can be of particular importance to the transition countries since experience has shown that countries around the world in which FDI has concentrated have enjoyed accelerated economic growth, easier integration into world markets and less painful structural reform. With the help of Bulgarian official statistics, we can argue that one third of the total FDI inflows in Bulgaria are through privatisation deals and more than half of the latter inflows are a result of privatisation deals occurred in the banking system.

The analysis through questionnaires revealed important aspects of the FDI flows, which may not be captured by the standard analysis. The derived results indicate that the high risk business environment, the market size and bureaucracy have been considered similarly by foreign banks and any other MNEs participating in Bulgaria and macroeconomic instability, unstable legal framework, low transition progress and lack of managerial skills have been considered by foreign banks as highly positive factors responsible for the FDI inflows in the banking sector. On the other hand, an unexpected finding was that corruption, crime and mafia have not been taken into account at all by foreign banks. Lastly, the low cost of a skilled labour force together with the theory "following the clients", lack of local competition and the existence of international/globalisation pressures were significant incentives for foreign banks in order to enter Bulgaria. The findings that multinational firms may be discouraged to invest by factors such as macroeconomic instability and inadequate institutional framework are in accordance with a previous work (Liargovas and Chionis (2001)). Our main hypothesis is that

besides the role of the conventional determinants of FDI, factors such as the form of monetary stability and the progress of economic and institutional reforms, which constitute the essence of the transition process, might be responsible for stimulating FDI flows. Given the fact that Bulgaria moved slowly towards a market-based economic system, relative to other transition economies, and that the investments in the banking sector consist of a large proportion of the total Bulgarian FDI flows, we insist that this comparative analysis constitutes of considerable importance in determining the role of the transition process on the FDI flows.

The privatisation of the state-owned banks has a direct effect in the Bulgarian FDI inflows and the delay of the transition process greatly affected the volume of the inward FDI. The Bulgarian stock market is still not well-functioning and a market economy needs a developed system with institutions, reliable regulation, strong foreign participation, comprehensive consumer protection, lack of uncertainty and general stability in all of the economic activities, along with guaranteed governmental credibility. The development of the secondary markets is crucial for the transition progress. Bristow (1996) has argued that[27] *"the least inflationary way to finance a budget deficit is to sell securities to the non-bank public... a huge volume of capital has to be mobilised to finance enterprise restructuring... and the absence of secondary markets could seriously inhibit privatisation programmes, whether they involve the selling of shares or are mass privatisation schemes"*.

There was a need for new corporate governance in the banking system, and it is necessary to grant bank managers enough independence from their customers, the loss-making enterprises. There was also a need for quick privatisation of the new consolidated large Bulgarian banks and re-capitalisation and restructuring whenever appropriate (much before 1997). Re-capitalisation should prevent banks from accumulating more non-performing loans, provide new corporate governance and provide with incentives for collecting the remaining bad loans. The western help is needed not only for financing the projects, but also on the way of upgrading the skills of bank managers and supervisors with their own participation in the Bulgarian banking environment being participants as shareholders (like the example of the EBRD).

An important policy question was how much entry **of foreign banks** should be permitted. The answer was that there is a need for foreign participation. The Bulgarian Banking laws (among the most liberal in the region) permits 100% of foreign participation in any bank that is going

to be privatised, and unlimited foreign participation in the banking system if the banking rules are ensured. The advantage of large foreign bank participation in Bulgaria was that Bulgarians could learn new skills by working in branches of foreign banks and learning and adopting new payment methods, marketing skills, new products, advanced computerised techniques etc. Bulgarian banks can also learn from the example set by foreign banks. On the other hand, the local banks will need time before they are fully able to compete with foreign banks, due to the burden of bad loans and lack of skills and experience.

The results of the first four years of the BNB functioning as a **currency board** indicated a gradually reviving confidence in the lev and the banking system. Moreover, as a shareholder in the **Bank Consolidation Company**, the BNB supported the government in privatisation of state banks. Given the general Bulgarian performance the BCC was very successful since it managed to consolidate 59 small banks into 4 (together with Bulbank, Postbank) and to privatise 5 out of 6 banks to foreigners, up to the end of 2001.

The privatisation of large state-owned enterprises with the help of the BCC significantly helped the FDI inflows in Bulgaria. Around 1/6 of the total FDI inflows belong to these five privatisation deals with strategic foreign investors. Incentives for this foreign participation in the banking sector is the market size[28], the geographical proximity, the presence of other companies of the same origin with the home country of the foreign bank (follow the clients), lack of competition, or exploiting ownership advantages such as brand name, superior skills, multinationality, physical presence in many countries, globalisation pressures etc. Other incentives, which may encourage foreign investors are: economies of scale, ethnic minorities, foreign exchange arbitrage, knowledge of the host country, MNE's experience at operating internationally, past experience, etc. [29]

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5. Introduction

Greece and Bulgaria have had trade relationships for centuries, mainly because of their geographic proximity, their cultural closeness and common religious beliefs. Bulgarian people have always admired Greek traders[1]. The fact that the two countries were historically connected both by the Byzantine Empire and the occupation of the Ottoman Empire brought the two countries even closer. The rise of the communist regime and the 'cold war' between Eastern Europe and Western countries, deactivated more or less the relations of the two countries, but after the fall of communism the relationship recovered significantly and the two countries are currently on very good terms with each other.

After the fall of the Iron Curtain, the advanced countries from Central & Eastern Europe (CEE) such as the Czech Republic, Hungary and Poland created close ties with neighbor Europe's strongest economy, Germany. On the other hand, Bulgaria, FYROM, Albania and Yugoslavia created ties with their neighbor, Greece, one of the European Union's poorest members. Still, Greece is the closest EU member to Bulgaria, in fact it is the only EU member in the Balkans and one of the richer countries in the Balkan region, and since Greece supports the membership of Bulgaria, in the EU, Greek entrepreneurs and their products are very welcome in the country.

There are many more reasons why Greek enterprises, both small and large, are so economically active in Bulgaria, as well as in other South East European countries (SEECs). Greek entrepreneurship and trade flourish in the Balkan area due to the strategic geographical position of Greece in the Balkan region and the fact that it is the only country in the region that is close to Western standards.

The subject of this chapter is the presentation of the incentives and barriers of Greek foreign direct investment (FDI) outflows in an ex-communist country, Bulgaria, during its transition period. The main reason that the case of Bulgaria is of great interest is the fact that the adverse initial economic conditions of the country in the initial stages of its transition were one of the worst among the CEE countries. Another reason is the external shocks the country suffered, which were more severe than the other countries of the region had to face. Reference is made to the specific reasons and obstacles that the Greek entrepreneurs had to confront during the establishment of their FDI projects in Bulgaria. Finally, an analysis is also presented of the issue whether Greece is the main investor in Bulgaria and if this holds, whether this is due to lack of Western investment interest or due to the great number of Greek private companies accumulated in Bulgaria or maybe even

due to investments made by Greek state companies.

5.1 Greek FDI Activity in Bulgaria during the Transition Period

The Greek business presence in Bulgaria started in 1992 and it is possible to distinguish five time periods.

The first period is between 1992-1994, the main characteristic of which was the ability of Greek firms to obtain quick and easy profit. The CEE market in general was viewed as an 'El-Dorado' country, so dozens (over 500) of small entrepreneurs registered for entry in the Bulgarian market paying a trivial amount. Most of them, though, never activated their business. The core activity of the vendor -traders in this period was focused on food products, clothing and footwear, as well as the export to Greece of industrial products, such as scrap, sheet-iron and building's iron. Some big companies started gradually to carry out the first market research programs and an increase of exports to Bulgaria of final food products was observed.

During the second period, between the end of 1994 and well into 1995, the main characteristic was the entry of significant Greek firms with their own representative offices inside the Bulgarian market targeting their business activity mainly in the food products, the durable consumer goods and the services sectors. With the increase of the number of important Greek firms in the Bulgarian market, the share of each vendor was reduced. Many of these traders transfer their activity into other sectors where it was possible to get higher and easier profit. Moreover, during this period, Greek industrial activity was focused on the manufacturing industry, trade activities and recreation services.

The main characteristic of the third period, from 1996 until the end of 1997, was that although there was a significant amount of new companies registered in Bulgaria, those companies did not actually become active. Some even withdrew due to the three financial crises the country went through, which lead to high inflation rates, instability, corruption and very limited per capita consumption for the Bulgarian citizens.

In the fourth period when the situation had changed and the country had become politically stable, with a fixed exchange rate, a currency board and a significant lower inflation rate, the remaining large Greek companies slowly overcame their doubts and cautiously entered the Bulgarian market. There was a distinct predominance of firms bigger in size and the

creation of vertical and horizontal joint ventures, focusing again on the sectors of food products, beverages, durable consumer goods and services.

In the fifth period, from 1998 and onwards, there is intense interest from all the big Greek banks to participate in the Bulgarian market through acquisitions. Eurobank, National Bank of Greece and Commercial Bank of Greece have succeeded in the Bulgarian privatisation programmes, while at the same time Pireus Group, Alpha Bank of Greece and the National Bank of Greece have also established local branches in Bulgaria.

In the years 1992 and 1993, there was a registration of less than 100 Greek companies. Then in 1994 there was an accumulation of around 450 new Greek companies and in the years 1995-1997, there were around 750 new registered companies. In the years 1998-2001, there was a registration of additional 2400 Greek companies. Thus, we reached the total number of 3746 registered Greek companies in the Bulgarian business environment at the end of 2001 (see Table 1).

Table 1: DISTRIBUTION OF FOREIGN INVESTORS IN BULGARIA [BY REGIONS (NUMBER)-data end 2001]

№	COUNTRY OF INVESTOR	BOURGAS	VARNA	PLOVDIV	SOFIA CITY	STARA ZAGORA	HASKOVO	TOTAL BY COUNTRIES
1.	TURKEY	400	205	1153	1203	152	586	6366
2.	RUSSIAN FEDERATION	350	743	302	1225	88	59	4004
3.	GREECE	60	52	547	1575	43	96	3746
4.	CHINA	4	12	51	2733	1	2	2878
5.	SYRIA	43	136	216	1747	31	3	2399
6.	ARMENIA	378	323	564	356	34	39	2254
7.	ITALY	56	69	360	895	30	7	1867
8.	FYROM	6	9	38	232	10	4	1606
9.	UKRAINE	163	255	123	490	23	26	1578
10.	GERMANY	89	146	115	757	31	15	1554
11.	YUGOSLAVIA	27	35	94	918	10	6	1496

Source: BFIA August 2002

An increasing number of Greek companies became active in the areas of South Bulgaria, near the Greek borders because of the low labour and transportation cost, which helped the creation of an export base. Indicatively, around 200 to 300 Greek textile and clothing companies operate in these particular areas, despite the fact that they have to employ almost twice as many workers – over 90% of them women – as they would in Greece because of the inferior skills of Bulgarian textile workers (especially in the earlier transition years). Still, the companies make high profits because of the comparatively low salaries they pay. This accumulation of textile companies has greatly contributed to the appearance of a strange phenomenon in these areas: a very high rate of women employment opposed to very high rate of male unemployment. An interesting issue was the fact that there were no textile workers available due to the operation of a great number

of Greek textile companies. The pressing need for more workers had pushed several companies to try to attract workers already hired by competitors, by promising them higher salaries. The situation was deteriorated from the 300 small and medium-sized local tailoring and textile companies, which were released by the Bulgarian trade unions and may export ready-made clothes to Greece.

Greece holds the first position among the European community countries, as far as the number of firms registered is concerned (Italy is in the second place). On a worldwide scale, Greece is in the third place after Turkey and Russia (table 1).

Greece, Turkey and Russia share the same statistical problem of many registered but not active firms. The bulk of the small-scale Greek firms which expand their operations in the Bulgarian market, have a family character and they avoid employing personnel specialized in management. Moreover, there is an absence of continuity in the main productive direction (absence of long-term planning and innovations). A key factor behind the above problem is also the inability of the firms to promote a quick transformation of the business structure and the re-adjustment of the existing human resources to the changing competitive conditions. In general, there is a low level of application of methods for improving productivity in the development of the business plan of the firm. A great drawback is also the relative shortage of executives with sufficient knowledge of the conditions in the Balkan market.

Nevertheless, Greek traders have a relatively good knowledge of the specific features and conditions of the Bulgarian market; low transportation costs, low management- transaction costs and high quality of goods sold at relatively affordable prices form their competitive advantages in such as environment. Bulgaria is considered and in practice is the gate of the Balkans towards the market of Russia, Moldova and Ukraine, while its role in the trade with countries of Central Asia (Uzbekistan, Takzikistan, Kazakhstan, Turkmenistan) as well as Georgia, Armenia and Azerbaijan is also growing in the course of time.

Large Greek companies invest in more than one country in the Balkan region, since they find more opportunities than simply the geographical proximity and low labour cost, factors that constitute the main reasons for investments by small companies. These large companies recognised among other things, the lack of local competition, the lack of intensive Western investment interest and the opportunity to become multinationals. Therefore, they made successful strategic investments. Most of these Greek enterprises

have also invested in Romania, FYROM and Albania (except for Bulgaria).

5.2 Greek investors in Bulgaria: Are they leading in investments in Bulgaria? Is the significant Greek interest in Bulgaria a fact or a myth?

A few Greek entrepreneurs and Greek MNEs (together with Turkish and Russians) used the tax heavens of Cyprus and Luxembourg to create offshore companies in these tax paradise centers and then invested in Bulgaria (and in the whole Balkan region) for financial and tax reasons.

Table 2. The biggest Greek interest investments in Bulgaria using an offshore centre

	NAME	COUNTRY	BULGARIAN PARTNER SECTOR	DATE	$ M.
1.	ALICO/CEH (EUROBANK 43%) CONSORTIUM	CYPRUS	POSTENSKA BANKA FINANCE	98	24,08
2.	KLARINA HOLDING	LUXEMBOURG	FOOD INDUSTRY VARIOUS BEVERAGE COMPANIES	93-99	38.6
3.	SOFTBUL INVESTMENT LTD	CYPRUS	FOOD INDUSTRY	97 97 97	12.2
4.	GLASINVEST LTD	CYPRUS	GLASS INDUSTRY STIND	97, 98	32.7
5.	BARECK OVERSEAS LTD.	CYPRUS	GLASS DRUZHBA JSCO. PLOVDIV	98, 99	23.2
	TOTAL	GREEK INTEREST INVESTMENTS	in million USD$ dollars	1989-2000	130,78

Source: BFIA and author's research

If the cases of CocaCola – 3E (HBC), Frigoglass, Yioula (Leventis and David family Group) and Eurobank (Table 2) are taken into account, Greece is to be considered in first place as far as investments are concerned with a total amount of around 750 USD$ invested.

We can also point out that there are some countries such as Cyprus, the Bahamas, Luxembourg, Malta and Liechtenstein that seem to appear to MNEs as offshore centers or tax heaven centers. The total FDI outflows from these countries having Bulgaria as a target, were about 300 USD millions. Half of these inflows have been exploited by Greek MNEs (table 2). The remaining inflows of 300$ millions in Bulgaria belong mainly to Russian and Turkish entrepreneurs. Unsurprisingly, the tax havens of Cyprus and Luxembourg are in the top ranking in the table of FDI inflows in Bulgaria. This shows that most of the stakes of Bulgarian companies were bought by companies registered in Cyprus or Luxembourg. Offshore registration helps avoid paying taxes on the proceeds from capital market transactions and dividends in Bulgaria and provides a handy cover up for the buyer's identity. It is a common way for the Greek companies, not only to invest in Bulgaria, but also in other foreign countries due to the high Greek taxation base.

5.3 The decisive role of Greek investments in the Balkan region; the low western investment interest

> *"Although, Greece is a small country with a weak economy in global economic figures, Greek investments are significant both in volume of invested USD$ and in the number of FDI projects (data -end 2001) in most of the countries of the Balkan region and especially in Bulgaria (more than 700$ million), Romania (more than 1000$ million), FYROM (more than 300$ million), Albania (more than 250$ m) and Yugoslavia (FRY) (more than 500$ million). The lack of significant western investment interest for FDI outflows in the Balkan countries has given Greek enterprises, the advantage for becoming MNEs, by investing in neighboring countries a large amount, in respect to their worldwide economic figures and their home country's* [Greek] *economy"* [Bitzenis, A, 2003, p.9][2] .

Table 3. The largest Greek Investments in Eastern Europe (over $20 Million USD each one)

Ten Greek Investments over $20 Million USD in South Eastern Europe (SEE)							
Name of MNE	**Home Country**	**Host Country**	**Local or Foreign Partner**	**Purpose of Investment**	**% of Partici pation**	**Amount of Investment $**	**Additiona Investmen**
OTE + Cosmote	Greece	Bulgaria	GLOBUL	15year license for second GSM operator	100%	USD $135 million	$80-$250 million
Coca-Cola (3E or HBC) + Athenian Brewery S.A.	Greece	Bulgaria	KLARINA HOLDING, BREWINVES T, SOFTBUL INVEST LTD.	Bottling Company	100% 80%	USD $78 million	
Frigoglass + Yioula S.A. + Leventis/ David Group	Greece	Bulgaria	STIND, DRUZHBA	Glass Industry	100% 51%	USD $55.9 million	
National Bank Greece	Greece	Bulgaria	UNITED BULGARIAN BANK	Bank	90%	USD $270 million	
EUROBANK	Greece	Bulgaria	POSTENSKA BANKA ALICO INC. USA (57%, 43% EUROBANK)	Bank	78%	USD $24.08 million	
National Bank Greece	Greece	FYROM	Stopanska Banka	Bank	65%	USD $58.6 million	
Coca-Cola (3E) + Athenian Brewery S.A.	Greece	FYROM	Balkanbrew Holding, AD PIVARA	Bottling Company	100% 51%	USD $35 million	
Hellenic Petroleum	Greece	FYROM	OKTA REFINERY (SKOPJE)	Oil refinery, Petrochemicals	54%	USD $32 million	
TITAN	Greece	FYROM	A.D. CEMENTARN ICA USJE OF SKOPJE	Cement factory (JOINT WITH HOLDERBANK, SWISS)	85%	USD $30 million	
OTE*	Greece	Romania	RomTelecom	Telecom Services	35%	USD $675 million	
Coca-Cola (3E or HBC)	Greece	Romania	Molino Beverages, CocaCola Beverages	Bottling Company		USD $60 million	
Delta International Holdings (Lux)	Greece	Romania	Danone	Food Industry	65.6	USD $25 million	
Mytilinaios Holdings	Greece	Romania	Sometra S.A.	Metallurgical industry	88%	USD $20 million	
OTE	Greece	Yugoslavia	Telecom Serbia	Telecom Services (49% withTelecom Italia-STET)	20%	USD $350 (DM 675,070,000 June 1997)	
Delta International Holdings (Lux)	Greece	Yugoslavia	Danone – Delyug A.D. – Chipita S.A.	Food Industry	90%	USD $35 million	
Coca-Cola (3E or HBC), Balkaninvest Ltd	Greece	Yugoslavia	IBP Beograd	Soft drink producer	68%	USD $30 million (84 million dinars in 1997)	USD $24
Cosmo-Holding Albania (97% OTE and 3% Telenor /Norway)	Greece	Albania	Albanian Mobile Communicatio ns (AMC)	Mobile Services - license for first GSM operator	85%	USD $85.6 million + USD $21 million =106.6 USD$	USD $80 Million
Panafon-Vodafone	Greece	Albania	Vodafone International Holding (UK)	Mobile Services - license for second GSM operator	100%	USD $38 million	
TOTAL (USD $2037 million) – **in the Balkan Region (exc. Turkey, Bosnia, Slovenia, Croatia) * there are extra investments of OTE in Romania**						USD $2.037 billion	

Source: Author's research

The total amount of the ten Greek FDI outflows[3] (according to Table 3) is more than $2 billion USD. The Greek FDI outflows in the Balkan region (in 5 SEE countries) account for around 3 billion USD$ (see Tables 4 & 5).

Table 4:GREEK FOREIGN DIRECT INVESTMENT OUTFLOWS IN SEE REGION (million USD$, or in %)

END, 2000 DATA	***GREECE***	*CYPRUS*	*GERMANY*
IN FYROM	*124,9 (16%)*	*67 (8%)*	*41 (5%)*
END, 2001 DATA	*ITALY*	***GREECE***	*GERMANY*
IN ALBANIA	*(47.9%)*	*(34.2%)*	*(1.3%)*
END, 2000 DATA	*NETHERLANDS**	***GREECE***	
IN YUGOSLAVIA	*560(52%)*	*481(45%)*	

SOURCE: VARIOUS SOURCES

Thus, around 70% of the total Greek FDI outflows belong to those 10 (see table 3) large Greek MNEs. At the same time only four companies (OTE/Cosmote, National Bank of Greece, Coca Cola/HBC and Frigoglass/Gioula/Leventis/David Family Group) have invested more than 80% of the total Greek FDI outflows in one country such as Bulgaria. These four companies have also invested more than 60% of the total FDI outflows in the above-mentioned five countries of the Balkan region. The Greek FDI outflows in these five countries are around $3 billion USD (26% of the total), when at the same time the total FDI inflows are about 14 billion USD$ (end 2001 -see Table 5).

Table 5: FDI Inflows in CEECs and in the Balkan Region (1990-2001)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	TOTAL
Eastern Europe													
Albania [c]	–	–	20	58	53	70	90	48	45	41	143	180*	748
Bulgaria [c]	4	56	42	40	105	90	109	505	537	819	1002	651	3960
Romania	–	40	77	94	341	419	263	1 215	2 031	1 041	1 040	1 137	7698
Yugoslavia	..	..	..	..	..	..	–	740	113	112	25	90	1080
FYROM [c]	–	–	–	–	24	9	11	16	118	32	170	420*	800
TOTAL for 5 countries	4	96	139	192	523	588	473	2524	2844	2045	2380	2478	14286
Bosnia and Herzegovina	..	..	..	..	–	–	–	–	100	90	150	164	504
Croatia	–	–	16	120	117	114	511	533	932	1479	1115	900*	5837
Slovenia	4	65	111	113	128	177	194	375	248	181	176	442	2214
BALKAN REGION													22841
Hungary [d]	311	1459	1471	2339	1146	4454	2275	2173	2036	1970	1649	2443	23726
Poland (cash basis) [c]	10	117	284	580	542	1 132	2 768	3 077	5 129	6 471	8 294	6 929	35333
Czech Republic	132	513	1004	654	869	2562	1428	1300	3718	6324	4595	4500*	27599
Slovakia	18	82	100	195	269	308	353	220	684	390	2 075	2 000*	6694
CENTRAL EUROPE VISEGRAD COUNTRIES													93352
Eastern Europe	479	2332	3125	4193	3594	9335	8002	10202	15691	18950	20434	19856	116193
Baltic states			119	238	460	454	685	1142	1863	1139	1173	1457*	8730
CIS			1777	1875	1770	4065	5288	8856	6726	6735	5367	7021*	49480
Russian Federation	–	100	1454	1211	690	2066	2579	4865	2762	3309	2714	2921	24671
Estonia	..	..	82	162	215	202	151	267	581	305	387	600*	2952
Latvia	..	..	29	45	214	180	382	521	357	347	408	257	2740
Lithuania	..	..	8	30	31	73	152	355	926	486	379	600*	3040
Total above	479	2332	5021	6306	5824	13854	13975	20200	24280	26824	26974	28334	174403

Source: Bitzenis' calculations and modifications - National balance of payments statistics; IMF, *Balance of Payments Statistics* (Washington, D.C.), various issues and *Staff Country Reports* (www.imf.org); UNECE secretariat estimates.

Note: Changes in coverage are available in UNECE, *Economic Survey of Europe, 2001 No. 1*, chap. 5, box 5.3.1.

a Inflows into the reporting country. ***c*** Net of residents' investments abroad. Bulgaria, 1990-1994; Poland, 1990-1992.

d Reinvested profits have been excluded.

The low western investment interest in the Balkan region is very profound from the statistical data. In the Balkan region we have only 23 billion USD$ FDI inflows when in the whole CEE region we have 174 billion USD$ (accumulated in 12 transition years). In the above-mentioned 5 countries of the Balkan region, we have only 14 billion USD$ FDI inflows. This interesting finding can be supported also by the economic figures of GDP per capita and FDI per capita (see Tables 6 & 7). Countries of the CEE region that have received limited FDI inflows display low levels of GDP per capita as well as low levels of FDI per capita. For example, countries from Central Europe such as Hungary, Poland, the Czech Republic, Slovakia and even a country from the Balkan region such as Slovenia, all have over 200 USD$ per capita annual FDI inflows and more than 10,000 GDP per capita at PPP prices when countries such as Bulgaria, Albania, Romania and the remaining Balkan countries (except Slovenia) have less than 100 USD$ per capita annual FDI inflows and only around 7000 USD$ GDP per capita at PPP prices. Thus, we can conclude that the advanced CEECs attract more FDI inflows that the remaining countries. The same is true for the rest of the world when countries such as the USA, the UK, Germany etc. received significant FDI inflows having at the same time significant and high per capita annual FDI inflows and GDP per capita at PPP prices.

Table 6 - Basic indicators of South East European Countries (SEEC-7) and Central European Transition Countries (CETC-5), 2001

	POPULATION	GDP	GDP/CAPITA	GDP/CAPITA	GDP GROWTH, REAL, IN %			
	Thousand of persons	in USD million	USD at ER*	USD at PPP**	1991-2001	2001	2002	2003
					average		WIIW forecast	
Albania	3435	4186	1219	.	1.5	6.5	6	6
Bosnia and Herzegovina	3750 [1]	4618	1231	.	26.3 [4]	5.6	3	.
Bulgaria	7929	13557	1686	7650	-1.6	4.0	4	4
Croatia	4381	20263	4625	9660	-0.9	4.1	3.5	4
FYROM	2041	3426	1674	6400	-1.3	-4.6	0	2
Romania	22456	39714	1772	6180	-1.1	5.3	3.8	4
Yugoslavia [2]	8319	10500 [3]	1260	.	-6.2	6.2	4	4
SEEC-7	55951	97741	1747	.	.	.	.	.
Czech Republic	10280	56728	5514	15170	0.4	3.3	2.4	3
Hungary	10195	51917	5092	12960	1.0	3.8	3.3	4
Poland	38632	176256	4561	9890	3.4	1.0	0.8	1.3
Slovakia	5379	20462	3804	12660	0.8	3.3	4	3.5
Slovenia	1990	18810	9443	17740	2.0	3.0	2.8	3.5
CETC-5	66476	324175	4875	11630	2.1	2.2	1.6	2.5

*ER = Exchange rates. **PPP = Purchasing power parity - estimates by WIIW.
Notes: 1) Excluding refugees. - 2) Excluding Kosovo. - 3) WIIW estimate. - 4) 1994-2001.
Source: National Statistics and WIIW estimates.

Table 7 - FDI inflow per capita, USD

	1990	1993	1994	1995	1996	1997	1998	1999	2000	2001	
Albania	.	18	17	22	27	14	13	12	42	58	1)
Bosnia and Herzegovina	.	.	.	.	.	.	27	24	40	35	
Bulgaria	0	5	12	11	13	61	65	100	123	86	
Croatia	.	26	25	26	115	121	225	359	257	343	
FYROM	.	.	10	5	6	8	59	16	87	217	
Romania	.	4	15	18	12	54	90	46	46	51	
Yugoslavia	.	.	.	.	.	70	11	13	3	20	
SEEC-7 2)	0	6	12	13	17	54	69	68	68	79	
Czech Republic	7	63	84	248	138	126	361	615	485	478	
Hungary	30	227	112	435	223	214	201	196	163	240	
Poland	2	45	49	95	116	127	165	188	242	207	
Slovakia	.	34	51	48	67	41	127	72	384	274	
Slovenia	2	57	64	89	97	189	125	91	88	222	
CETC-5 2)	7	75	65	167	132	135	196	243	274	260	

Notes: 1) Estimate. - 2) Calculated weighted average. *Source*: *Gábor Hunya* and WIIW Database.

5.3.1 Did the Greek government encourage FDI outflows in the Balkan region?

Although the results from the interviews imply that the Greek government did not encourage (direct) individual investors to proceed to an FDI project by offering financial incentives, tax exceptions, loans and grants, it is clear that two big national companies (OTE / Cosmote and the National Bank of Greece – see Table 3) have themselves invested around 1.6 billion USD$, corresponding to 55% of the estimated amount of money totally invested in the five countries in the Balkan region by Greek MNEs (author's research). However, from the analysis the author has also found that the two national companies have undertaken these FDI projects due to the following reasons: absence of other significant foreign investment interest, lack of local competition, belief of a profitable investment project, geographical proximity, interest for expansion of their activities in neighbor countries, follow the clients theory, increase of market share, participation in new markets, acquisitions in affordable and reasonable prices (the high investment risk was embodied in the low price of privatisation deal) and their knowledge of the Balkan market. Thus, it can be concluded that although these national companies primarily invested in the Balkan countries for the above-mentioned strategic reasons, simultaneously they encouraged (indirectly) the other Greek MNEs and entrepreneurs to invest in these countries.

Moreover, except for the specific amount spent on Greek FDI projects in the Balkan region, there are more than 5000 active Greek enterprises in the Balkan area (more than 10,000 are registered – see section 3.5 for the reasons behind the difference in registered

and active companies). As mentioned before, there are also about 1500 companies active (around 3800 registered companies) in Bulgaria. These companies may have not invested significant amounts of money, however they have made value-added activities, thus offering job positions, variety and quality of services and goods, all the while playing a vital role in the local market growth.

5.4 The causes of the great accumulation of Greek companies in Bulgaria

There are many reasons[4] why Greece is such a significant investor in Bulgaria. Following, is a cumulative reference according to their importance:

- The Greeks took advantage of the fact that there is a lack of interest in the Bulgarian market on the part of Western investors (market hunters). They grasped the opportunity to become multinationals, only a short time period after the liberalisation and opening of the Bulgarian borders. Before 1989, only a few (one digit) Greek MNEs appear to have invested in a neighbouring foreign country.
- The Balkans and in particular, Bulgaria offer Greece and Greek MNEs a completely new market (market hunters).
- This new market is located very close to Greece (geographic proximity).
- This market displays a lack of local competition (strategic market hunters).
- Due to the high growth of the Athens Stock Exchange Market (ASE) in the summer of 1999, a large enough number of Greek companies received extremely high capital inflows (cash flows) from various increases of their capital (stock issues), which in turn was used mostly to invest in the Balkan region
- The selling out of Bulgarian state owned companies through privatisation or the creation of several joint ventures, tempted large Greek companies such as the Hellenic Bottling Company-Coca Cola, Titan, Intracom, Titan, Delta, Goodys, Nikas, Thrace Papermill et al., to step in and acquire a share in the market. This participation of the Greek companies boosted their power and their position in the world market and increased their global market share (e.g. the Hellenic Bottling Company became the second bottler in power in the world) (pressures from competition).
- Historical ties, a common religion and cultural closeness (Greek business mentality rather the Western mentality is at least closer to the Bulgarian one). Between the West European countries and Bulgaria there is a cultural distance, which according to a recent economic theory [Morosini et. al., 1998], encourages investments (this

apparently contradicts the commonly held view that the opposite is the case, i.e. that culture closeness encourages investments). However, there is a tendency among modern Bulgarians (just like most other East European citizens) to mimic western consumer activities and thus the cultural distance becomes cultural closeness. As Greece has been a member of the EU since 1979, in the eyes of the Bulgarian public, Greek goods and services are West European and therefore of higher quality. The fact that Bulgarian people often travel to Greece also affects their attitude since they become more familiar with the Greek brands.

- There was a general euphoria arising from the collapse of the communist regimes and the subsequent need for goods and services in these countries that point to quick and easy profit. This euphoria encourages Greek entrepreneurs to act in haste and without prior thorough investigation of the market. In other words, there is a common practice among Greek investors -especially the small ones- to move quickly and en masse towards Eastern European markets without proper preparation and adequate experience in economic activities. Furthermore, they set up small companies with limited capital and second hand machinery that produced low quality commodities (products that have gone out of fashion or with expired sell-by date) [Labrianidis L., 1997]. They even offer inadequate services. Many of these Greek companies in Bulgaria have already closed down or become passive. It was a hard lesson for the Greeks to realize that Bulgaria was not the market paradise as they had initially thought (emigrant entrepreneurs). Labrianidis (1996/97, p.219) has argued, "... *most of these companies have been thrown out of the Greek market, some of them having left the country overnight, leaving debts behind as well as unpaid employees*" [Labrianidis L., 1996/97].
- The low labour energy and raw materials cost. Bulgaria offers cheap labour and unfortunately the transferred enterprises contribute to the increase of unemployment in Greece and in particular in Northern Greece (resource hunters).
- Greece specializes in textile production (esp. Northern Greece), which also relies on the low cost of unskilled labour. The neighbouring Bulgaria offers extremely good conditions in this respect. It will suffice to note that the ratio of wages between Greece and Bulgaria was 1:10 at the beginning of the transition and is now 1:5. However, the productivity of the Bulgarian labour in the early transition years was 1:3 but with the experience gained in certain areas, the productivity is catching up to that of the Greek workers. The latter development is due to the accumulation of a great number of Greek textile companies (esp. in South Bulgaria) that created a higher demand for labour and subsequently raised the salaries (low cost hunters).

- Prior to and during the transition years, many Greek companies already had trade relations with Bulgaria. The success of these relations and the good reception of the Greek products in the Bulgarian market encouraged the Greek companies to undertake FDI projects (from trade to FDI). The main reasons for the Greek FDI projects to replace or complement trade relations are to overcome trade barriers, to minimise the production cost, to avoid transportation cost, and to gain brand preference utilising the 'locality' advantage.
- Many Greek companies aim at creating an export base in Bulgaria, which again offers the advantage of low cost due to both cheap labour and transportation. The latter is greatly facilitated by the geographic proximity and especially the low cost of Bulgarian transportation means (export base).
- The existence of very favourable trade agreements (tax relieves, lack of quotas and tariffs etc) between Bulgaria with other neighbour countries (favourable investment law hunters).
- Bulgaria provides a crucial link between Greece and the Commonwealth Independent States (CIS) countries (strategic reason).
- Bureaucracy, briberies, a high risk environment and corruption while discouraging factors for Western investors were viewed by Greeks as a more or less familiar reality as they were in practice in Greece during the 1980s. The Greeks are very experienced in the black economy prevalent in the Balkans (knowledge of similar markets)(see Table 8). Most of the Greek participating companies in Bulgaria are small in size with limited invested capital. Thus, they did not really take into consideration the high risk Bulgarian environment, especially in the early years of the Bulgarian transition [Labrianidis L., 1999b], because there were high anticipated earnings.

Table 8: The Transparency International Corruption Perceptions Index: 10 (highly clean) and 0 (highly corrupt)5

Rank	Country	CPI 2002 score	Surveys used
1	Finland	9.7	8
2	Denmark	9.5	8
	New Zealand	9.5	8
27	Slovenia	6.0	9
29	Estonia	5.6	8
31	Italy	5.2	11
33	Hungary	4.9	11
44	**Greece**	**4.2**	**8**
45	Brazil	4.0	10
	Bulgaria	**4.0**	**7**
	Poland	4.0	11
51	Croatia	3.8	4
52	Czech Republic	3.7	10
	Latvia	3.7	4
	Slovak Republic	3.7	8
81	Albania	2.5	3
101	Nigeria	1.6	6
102	Bangladesh	1.2	5

Source: Transparency Index (TI)

- The intensive competition within Greece (due to the presence of many foreign

companies) pushed many companies to move towards markets like that of Bulgaria [Chatzidimitriou Y., 1997]. Those companies were mostly small in size. However, other small companies made the same move because they had lost their share in the Greek market and even faced bankruptcy (survival or defensive reasons, follow the competition).

- Bulgarian laws have given incentives (such as tax relieves, profits when invested are deductible) for establishing FDI projects. There are also significant incentives for very limited taxation for foreign companies established especially in the Southern part of Bulgaria (which is also the nearest to Greece) where there is a high unemployment rate (favorable investment law hunters).
- A few Greek companies, mainly small and a step before bankruptcy moved in Bulgaria, hoping to survive in a new market mainly because of the low cost of labour and energy and the lack of local competition [Labrianidis L., 1996]. Moreover, their hope was to export these products back to Greece (a way to survive).
- In Bulgaria, Greek constructing companies such as Michaniki and Sarantopoulos, Latsis Group have undertaken large infrastructure projects, which have also been subsidized by the Greek, Bulgarian and Russian governments and through European funds such as Phare, Interreg II, III, etc. [Petrakos C. G., 1997]. Greece is a member of the EU and Bulgaria is a road for connecting Greece with other EU members. Also, there are several other projects in Bulgaria, like the pipeline for gas, which will help Greece in its energy shortage (market strategic hunters).
- Greek banks established branches or acquired existing Bulgarian banks not only because of the geographic proximity and the lack of foreign and local competition, but also because of the influx of Greek companies in Bulgaria (follow the client)
- The presence of thousands of students in Bulgarian universities attracted Greek entrepreneurs to invest, especially, in the areas of entertainment, restaurants and food industry (follow the clients).

As a result of the abovementioned reasons, about 1500 Greek companies (3800 registered companies, 1500 active – data up to the end 2001) entered the Bulgarian market.

5.5 Failure or inability to initiate MNEs' operations in the Balkan region? The case of Greek companies in Bulgaria

The number of the announced Greek investment projects did not correspond with the real

number of firms under operation. It appears that several Greek companies existed only in name in the Bulgarian market awaiting better days to come for them to act. Out of 3800 registered Greek investments in Bulgaria, less than half are active today. The same stands for the Turkish and Russian companies in Bulgaria.

One should assume that the difference between the registered number of Greek companies in the Bulgarian market and the real number of firms operating in this market, is due to the departure, the bankruptcy or to the failure of a significant number of small and medium sized Greek firms to become active in the Bulgarian market. Some of the reasons for their departure are related to the improvement in the structure of control of the domestic market and also to the intensification of the competition from domestic businessmen.

More specifically and according to their importance, we can point out the following reasons:

- That only half of the Greek companies are active in Bulgaria is primarily due to the fact that Greek entrepreneurs wanted easy and quick profits, using limited capital and with no previous experience in economic activities. Their fast produced low quality commodities are no longer bought by the Bulgarians, leaving them with no option but to return to Greece.
- In the early years of the transition, many Greeks hastened -without any plan for investment and without any market research- to create and register firms in Bulgaria. However, they quickly understood that their hopes for easy profits were unfeasible.
- After severe economic crises, a slow transition reform, an increased unemployment rate and a low per capita income resulted to low per capita consumption. This deteriorated Bulgarian companies' revenues and profits. It affected the small enterprises more, since their target market is the individual household, which most experienced the economic crises.
- The three economic crises in Bulgaria made a lot of Greek companies return back to Greece. Especially in the third period (see Section 3), when the companies had already been weakened by the two in a row Bulgarian crises in one year (1996-1997), there was a great amount of withdrawals.
- A number of small Greek companies that were established in the very early years of the Bulgarian transition lasted particularly little as, the multinationals from western advanced countries that very soon came along, offered the same products with better quality and at affordable prices (increased competition).

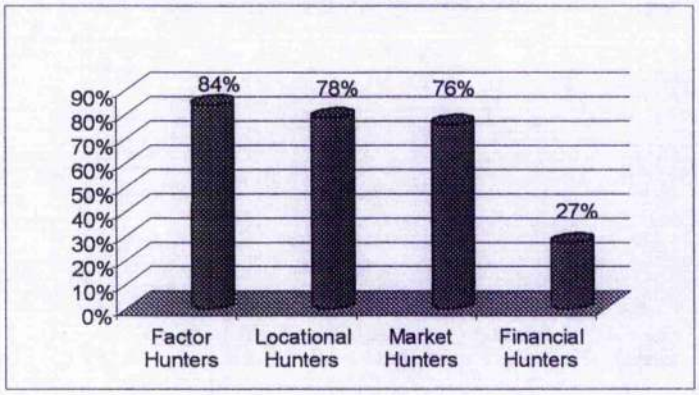
- Bureaucracy, bribery, high risk and corruption are some of the factors that led a lot of Greeks to close down their companies in Bulgaria and return home.
- Some joint ventures due to the inability to cooperate with the local investors were led to failure.
- Some Greek companies in the textile sector returned back to Greece because of the insufficient skills of the Bulgarian workers, which resulted in low quality products. The low labor cost was not enough to keep these investors in Bulgaria.
- Some of the follow the leader cases failed because the profits the entrepreneurs had expected to gain after a few years did not come. Many of them gave up their efforts either because the losses were significant in the first years of their establishment or the market did not seem to have the potential growth they had hoped for.

In fact, it is not easy to be exact with the number of those companies that are still active or have left Bulgaria. This is due to a problem with the Bulgarian data, which do not deduct from the total number of investments, the companies that never acted in Bulgaria or are inactive now.

5.6 Potential incentives and barriers for Greek FDI outflows in Bulgaria; Results of a questionnaire survey

As far as the Greek investors in Bulgaria (results of our questionnaire survey) are concerned, Figures 1a-4a show the differences between them and the other worldwide investors (see also previous section). Greek investors have proved to be factor hunters with a percentage of 84%, closely followed by a percentage of 78% that are locational hunters (Figure 1a). Apart from the obvious reason of geographical proximity, this change in the ranking of the group of incentives is due to the fact that most of the thirty seven (37) Greek companies participating in the research were in the textile sector, industrial and food sector that required low cost manual labor.

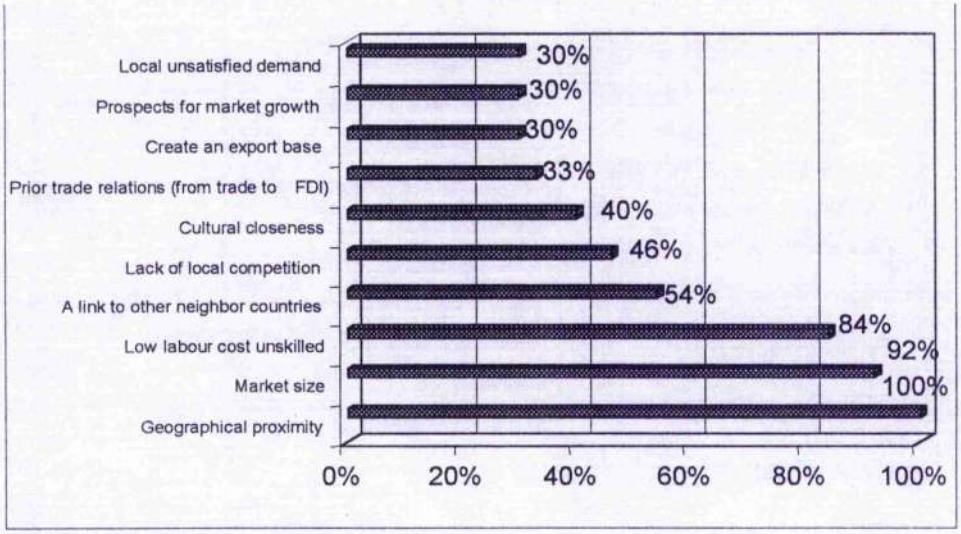
Figure 1a. Greek entrepreneurs in Bulgaria are...



Source: Author's Questionnaire Analysis' Results

As far as the separate incentives (Figure 2a) are concerned, Greek investors, as expected, ranked geographical proximity (100%) as the main motive for their FDI activity. Other important factors were the market size (92%) and the low labour cost for unskilled workers (84%).

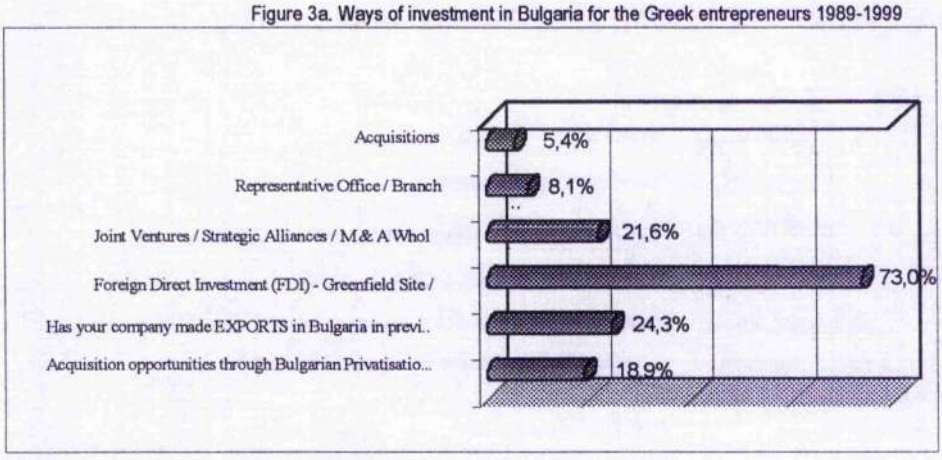
Figure 2a. Determinants (Incentives) for the Greek FDI outflows in Bulgaria



Source: Author's Questionnaire Analysis' Results

Regarding the ways of investing (Figure 3a), Greek investors have also preferred the green-field way, while at the same time, they have rejected the way of privatisation as a means of FDI.

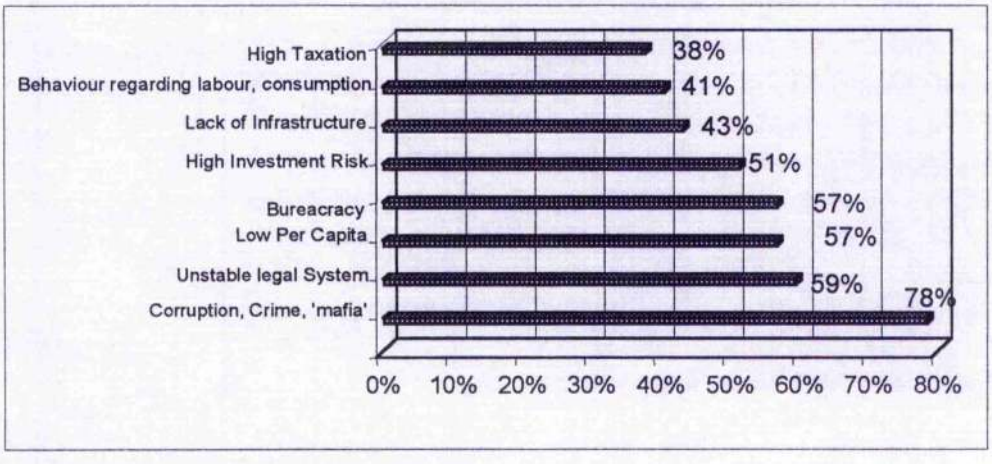
Figure 3a. Ways of investment in Bulgaria for the Greek entrepreneurs 1989-1999



Source: Author's Questionnaire Analysis' Results

The main barrier (Figure 4a) that Greeks had to face in their investment was corruption, crime and mafia (78%) followed by the unstable legal system (59%), the bureaucracy and the low per capital income being in the same position with 57%. These results are somehow surprising because the same conditions as far as bureaucracy, unstable legal system and corruption are concerned also prevail in Greece. However, the "Balkan Enlargement Spirit" that dominates the behavior of the citizens in the Balkan region is a factor that explains this situation.

Figure 4a. Barriers for Greek FDI projects in Bulgaria



Source: Author's Questionnaire Analysis' Results

It was a surprise for the author that although the Greek origin MNEs have the knowledge of the Balkan business ethics and the know-how to cope with risky environments, half of them made mention of the high investment risk as a barrier. Unexpected was also the fact that the barrier corruption, crime, bribery, mafia and illegal actions (Y67), has also been

mentioned by 29/37 (78,4%) of the Greek companies.

34/64 interviewed companies (53,1%) considered as a significant barrier corruption, bribery etc. At the same time, only 18,5% (5 out of 27) of foreign MNEs except for the Greek ones, looked upon this barrier as a crucial one. Although, Greece is a country where most of the every – day economic activities are characterized by bureaucracy and corruption, unanticipated was the fact that more than half of the Greek MNEs (56.8%) have also regarded bureaucracy (Y72) as a decisive barrier in their investment plans.

Interviews and personal contacts in a time period of 18 months were enough for the author to find out that the Greek investments and the Greek entrepreneurs were among the first and maybe the only cases among the foreign investors that received threats, patronage acts and other illegal actions from the mafia. Such acts are explainable as most of the Balkan countries and the majority of their citizens down through history have held a grand idea of their nationality and their origin. Similar examples are Greece with Alexander the Great's walk, the Greek expansion movement and the 1900s Asia Minor catastrophe. Other examples are: the Great Idea of Albania, the expectations of Bulgaria to expand its borders to the south with the union of Greek Thrace and to the West with the union of a part of FYROM (because of the minorities), the expansionist expectations of Romania during the Balkan Wars, the creation of the Republic of Yugoslavia with the leadership of President Tito and its subsequent dissolution, and finally, the Turkish occupation (Ottoman Empire) for almost five centuries in most of the Balkan countries. The above mentioned are proof that there has been a "Balkan Enlargement Spirit" (strong cultural and historical linkages are accompanied by strong historical rivalries within the Balkans), among the citizens of this region throughout the years for an expansion of their borders and their desire to become predominant in the region. Having in mind this last argument, we can explain the behavior of a small percentage of Bulgarians against Greek entrepreneurs. It may be difficult for some of Bulgarians to accept that Greeks at this time of the history are economically stronger and that Greeks have the opportunity to become economically dominant in the region. Thus, during the transition years, events of patronage, nepotism and mafia for the sake of quick and easy profit for nonexistent reasons (asking money for protection from thieves, asking money for the avoidance of losses and damages, even asking for money from an entrepreneur in order to balance the supposed illegal avoidance of taxes or the low level payment of tax rates) have existed. Moreover, reasons such as the fact that Greek entrepreneurs have come from their neighbor country to acquire or create enterprises at low cost and to employ citizens with very low wages, have been received

from the underground people (mafia) as a good enough reason to gain illegally money. From the research, the author discovered that the mafia did not react the same against the other foreign investors such as the Germans or the Americans.

5.7 Conclusions

Bulgaria has made **significant progress towards becoming a functioning market** economy, although it is not yet able to cope with competitive pressures and market forces within the European Union in the short term. Bulgaria is establishing a satisfactory track record of macroeconomic stabilisation and performance. However, the volume of invested inflows is very limited and there is **a lack of western investment interest**. Under this situation the Greek entrepreneurs have found enough space to make large enough investments compared to their home country's economic magnitude on a worldwide scale. This regional attitude can be seen by the fact that the Greek investments are significant both in volume of invested USD$ and in number (tables 9 & 10).

Table 9: DISTRIBUTION OF FOREIGN INVESTORS IN BULGARIA [BY REGIONS (NUMBER)-data end 2001]

COUNTRY OF INVESTOR	BOURGAS	VARNA	PLOVDIV	SOFIA CITY	STARA ZAGORA	HASKOVO	TOTAL BY COUNTRIES
TURKEY	400	205	1153	1203	152	586	6366
RUSSIAN FEDERATION	350	743	302	1225	88	59	4004
GREECE	60	52	547	1575	43	96	3746

Table 10: FOREIGN DIRECT INVESTMENT INFLOWS IN BULGARIA BY EACH COUNTRY BY YEARS In USD$

Nr.	Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Jan-June 2002	Total by countries
1	GREECE	0.2	5.1	3	29.8	14.6	16.1	3.3	14.9	241.1	213.6	78.2	619.9
2	GERMANY	0.1	56.6	111	16.2	53.1	31.4	55.7	101	72.3	65.1	23.0	586.2
3	ITALY	0	0.2	5.2	2.3	1.2	0.4	2.1	23	339.7	77.3	13.9	465.3
4	BELGIUM	0	0.1	0.3	10	0.8	264	31.2	66.2	39.8	3.1	0.6	416.5

The lack of significant western interest for FDI outflows in Bulgaria has given to the **Greek enterprises**, and especially the large ones, the **advantage to become MNEs** and the opportunity to invest in neighbor countries such as Bulgaria a large enough amount of USD$ if we consider and compare the Greek economy with the German or the British one.

We can point out that the **Greek investments in Bulgaria exceed the amount of 750 millions** USD$ instead of only 620 million USD that appear in the BFIA catalogue. This is attributed to the fact that there are a few Greek entrepreneurs (others that followed the same investment way were the Russians and the Turks) that have invested in Bulgaria through **offshore** companies, established in Cyprus or Luxembourg.

We can conclude that the **leading incentives** for the Greek entrepreneurs were geographical proximity, market size, low labour cost and using Bulgaria as a link to neighbour countries instead of market size, low labour cost, geographical proximity and international pressures from competition and globalisation. From the results, it can also be argued that the Greek enterprises' decisions for FDI outflows were based upon the geographical proximity, the low labour cost, the lack of foreign competition, and the cultural closeness. The Greek firms were planning to use Bulgaria as a bridge for further investments in other neighbour countries and previous trade relations have proved very helpful in their decision for FDI.

Problems such as corruption, a shadow economy, bureaucracy, and the primitive market infrastructure, discourage foreign investors and additionally decrease the competitiveness of the Bulgarian economy. However, the significant growth in most of the macroeconomic data of the Bulgarian economy and the political stability provide the author with signs that in the following six years, Bulgaria will enjoy substantial growth and development and that a possible date of 2007 for EU membership may not be so far from becoming a reality.

As previously mentioned, the importance in the consideration of corruption, bureaucracy, mafia and briberies as a barrier for the Greek MNEs came as a surprise. However, we based our arguments firstly on the fact that a lot of small in size Greek MNEs participated to the Bulgarian business environment which were vulnerable to the mafia (it was easier to be approached and to be frightened by the mafia), secondly on the **Balkan enlargement spirit** and thirdly on the tendency of Bulgarians (the same is valid for most of the ex communist citizens) to respect and mimic western civilization and thus the large western MNEs and their business activities.

Although we have concluded that ten Greek MNEs have invested around 80% (2 out of 3 billion USD$) of the total Greek FDI outflows in the whole Balkan region, on the other hand more than 5000 active Greek companies (especially small ones) offered and are offering **value added activities** to the Balkan economies such as job placements, quality, variety of products, production, contribution to the GDP etc.

We also presented unique and very important reasons (ranking them according to their significance) responsible for **the great accumulation** of Greek MNEs in Bulgaria, together with the reasons that resulted in their **failure**, bankruptcy, departure or their inability to start operations. This accumulation of Greek entrepreneurs during the twelve transition

years in Bulgaria has been divided into **five time periods**.

The Greek enterprises have found the **opportunity** to become MNEs and to participate in many Eastern European countries. The following decade (2001-2010) **is a crucial decade for them and for the entire Greek economy**. If these companies take advantage of the absence of foreign interest for FDI in the region, and their investments become healthy and profitable, then it will not be a surprise if the Greek firms become dominant and strong enough economical entities in the near future.

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[1] **CRAMPTON, R. J.**, 1997, A *Concise History of Bulgaria*, Cambridge University Press, UK.

[2] BITZENIS ARISTIDIS, 2003, "Is Globalisation consistent with the accumulation of FDI inflows in the Balkan countries? Regionalisation for the case of FDI inflows in Bulgaria", *European Business Review, Forthcoming No.2, 2004*

[3] OTE, Cosmote, National Bank of Greece, Vodafone/Panafone, CocaCola/HBC, Titan, Hellenic Petroleum, Delta, Mytilinaios Holdings, Frigoglass/ Yioula/ Leventis and David Family groups.

[4] **BITZENIS ARISTIDIS,** 2002, "The Determinants of FDI in Transition Countries; Incentives and Barriers Based on a Questionnaire Research: the Case of Bulgaria, 1989-2000", *International and Monetary Aspects of Transition in Southeastern Europe*, D. Chionis and G. Petrakos (eds.), p. 89-144

[5] The Corruption Perceptions Index, which Transparency International (TI) first launched in 1995, ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The surveys embrace the perceptions of business people, the general public and country analysts. The surveys were undertaken over the last three years and no country is included in the CPI unless there are results from a minimum of three surveys (a perfect 10.00 would be a totally corruption-free country). Standard Deviation indicates differences in the values of the sources for the index: the greater the variance, the greater the differences of perceptions of a country among the sources. The number of surveys used had to be at least 3 for a country to be included in the CPI. High-Low Range provides the highest and lowest values of the sources.

6. Conclusions

Although earlier analysts have seen Bulgaria as a country which undertook a 'big bang' **transition path,** the eleven years of Bulgarian transition studied by the author indicate otherwise. The instant price liberalization of more than 70% of the commodities in 1989 was the only sign pointing towards a 'big bang' strategy, when even the prices of the remaining commodities have not been liberalized after those years and the big state monopolies are still under state control.

Having chosen the road of economic reforms and introduction of the market principles, in the past several years, Bulgaria has taken a number of steps to introduce a liberal economy and attract foreign investment, which are the prerequisites to a modern economy with developed infrastructure. This is particularly true for the legislative initiatives, where many new acts have been adopted or old ones amended. Currently there is an acting legal framework for doing business by modem standards, in favour of the inward investment. The conditions for doing business in Bulgaria are quite liberal and **there are no restrictions for foreign investors** to settle in the country.

All the signs of economic life were negative until mid-1997. The governmental had failed to increase the private sector and to create adequate financial intermediaries, having at the same time one of the weakest stock markets in the region even to the present day. The development of Bulgarian privatisation is not only a far cry away from a 'big bang' path, but also raises doubts on whether it falls under gradualism. An explanation may be that Bulgarian governments in the sense of thinking political cost take a gradual approach in the privatization programmes, thus first to restructure and then to privatize.

However, after mid-1997, things changed and only positive signs in the Bulgarian economy can be seen. There is acceleration in privatisation and restructuring, an increased private sector, an one-digit inflation rate, low interest rates, macroeconomic stability, increased FDI inflows, a significant participation of foreign banks, a start towards the abolishment of the remaining monopolies, imposing of hard budget constraints and adequate legal framework.

Although the signs for **economic growth** (after July 1997 and especially in 1999-2001) are obviously positive, Bulgaria is still behind most of the other CEE countries since it has not yet

recovered economically, neither in GDP and industrial output nor in trade balances. Thus, increases in the real GDP, in volume of exports and imports and in industrial output are needed. Moreover, the Bulgarian government should try to decrease the high unemployment rate, to increase the low level of stock market performance, to balance the current account deficit and to proceed to the finalization of the remaining privatisation deals together with the abolishment of the remaining monopolies.

The Bulgarian government may very well consider all the above as the most important tasks to achieve or to overcome. Simultaneously, keeping to the same level or increasing the growth rate of the macroeconomic performance within the period of the following years (up to 2007), may well give Bulgaria the chances for **nominal convergence** and thus to become one of the next members of the EU. This will be true if Bulgarian economy succeed in the Copenhagen criteria. However, the **real convergence** of the Bulgarian economy with the other western economies will be mainly based on the **minimization of the level of the black economy** which occurs in the CEE countries and especially in the Balkan countries. This is around 40%-50% of the GDP level of each country (the EU countries have around 10%-15% level of underground economy, and Greece is the only country among the EU, with the highest level of hidden economy - around 30%-35% of GDP). Considering firstly that the GDP per capita of Greece (a member of the EU), Cyprus and Malta (both are countries that satisfy the Copenhagen criteria for an accession to the EU in the year 2004) is around 13,000 US$ each and secondly the GDP growth for most of the CEE countries is around 5%-7% per year, then we conclude the following: with such a growth rate, if we assume the level of black economy in 50% of the real GDP, then we also conclude that the GDP per capita of one country, such as Bulgaria, will reach the level of 13,000 US$ in a period of 7 - 10 years.

It is conventionally thought that to develop competition in a transition economy, **privatisation, restructuring** and creation of new firms should take place first. Restructuring involves changes in corporate governance, organizational and managerial rules, labour behaviour, composition and quality of the products, output and sales' goals, introduction of new technology and capital along with settlement of the bad loans. Bulgaria's experience raises the question of whether its chosen methods of privatisation reform and the pace of this reform are sufficient enough to promote competition in such a market. To answer this, we need to explore the barriers and the incentives faced by foreign MNEs during their

participation in the Bulgarian privatisation programs. This thesis investigates those questions on the basis of a survey of both theory and empirical evidence (using questionnaire and statistical analysis). It was determined that Bulgarian privatisation deals have been accelerated since 1997. On the other hand, Bulgaria still lacks in transparency and it follows slow paths in abolishment of monopolies. At the same time, it displays bureaucratic procedures and shows little progress in the transition process and in macroeconomic development.

Privatisation in Bulgaria proceeded very slowly, despite the motives provided by the World Bank and IMF in the form of aid packages. This delay is attributed to the political instability of the country (up to 1997) and governmental inability or unwillingness during the years of the transition, the social dislike towards privatisation as well as to several economic factors. A sociological investigation that studied public reaction was indicative that Bulgarians are indifferent and some times negative towards privatisation. Another social factor is the fact that any substantial private capital in Bulgaria in the initials years was obtained illegally and thus was unlikely to be used for privatisation purposes given that the Privatisation Law requires that all owners of any Bulgarian capital entering the Privatisation process must explain its origin.

Considering the economic factors contributing to the delay, one must pay close attention to the **collapse of COMECON**, which also contributed to other factors like the prolonged recession, the decrease in real income, and the very low internal demand. Political uncertainty, underdeveloped infrastructure and communications, delay in structural reforms and delay in the establishment of a legal background, resulted in reluctant foreign investors. Both domestic and foreign investors were further discouraged by the low net present value of the enterprises offered for privatisation.

One of the most difficult tasks in a privatisation process in a transition country is to determine the market value of public enterprises. Thus, in Bulgaria, an administrative rather than a market approach to valuation was adopted. The problem was intensified not only by the inexperience of evaluators, but also by the high inflation that often necessitated re-evaluation. The valuation of the privatized company was made even more difficult because of difficulties in allocating the appropriate assets to each company (the legal analysis of enterprises). During the communist years, ownership was always considered public. The enterprises' assets were

not clearly defined since many companies might have "use" the same asset. Hence, the documents identifying these assets, including land and physical plant, are usually not available or non-existent. The asset allocation problem becomes even more complicated if the claims for restitution are considered. **Delays in the privatisation** process became even more complex when disagreements led the cases to courts. The valuation problems were often solved by artificial evaluations of enterprises, resulting in abuses of authority and corruption by the agents in charge of the process.

Corruption is another prime factor responsible for the delay of Privatisation. The former Bulgarian authorities were determined to obtain ownership of state-owned property for themselves (or friends) at preferential prices and without public auctions. This kind of ownership transfer is considered as "quiet" if the information concerning the sale is not made public, or "illegal" if working rules are violated.

From our research we can conclude that the **delay in the privatisation process** affected multinationals' FDI decisions (MNEs which belong to the banking sector). Moreover, the way of privatisation as an entry mode has been chosen mainly from MNEs other than Greek ones. Privatisation deals mostly took part in the industrial sector because most of the Bulgarian SOEs which were offered to the privatisation programs belonged to this sector.

A sound **banking system** that helps the companies in their investment plans through financing their projects, as well as a functioning stock market exchange, which is a basic tool for mass or market privatisation, are essential parts of a stable economy. A sound banking system is a very crucial factor in attracting foreign investors. The privatisation of the state-owned banks had a direct effect in the Bulgarian FDI inflows and the delay of the transition process greatly affected the volume of the inward FDI. The Bulgarian stock market even today is still not well-functioning and a market economy needs a developed system with institutions, reliable regulations, strong foreign participation, lack of uncertainty and general stability in all of its economic activities, along with guaranteed governmental credibility. The development of secondary markets is also essential for the transition progress.

The privatisation of large state-owned enterprises with the help of the BCC significantly helped the FDI inflows in Bulgaria. **Around 1/6 of the total FDI inflows belong to five**

privatisation deals with strategic foreign investors. Incentives for this foreign participation in the banking sector is the market size, the geographical proximity, the presence of other companies of the same origin with the home country of the foreign bank (follow the clients), lack of competition, or exploiting ownership advantages such as brand name, superior skills, multinationality, physical presence in many countries, globalisation pressures etc. Other incentives which may encourage foreign investors are: economies of scale, ethnic minorities, foreign exchange arbitrage, knowledge of the host country, MNE's experience at operating internationally, past experience, etc.

An important policy question was to what degree of entry should **foreign banks** be permitted to engage in. The answer was that there is a dire need for foreign participation. The Bulgarian banking laws (among the most liberal in the region) **permit 100% of foreign participation** to any bank that is going to be privatised and unlimited foreign participation in the banking system if the banking rules are ensured. The advantage of large foreign bank participation in Bulgaria was that Bulgarians could learn new skills by working in the branches of foreign banks. They could learn and adopt new payment methods, marketing skills, advanced computerised techniques, initiating new products etc. Bulgarian banks can be taught from the examples set by foreign banks. On the other hand, the local banks will need time before they are fully able to compete with foreign banks, due to the burden of bad loans and lack of skills and experience.

The transition to a market economy needs a sound banking system, which is a crucial factor in attracting foreign investors. Foreign direct investment in the banking sector can be of particular importance to the transition countries since experience has shown that countries around the world in which FDI has concentrated have enjoyed accelerated economic growth, easier integration into world markets and less painful structural reform. With the help of Bulgarian official statistics, we can argue that one third of the total FDI inflows in Bulgaria are through privatisation deals and more than half of the latter inflows are a result of privatisation deals occurred in the banking system.

The analysis through questionnaires revealed important aspects of the FDI flows, which may not be captured by the standard analysis. The derived results indicate that the high risk business environment, the market size and bureaucracy have been considered similarly by

foreign banks and any other MNEs participating in Bulgaria and macroeconomic instability, unstable legal framework, low transition progress and lack of managerial skills have been considered by foreign banks as highly positive factors responsible for the FDI inflows in the banking sector. On the other hand, an unexpected finding was that corruption, crime and mafia have not been taken into account at all by foreign banks. Lastly, the low cost of a skilled labour force together with the theory "following the clients", lack of local competition and the existence of international/globalisation pressures were significant incentives for foreign banks in order to enter Bulgaria. The findings that multinational firms may be discouraged to invest by factors such as macroeconomic instability and inadequate institutional framework are in accordance with a previous work (Liargovas and Chionis (2001)). Our main hypothesis is that besides the role of the conventional determinants of FDI, factors such as the form of monetary stability and the progress of economic and institutional reforms, which constitute the essence of the transition process, might be responsible for stimulating FDI flows. Given the fact that Bulgaria moved slowly towards a market-based economic system, relative to other transition economies, and that the investments in the banking sector consist of a large proportion of the total Bulgarian FDI flows, we insist that this comparative analysis constitutes of considerable importance in determining the role of the transition process on the FDI flows.

The results of the first five years of the Bulgarian national Bank (BNB) functioning as a **currency board** indicated a gradually reviving confidence in the lev and the banking system. Moreover, as a shareholder in the **Bank Consolidation Company (BCC)**, the BNB supported the government in the privatisation of state banks. Given the general Bulgarian performance, the BCC was very successful since it managed to consolidate 59 small banks into 4 (together with Bulbank, Postbank) and to privatise 5 out of 6 banks to foreigners, up to the end of 2001.

Our survey tried to specify the main incentives and barriers for a specific country case study, namely Bulgaria during its post communist period. The size of the market, low unskilled labour cost, geographical proximity, prospects for market growth and using Bulgaria as a link to other neighbour countries were considered as **important reasons for undertaking FDI projects in Bulgaria**. On the other hand, unstable legal framework, bureaucracy, corruption and the high risky environment were the **most decisive barriers** for foreign MNEs, when considering investing in Bulgaria. We concluded that the constant changes in the legal framework, lack of adequate and efficient laws, insufficient enforcement of laws, which

leaves space for corruption, bureaucracy and bribery, discourage foreign investors in participating in such an environment.

In addition, although **bureaucracy and corruption** were important barriers for establishing an FDI project in Bulgaria, only about 1/3 of MNEs who participated in the research suggested that bureaucracy or/and corruption was an important barrier for them. Finally, **risk** was also a significant barrier in the decision of making an investment in an environment such as Bulgaria.

More specifically, in our survey the findings regarding the significance of **geographical proximity** were in accordance with Pye (1998), Pitelis et al. (2000), OECD (1994), Meyer (1995-6) and SECI (1998)) and the **low labor cost** were in accordance with with Pitelis et al (2000), OECD (1994) Altzinger (1999).

On the other hand, the finding regarding the importance of low labour cost is against with Meyer's findings, who considered that for British and Germans MNEs were interested in low labour cost as a secondary incentive. Our survey in which Greek, Turkish and Russian MNEs prefer to invest in the neighbor Balkan region and in particular in Bulgaria, exploring low labour cost especially for labour intensive industries and export oriented industries. Geographical proximity and the importance of low labour cost for export- oriented companies were also in accordance with Lanks and Venables (1997) and Pitelis et al. (2000).

We agree with Lanks and Venables (1997) who argued that "*The importance of factor costs seems to depend, not surprisingly, on the purpose of the investment. They found that export oriented firms place much greater importance on production costs and cheap skilled labour*". Our findings regarding the importance of **cultural closeness** together with the importance of **strong historical links and strong cultural ties** was in accordance with Andersen (OECD), SECI and Altzinger.

The absence of **political stability** as a major incentive for the case of Bulgaria can be explained by the fact that Bulgaria faced political instability from the start of its transition period and up to the year of 1997 (8 governments in 8 years). So, it was not evident the Bulgarian political stability at the time period when this survey was conducted.

Meyer (1995-96) found that the **qualified labour force** was an important reason for investment in Hungary together with its political and economic stability. Also Pye (1998) mentioned the importance of skilled labour force in Slovakia. However, sometimes the absence in consideration of the low labour cost as an significant incentive and the searching of the availability of qualified labour force is the key difference for foreign investors who prefer to invest in the Central European countries such as Hungary and Poland instead of investing in the Balkan region. This also clarifies the lack of western investment interest in the SEE region and the preference of British and German MNEs to invest in Hungary or Poland and not in the Balkan region or even more not in Bulgaria. The Central European countries are neighbor countries to the advanced economies of Germany, the UK etc. and they provide more stable environment and they are more advanced economies with qualified labour force compared to the Balkan ones. On the other hand, the MNEs from advanced economies are less considering the low labour cost as the Greeks, Turkish and Russians are considering this.

We can also conclude in this paper that there is a specific finding in the KPMG research which we believe that it is a biased one and not in accordance with our findings. This is regarding the above-mentioned incentive of skilled labour force which has been highly considered by the KPMG. In other words, the skilled labour force has been one of the driving considerations for more than a third (36%) in KPMG research. This author argues that this high percentage is biased and it depends on the sample. So, we can conclude that there was a participation of a large enough number of companies (in KPMG sample), which belong to a sector which prefers/needs skilled labour force and not that the skilled labour force is a so significant factor for foreign MNEs which prefer to invest in Bulgaria.

We disagree with Lankes and Venables (1997) who found that almost half of the investors are positively influenced by similar investments by competitors in the same country (**following the competitors' theory**). The explanation behind our disagreement is the fact that our survey mentioned that only 12.5% mentioned the theory of following the competition theory because for the case of advanced economies such as German or British there are a lot of strong MNEs so the first movers are not the only MNEs interesting in investing in Central Europe. This is not the case of Greeks or Russian or Turkish MNEs which have only limited number of MNEs

which prefer to invest in the Balkan region. Thus, it is difficult to have a lot of strong Greek or Turkish MNEs in order to follow each other in their investment paths.

The finding of **market size and its prospects for growth** are in accordance with Lankes and Venables, Meyer, OECD. However, another unique finding of this survey was the high consideration of Bulgaria as a link to other neighbor and prospective countries. We agree with SECI regarding the finding that the investors are considering Bulgaria as an **investment link to other neighbour countries.**

The finding of KPMG regarding **limited purchasing power** which was scored with 71% we can argue that this high percentage it was an expected outcome for the KPMG research because of the chosen time period (April 1998) that the survey was conducted. In other words, we have to consider that in February 1997, Bulgaria experienced its third economic crisis in a row, after the 1994 and 1996 crises. In our survey we have also found a significant percentage of 50% and this difference in the importance from 71% to 50% can be partially explained by the later time period that our survey was conducted and the positive outcomes for the Bulgarian environment due to the introduction of the currency board.

Lack of competition was also a significant incentive and it was in accordance with Meyer's survey. At the same time, the importance of **following the clients'** theory as an incentive was also in accordance with OECD.

Furthermore, our finding regarding **corruption** and its consideration as an important barrier was in accordance with only the SECI survey and it was not followed by OECD and Pitelis et al. The finding of corruption ranking in such a high place of importance for an MNE project was a significant and unique outcome of this survey and it was revealed as an incentive from Greek entrepreneurs. However, our finding was in contrast with the KPMG research in which corruption ranked at the end with a very low percentage of only 8%.

The outcomes regarding the **unstable legal system and bureaucracy** in high levels in the ranking were a surprise. They were in accordance with OECD, Pitelis et al. and KPMG. Moreover, **political and macroeconomic stability** were of minor importance for the MNEs

because of the successful establishment of the currency board in mid 1997 and the political stability that has existed in Bulgaria from early 1997.

Finally, the fact that only half of the interviewed MNEs considered the Bulgarian environment as **a risky** one and not by all the MNEs (if you considered that the whole region is associated with the high risk consideration) is in accordance with all the surveys presented in the literature review with similar percentages and similar ranking places.

The significant sample used in this questionnaire survey consisted of sixty-four MNEs. These MNEs made a significant volume of investment, over one million $US dollar each one. According to the literature the present survey is a significant contribution to the field because was conducted for an ex-communist and isolated country from the western investment interest in the specific chosen time period, having a large enough sample, high response rate and a proportional distribution of the participants in all the sectors of the Bulgarian economy.

Finally, we discussed **the special role of the Greek investments** in Bulgaria and examined the Greek – Bulgarian relations. The geographical proximity, the absence of western interest for investments in Bulgaria and the relatively cultural proximity (at least Greece and Bulgaria were closer compared Bulgaria to other western countries) were proved to be significant factors for Greek entrepreneurs to invest in Bulgaria. Moreover, it is believed (by the researcher) that the cultural distance instead of **cultural proximity is another incentive**. This view is supported by the Bulgarian policy for transition to a market economy along with the **tendency of Bulgarians to behave and mime the "westernalised" style of life**. Thus, cultural distance led to cultural proximity. A later argument supporting this view is also presented and the results from the questionnaire validate it.

Greek investments in Bulgaria exceed the amount of 750 million USD (end 2002) instead of 620 million USD that appears in the BFIA catalogue. This is due to the fact that there are a few Greek entreprenеurs that have invested in Bulgaria through offshore companies, which have been established in Cyprus or Luxembourg.

It can be concluded that the major **incentives for the Greek entrepreneurs** were geographical proximity, market size, low labour cost and using Bulgaria as a link to neighbour

countries instead of market size, low labour cost, geographical proximity and international pressures from competition, globalisation, which were the incentives from the whole questionnaire. The Greek firms were planning to use Bulgaria as a bridge for further investments in other neighbour countries and previous trade relations had proved very helpful in their decision for FDI.

We also presented unique and very important reasons (ranking them according to their significance) responsible for the **great accumulation** of Greek MNEs in Bulgaria, together with the reasons that resulted in their **failure**, bankruptcy, departure or their inability to start operations. This accumulation of Greek entrepreneurs during the twelve transition years in Bulgaria has been divided into **five time periods**. The existence of around 1500 Greek companies in Bulgaria (especially small ones) offered and are offering **value added activities** to Bulgaria such as job placements, quality, variety of products, production, contribution to the GDP etc.

The Greek enterprises have grasped the opportunity to become MNEs and to participate in many Eastern European countries. The following decade (2001-2010) is a crucial decade for them and for the Greek economy in total. If these companies take advantage of the absence of foreign interest for FDI in the region, and their investments become healthy and profitable, then it will be of no surprise if the Greek firms become dominant and strong enough economical entities in the whole Balkan region in the near future.

Western interest in Central and Eastern Europe is very low considering that only a percentage between 2-5% of the worldwide FDI outflows goes to these countries. The lack of significant western investment interest can be viewed from the following (1998-2000 figures) the USA has over 100-150 billion USD$ FDI outflows each year, the UK over 150-200 billion USD$ and Germany over 50-100 billion USD$, etc. Moreover, the world's foreign direct investment inflows exceeded $1 trillion in 2000 according to UNCTAD – it was 865 billion USD$ in 1999, 209 billion USD$ in 1990, and 58 USD$ billion in 1982. At the same time, 145 billion USD$ are the total FDI inflows, from 1989 and onward in the whole Central and East European region, when at the same period the Balkan region has received only 13% of the total FDI inflows in the CEE region. The FDI inflows in the Balkan region is insignificant when the total FDI INFLOWS in the eight countries of the Balkan region account for less than

20 billion USD$ in the last 11 years (1989-2000). In other words, these eight countries in a period of time of 11 years, have not managed to receive an amount that equals to one- year German or British FDI outflows.

Bulgaria has made significant progress towards becoming a functioning market economy. Although it is not yet able to cope with competitive pressures and market forces within the European Union in the short term, Bulgaria has established a satisfactory track record of macroeconomic stabilisation and performance in the last years (after 1997). However, the volume of invested inflows is very limited and there is a lack of western investment interest. Under this situation, the Greek entrepreneurs have found enough space to make large enough investments compared to their home country's economic magnitude on a worldwide scale. This regional attitude can be seen by the fact that the Greek investments are significant both in volume of invested USD$ and in their number. Although Germany (according to the BFIA catalogue) appears in the first place of foreign FDI inflows in Bulgaria, the amount of approximately 600 million USD$ is significantly low, having in mind, the strong economy of Germany, the worldwide existence of large-scale in economic figures MNEs of German origin and the amounts that German MNEs have invested in other CEE countries. This lack of significant German interest for FDI outflows in Bulgaria and the similar absence of British, French and American interest has given to the Greek enterprises, and especially the large ones, the advantage for becoming MNEs and to invest in neighbor countries such as Bulgaria a large enough amount of USD$ in respect with the Greek economy and their worldwide economic figures.

Problems such as corruption, shadow economy, bureaucracy, and the primitive market infrastructure, discourage foreign investors and additionally decrease the competitiveness of the Bulgarian economy. However, the significant growth in most of the macroeconomic data of the Bulgarian economy and the political stability after 1997 provide the author with signs that in the following six years, Bulgaria will enjoy significant growth and development and that the deadline of 2007 for EU membership may not be so far from becoming reality.

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