Bulgaria:

Current Economic Situation And Long-term Growth Prospects

Institute for Market Economics

Sofia, September 1997

[after English editor]

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PART ONE
BULGARIA'S ECONOMIC ENVIRONMENT: 1991 - 1997

INTRODUCTION

A prior version of this paper was a part of a larger Warning Paper, "Bulgaria: Risks of Political Future" which was drafted by the Center for Liberal Strategies (CLS) and IME under a special contract between CLS and UNDP. Copyrights on the Warning Paper, which consists of a broader policy analysis, belong to UNDP. On behalf of IME, the drafting team involved the following associates: Svetlana Alexandrova, Senior Economist, Andrey Ivanov, Ph.D., Senior Policy Analyst, Asia Yonkova and Lachezar Bogdanov, Economists; in certain sections, such as the paragraphs on Investment and Savings, and those on Banks, we used calculations made by Rossen Rozenov and Tzvetan Manchev, part-time 1996 and 1997 IME researchers; in the Property and Creditors' Rights section we used previous publications of Stefan Kuychukov (IME Newsletter, March 1996) and consulted current developments with Assen Djingov, partner at *Djingov, Gouginski, Kuychukov & Velichkov*; in the Annex we used materials prepared by IME as background material for CSFB Bulgaria's inevstor guide; scenarios and economic hypotheses have been discussed by the entire team; and Krassen Stanchev, Ph.D., IME Executive Director, is responsible for putting the paper together and deriving relevant conclusions.

Our goal was to propose foundations for a long-term (fifteen years) country risk forecast. This is a first attempt for Bulgaria. The idea is to follow probable scenarios in order to give recommendations on policies geared toward avoiding negative developments. The paper consists of two parts, the first dealing with the current economic environment and the second with scenarios. Separately we devote a section to policy recommendations ,and give an Annex with ten paragraphs of economic and political information important for understanding the entire text; the last of these paragraphs deals with methodological issues.

BACKGROUND

Bulgarian economic reforms started in February 1991, a delay of 15 months after the communist regime fell. A political consensus was achieved on the following main economic reform targets: a) monetary and fiscal policies: financial stabilization, inflation curbing, money aggregates and budget deficit regulation; b) structural reform: changing patterns of economic behavior through prompt privatization; c) effective economic governance: exercising pressure on enterprises to adjust to the changing economic environment, and setting up fundamental market economy institutions in the country; and d) effective general economic policies: attempting to follow coherent economic policy.[1]

The philosophy of this agenda, and even the wording, have been very similar to that of that of Poland, expressed in the “Government Program of Economic Stabilization” of October 1989, associated with the name of then Vice-Premier Leszek Balcerowicz.[2]

The difference between the two programs has nothing to do with their content. It lies in the political setting. Bulgaria’s reform goals have never been publicly announced as a part of any political party agenda. Moreover, they have never been included in a written government statement. The initial consensus was based on the effects of the unilaterally announced moratorium on the country’s foreign debt payments in March 1990. The implementation of market reforms proceeded successfully until the elections of October 1991. The democratic minority cabinet of 1991-1992 attempted to follow the same philosophy without daring to scrap price controls and promptly privatize This delay has caused corruption in public sector management. The emerging private sector grew on the decapitalization of the state-owned enterprises (SOEs), and especially of large and constitutionally protected[3] monopolies. With eroded parliamentary support, the democratic cabinet resigned. The cabinet of experts succeeded in signing, in mid-1994, a Brady plan for Bulgaria, restructuring its foreign debt by 47%. In order to fulfill foreign debt payment schedules the government had to achieve growth rates of 4-5% of GDP in 1995 and 1996. Technocrats, backed by ad hoc majorities in the legislature, failed to promote the private sector and an investment-friendly environment. Their

[1] See: Antonov, Ventzislav, Roumen Avramov (Eds.) *The year of the Iron Sheep: Bulgarian Economic Reform in 1991.* Sofia, Agency for Economic Coordination and Development, 1992.

[2] It included: “a) return to a monetary economy with stable money understood as the criterion, rather than narrowly as an instrument, and with money recognized as a measure of value, convertible, universally accepted and balancing the market; b) return to the market mechanism as the main mode of functioning of the economy, ensuring equilibrium of supply and demand, abandonment of economic function, genuine prices and a hard mechanism of verification of production influencing allocation decision; c) return to private ownership as the condition of microeconomic rationality and the basis of work on one’s own account and responsibility” *Waclaw Wilczynski*, Five Years of the Polish Transformation: 1989-1994, In: Five Years After June: the Polish Transformation, 1989-1994, Ed. by *Jan Winiecki*, London, The Center for Research into Communist Economies, 1996, p. 24. In Poland, the initial reform stage was interrupted by general elections as well, however, the reform philosophy was consciously and publicly pursued even after ex-Communists’ turnover in 1994, and managed to produce its main results.

[3] Article 18 of the Bulgarian Constitution establishes 12 exclusive government monopolies: on energy, communications, mineral, natural and water resources, coastal area and transport; the constitution, however, stipulates that execution of these exclusive rights should be regulated by a specific law; such a law was adopted in November 1995, the Concessions Law, which is still not implemented.

successors, the socialists, not only gave up 1991's reform ideas but introduced opposite economic policies. Zhan Videnov's administration, backed by an absolute majority in the Parliament, attempted a sort of second edition of the central planning,[4] supported loss-making public sector, at the price of draining the banking sector and causing severe macroeconomic disequilibrium, and brought the country back to the brink of defaulting in mid-1996, this time with a Brady deal in place.

Thus, Bulgaria has happened to have no economic agenda, nor a stable enough majority to proceed with reforms. The chain of changing governments is shown in paragraph 2 of the Annex. Each new government was experimenting with new ideas.

MACROECONOMIC HERITAGE

1996 was an extreme case of suffered financial shocks, providing the incentive to derive lessons for the future. (For more details on the previous year's macroeconomic dynamics see Annex, paragraph 3.)

At the end of December, when the socialists resigned, the National Statistics Institute (NSI) announced that the accumulated inflation for the year was 310%. (In the first quarter of 1997 inflation rocketed to 438%.) Consumer price index (CPI) deflated interest rate on bank deposits (even after the drastic increase of the basic interest rate (BIR) of the Bulgarian National Bank (BNB) in late September to 300% a year) was negative – minus 43%. (In February 1997, BIR was 18% a month, while inflation reached an unprecedented 242%.) Throughout 1996, both general public and business corporations were converting savings into hard currency and keeping as much as possible in cash.

The differential in yield between lev deposits and hard currency deposits is another lesson. On January 2, 1996, the BNB rate was 70.719 Bulgarian levs (BGL) to US $1, and on December 12 (the BGL depreciation peak in 1996) it was 511.69 BGL/USD. This means BGL depreciation of 624%. The accumulated interest rate on one-month time deposits barely reached 104%. The difference between the level of inflation and of BGL depreciation against the US dollar was mainly due to shrinking solvent demand. However, this did not last because merchants and manufacturers couldn't keep prices below costs. By mid-January 1997 the rate was already at the level of 1,000 BGL per USD, and by the first week of February it reached BGL 3,000. (Some markets dollarized completely; in real estate virtually all (96%) transactions were executed in US dollars, in the car market 80% of deals were in DM; in some special weeks most consumer goods were salable in hard currency; despite regulations, the USD became and in 1997 still is a

4 In 1991, price liberalization left only 10% of prices (those on fuel, communications, electricity and public transport) under government control; by 1994 price controls grew slowly to 16% of the consumer basket to reach 49% in 1996.

dominant accounting unit. In March 1997, after tight and coordinated monetary policies of the caretaker cabinet and BNB, the local currency appreciated by 50%, back to 1,500, and stabilized at this level.)

This was a logical end to an entire period of economic instability.

An indicator of instability is inflation. In 1991, it was 473.7%. If followed on a monthly basis, one will see that in the second half of 1993 and first two months of 1994 inflation averaged at 5%. According to NSI, in the period between April 1995 and April 1996 the monthly inflation rate decreased to less than 3%. For the remainder of 1996, after reaching over 20%, the CPI was steady at the two-digit level. Meanwhile, during the 1993-1996 period other transition economies had experienced, albeit uneven, progress in stabilization.[5]

More than five years of instability put the country among the highest in terms of risk, indicated by low level of foreign direct investments (FDI) in absolute and per capita terms. In the 1992-mid-1996 period FDI per capita was 19 times lower than in Hungary, 1.4 times lower than in Albania, almost 13 times lower than in Slovenia, and 3.8 times lower than in Croatia, which suffered war and isolation.[6] Some banks active in the region have put Bulgaria in 14th place in terms of country risk, among sixteen European emerging markets.[7]

Savings and Investment

Macroeconomic instability has been a factor in the constant diminishing of every incentive to save and invest. We may take, for instance, 1994, when the GDP showed a slight positive growth and the economy seemed to enter an upturn phase of the business cycle – which, however, later (in 1995) was suppressed, mainly by price controls and accumulation of bad debts in the banks (the 1996 crisis was combined with a

[5]For the sake of comparison, stabilization developments (CPI rates) in selected countries look as follows:

country/year	1993	1994	1995	1996
Czech Republic	20.8	10.0	9.1	9
Romania	295	62.	28	45
Slovakia	25.1	11.7	7.2	5
Slovenia	22.8	19.5	9	10

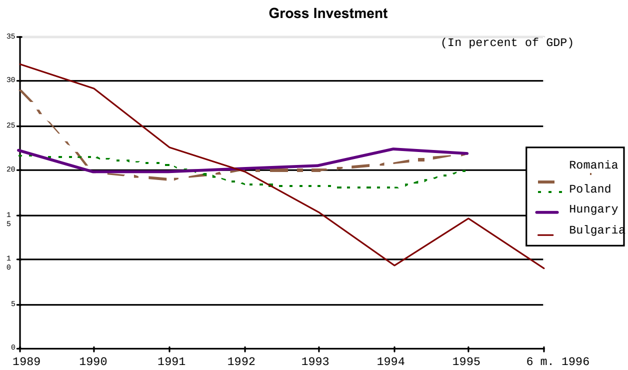
Source: OECD

[6]Source: OECD

[7]*Anton Burghardt, Guenter Lanier*, Competitiveness of CEE, A Bank Perspective, Giro-Credit Bank, February 1997.

lost confidence in the banking system). Because of the country's inability to attract a sufficient amount of foreign investments, it needed mobilization of domestic savings. However, for the period between 1991 and 1994, investments as a percentage of the GDP went down, from 22.6% to 8.2%. Graph 1 shows that up until 1990 the level of investment and savings was compatible with that of the developed economies. The high rate of savings during the 1980s, however, did not result from any voluntary decisions on the part of economic agents who valued their future consumption higher; it ensued rather from the restricted choice of goods and services available. The liberalization of imports and prices in 1991, as well as the drop in real incomes, brought about the shrinkage of the relative share of savings in the GDP.

Graph 1



A sharp drop in investment activity is visible after 1992.[8] The underlying reasons are in the volatile macroeconomic environment, weakened demand, and the absence of privatization. Investment distribution by sector is shown on Table 2.

Table 2: Growth of gross industrial output by sector[9]

sector	indices of output/year (previous year=100)				share of total output (%)
	1992	1993	1994	1995	1995
Industry - total	83	88.2	107.8	109.8	41.2
Electro/thermal power	82.3	88.4	96.9	105.7	3.1
Coal	95.9	99.3	96.6	108.2	0.7
Oil & gas	98.9	151.1	110.2	155	0.1
Ferrous metallurgy (incl. mining)	56.3	128.8	124.9	116	2.7
Mech. engineering	78.3	79.9	96.3	114.4	4.4
Electrical	67.7	94.5	95.6	113.2	2.1
Chemical & oil	83.4	88.6	137.1	121.7	9.9
Constr. materials	80.6	100.1	115.5	107.4	1.1
Timber & wood	88.1	91.5	111.4	100.4	1.3

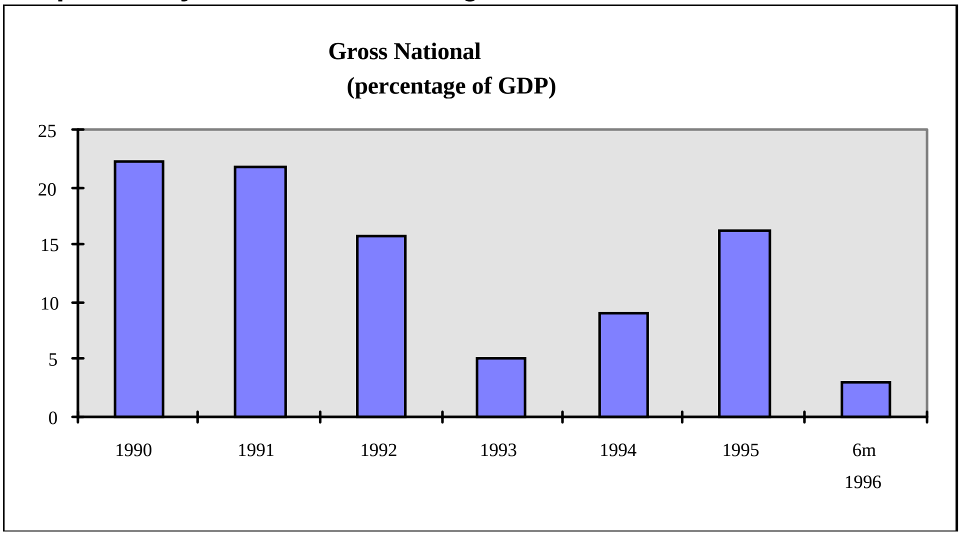
[8]According to BNB, at the end of 1996 gross domestic savings as percentage of GDP were at 13.5% while gross investment was 12.5% of GDP.

[9]Source: NSI and OECD.

Pulp & paper		90.4	89.4	112.4	120		0.8
Glass	82.5	95.9	123.1	107.7		0.6	
Textiles & knitwear		87.7	82.9	102.9	99.7		1.5
Clothing	89.3	91.3	112.6	87.5		0.7	
Leader	90.2	85.2	102.7	90.2		0.6	
Print & Publishing		83.1	126.5	112.9	85.3		0.6
Food processing	88.8	73.4	98.8	104.3		8.1	
Other	129.9	113.9	61.4	80.5		0.5	

Leading investment sectors are heavy industries, i.e. those with lower private sector shares and quasi-fiscal subsidies. The savings dynamic is similar to that of investments. The economic entities manifest different ways in which they dispose of income and therefore show a different savings picture. As Graph 2 reveals, improvements took place in 1994 and 1995, mainly due to favorable current account balances (see charts in economic scenarios section). In mid-1996, savings were only 3.5% of GDP.

Graph 2. Dynamics of savings as % of the GDP



In the first eight months of 1997, restoration of confidence resulted in a rise in hard currency savings by an amount equal to 6.5% of GDP, and those in BGL by 5%, by the end of the year gross domestic savings are expected to grow to 16.2% of GDP while investment will remain basically unchanged (13% of GDP).

However, it is impossible to draw a precise distinction between public’s at large and the private sector savings. As the next section shows, corporate businesses have been insufficiently developed, and the private sector is mostly sole proprietors, small-scale partnerships and limited liability companies. Businessmen prefer to keep an idle company for their personal accounts (which in early 90s meant better interest rates). In 1996, a “government protection of bank deposits” law was adopted, covering 100% of individual deposits from the budget and setting a strong incentive to convert corporate accounts into personal ones.[10]

According to the BNB, the population's deposits grew by 25.5 billion levs in 1993, and about 18 billion levs in 1994. But throughout the entire 1991-1996 period the interest rates on deposits were lower than the CPI. This has gradually undermined savings purchasing power, and depositors suffered losses. In the period between 1991 and 1997, two years marked record negative real interest rates: -24% in 1994 and -43% in 1996. In 1997 "memory" is a factor in restraining savings, and is likely to prevent slow confidence restoration in 1998.

After the 1991 removal of subsidies to SOEs, the latter found a substitute for state grants: non-payment of credits back to banks. A special incentive to do so was the law which had written off about US $1 billion debts accumulated prior to 1991. (About the impact of this factor of growth prospects, see scenarios below.)

Given poor financial health, SOEs' corporate governance total amount of retained profit in their 1994 balance sheets (the year of first registered transition growth) barely marked 0.2% of reported capital. The net profitability[11] in industry (66% of SOEs' capital in 1994-1996) was 7.87 in 1992, minus 12.74 in 1993, and minus 4.89 in 1994. A particularly grave situation was seen in electric and thermal power, coal mining, and the engineering and machine-tool industry. These are the sectors where 1997 reforms should start first, but in the first six months of the Democratic government there has been no change. The rate of covering losses in SOEs (through various forms of writing off debts) amounted to about 15% of the GDP for 1996, but in 1997 it will not exceed 1% of the GDP, i.e. this practice will in fact discontinue.

Private Sector Capitalization

In 1991-1996, the Bulgarian business community was involved in constant change. The emerging private sector encountered different impediments to development.[12] The increased number of private companies did not result in an adequate political establishment, promoting the interests of the private sector.

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[10]. In the fall of 1997 this law is likely to be discontinued.

[11] Net profitability has been measured as the ratio of (profit minus loss) to total receipts.

[12]On one hand, registration (but not all cost of entry) barriers are low. Formal exit barriers (opportunities to go out of business when the risk is estimated high) are also negligible but only in case given businesses operate at low credit levels. However, to registration one should add costs of: licensing, dealing with the government (reporting, unstable tax regulation, lax tax collection, increased price controls and of informal contract enforcement (according to IME survey 35% of private companies in the big cities of the country pay a protection fee in addition to insurance)).

There is no reliable data on how many sole proprietorships were established to reduce social welfare and other taxes.[13]

The response of the business community to slow privatization (see paragraph 3 of the economic Annex) and government control was to set up as many associations as possible and lobby for quotas.[14] This is especially true for the large (nation-wide and cross-sectoral) business associations, like Bulgarian Industrial and Trade Chamber (BITC), Bulgarian Industrial Association (BIA), and the Bulgarian Agricultural Chamber (BAC). The exceptions here are the Union for Private Economic Enterprise (UPEE) and the Vazrazhdane Union (VU). There are sectors such as banking, for which dependence on government decisions and the slow pace of privatization did not allow for effective self-confident alliance of private agents.[15] Foreign companies, united in the Bulgarian International Business Association (BIBA), are among the few players promoting business culture and corporate citizenship. With the political changes of 1997 BIBA's impact has gained momentum.

At the end of 1989 Bulgaria had about 24,500 private firms registered, set up as a response to Council of Ministers Decree 33/1984. In June 1994, 35% of individuals earning income in the private sector reported to NSI that they were self-employed, and 6% indicated they were family members in a business. The long-term assets of small private sector companies are basically capitalized from personal and family sources. By mid-1994 private companies already numbered 330,000 but by the end of 1996 their number had decreased to 307,000.[16]

[13] Opportunities to reduce some taxes explain why every eighteenth Bulgarian citizen at an active age is a sole proprietor.

[14] By December 1996, the total number of SOEs was 9,682, with 1,852,000 employees (39% of the total workforce), and 86% of the country's long-term assets (Source: NSI); business associations, seeking political influence, could close themselves against SOE representatives; however, this membership strategy reduced potential associations' political strength; in general they have been failing to influence economic policies.

Meanwhile, Bulgarian legislation has no realistic definition of small/medium enterprise (SME); Council of Ministers Decree 108 of June 21, 1991 On Establishing Preconditions for Small Enterprises' Development considers an SME to be an enterprise which employs fewer than 50 workers and possesses long-term assets of less than 20 million BGL (approximately US $1.2 million in June 1991, now US $10,250); already in 1992, more than 90% of private firms reported having fewer than 5 employees, and less than 0.1% of firms had more than 50 employees; a great majority of private firms were sole proprietors or family businesses with negligible facilities (long-term assets).

[15] Bulgarian Association of Commercial Banks (BACS) has been failing to self-regulate and represent the banking sector due to banks' dependence on BNB and State Savings Bank refinancing.

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

Incentives to register and stay "small" are numerous. Registration and lawyers', and other "fixers" of formality fees have been consistently low[17]. As start-off cost they are roughly the same as in other Central and East European countries, considerably lower than in Latin American countries but higher than in the US. However, there are different barriers to running a business. They are negligible in trade, where opening a shop or selling on the street or at an open-air market up until 1995 required no special permit or license. But the number of permits required grows with the sophistication of businesses.[18]

As mentioned, private firms capitalize on family resources (75-80% were set up in this manner, as an IME special survey indicated in 1996), but grow on links with the public sector. Private entrepreneurs reduce SOEs' operating costs as sub-contractors. Given their size however, SOEs are difficult to restructure. Lack of (political) will to do so set incentives to decapitalize them. SOEs' benefit was to avoid idle use of inventory and personnel; private firms collected profits as contributors to maintained production but did not report and invest the profits.

There are tax incentives to remain small. The number of sole proprietorships must be explained partially by preferential tax treatment, allowing lower social welfare duties (the general requirement is 42%, payable by the employers). Employees pay 12% to 40% of their monthly wages as income tax, if they work on a so-called "labor (full-time) contract." In fact, there is a practice a sole proprietor or a limited company to work with a staff of sole proprietors under so called "civic contract" (before September 1993) or "services contracts." Sole proprietors pay 20% of the minimum wage social insurance tax, and declare their revenues (and income) once a year.

Before April 1994, tax laws permitted registered businesses to import motor vehicles at preferential rates of import duty, and allowed businesses to write-off investment outlays in the year incurred (cars and apartments reduced tax duties, and

[17]Time to register is the following: for sole proprietors (SP): not more than one week; limited liability company (LTD): not more than two weeks; joint stock company (JSC): not more than four weeks.

[18] There are special licenses for trading tobacco and alcoholic beverages. There is no difference based on whether certain business activity is conducted on own land or own real estate, all industrial-like activities, starting, for instance, from operation of a small cafÎ, require at least 3 special permits (form: local fire brigades, local government architect, and local section of Institute of Hygiene, the office monitoring in-house pollution and public hygiene). Permit fees are equal to court registration fees but this is a special registration which is due after the court procedure. The bigger the business the greater the number of necessary permits, and the higher the costs. Again there is no full range data (first in the country IME research on this topic is expected end of May 1996), but for a sole proprietor to open a cafÎ or set up a small workshop the necessary time to collect the necessary permits is at least four weeks. Submission of permits to the local government office does not mean that the license will be issued by a provisional deadline, but the delay does not stop the applicant from operating the activity. The smaller the venture, the less likely is immediate issue of the license by the local government office; meanwhile the entrepreneur operates freely.

“investment” generated losses carried over to succeeding tax years).

Banks provided higher interest rates on accounts of physical persons (according to Bulgarian law, sole proprietors are physical, or non-incorporated, persons and are not required to hold double entry books). In fact, this was an incentive for many entrepreneurs, while participating in a limited or joint stock company, to keep their sole proprietorship. Banks’ interest policies must be explained by the following: family savings and properties (92% of Bulgarian citizens own their flats and homes) were regarded as the most accessible pool of capital; if such clients request a credit the bank has lower costs of providing the loan due easily identifiable mortgages; properties possessed by bigger companies and legal entities were subject to debates on property rights.

According to NSI, in 1994 42.3% of GDP was created in the private sector. According to balance sheets of private companies submitted to NSI by December 31 of that year, they possessed 5.2% of total assets. Then, the relative share of long-term assets was two times higher in the public sector (53.8%, compared to 22.7% in the private sector). The share of receivables of private companies was especially high (22.6% of overall assets). Reported financial indicators reveal that private companies have low coverage of loans by their own funds[19] – 0.27 (while in SOEs this figure amounts to 1.4). The dependence on lenders in the private sector is 5 times higher (1.58 against 0.3), i.e. own funds (or equity) represent a considerably lower percentage than the then-required two thirds of the loan to be covered by assets owned by the borrower. At the same time, the private sector had 47% of overall credit in 1994. Meanwhile, the private sector share in total profit was reported by NSI to be 6% in 1994 and 10% in 1995.

As some analysts calculate, from 1992 on the private sector became virtually the sole source of operational surplus in the economy, accounting for from 67% to over 100% (depending on the assumptions).[20] Many private firms sign employment contracts at the minimum wage rate in order to curb social security contributions. In 1996, the private sector accounted for 42% of all incomes, whereas its social security contributions amounted to only 7%.

The overall decrease in GDP produced in the private sector in 1996 was smaller than the decrease in the public sector; but even in the first months of 1997 this trend has continued. Investments in real terms have been constantly shrinking.

1997 private sector growth expectations for the immediate future (one year perspective) are, however, optimistic — mainly due to the government’s determination to accelerate

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[19] The ratio between equity and loan capital.

[20] *Financing Government in the Transition: Bulgaria*, p.59.

privatization pace (see paragraph 5 of the Annex) and its plans to reduce tax burden.

In 1997 positive signs are: the democratic cabinet invited foreign privatization consultants for the Bulgarian "blue-chip" deals (i.e. telecommunications, the petrochemical plant in Bourgas etc.); the banks' privatization has already started (the control package of the United Bulgarian Bank was bought by EBRD). The negative sides of the process are, however, still in place and consist of the following:

- The process is still not transparent;
- the emphasis is still put on the "negotiations with potential buyers," not on auctions;
- the sellers (different government agencies) restrict execution of buyer's rights through the inclusion in privatization contracts of provisions requiring the new owner to maintain a certain employment level and the completion of an "investment plan" (for more details, see below, next section);
- the public capital market is still underdeveloped.

REFLECTION ON PRIVATE PROPERTY AND CREDITORS RIGHTS

In brief, the history of private sector capitalization shows that Bulgaria lacks a critical mass of entrepreneurship to both influence political initiative and lead economic growth, investment and prosperity. Fundamental reasons for this are in slow privatization and poorly enforced property rights.

A mid-transition overview of these issues is provided by the World Bank special assessment of Bulgaria's private sector development.[21] Paragraph 5 of the Annex reviews the Bulgarian privatization experience, and demonstrates that 1997 results seem promising. Here we would like to comment on the enforcement of the property and creditors' rights established by Articles 17, 18 and 19 of Bulgarian Constitution. As has been pointed out, constitutions influence economic efficiency through a set of arrangements, not just provisions on property rights but also through other basic liberties, stability and accountability of the government machinery.[22]

Regarding private property rights, Article 17 of the Bulgarian Constitution declares their inviolability, but in a pure juridical sense, rather than in terms of execution of these rights. Article 18 establishes restrictions related to exclusive monopoly rights of the government: natural resources, coastal area and the Black Sea shelf, forests, natural and historic preserves, radio frequencies and geo-stationary orbit, road facilities, railroads, post and communications, nuclear energy, military industries, etc. Indeed, the same article requires that these rights be executed "in the citizens' and society's interests" as

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[21] *Bulgaria*, Private Sector Assessment, World Bank Document No. 14546 BUL/June 28, 1996.

[22] *Jon Elster*, The impact of constitutions on economic performance, Proceedings of the World Bank annual conference on development economics: 1994, The World Bank, 1995, p. 213-224.

established by law. Article 19 says that the Bulgarian economy functions on the "basis of free economic initiative," and that the "investment and economic activities" of Bulgarian and foreign persons are "protected by law." Article 21 says that arable land deserves "special protection by the state and society," and obligates owners to cultivate it. Article 22 prohibits foreigners from acquiring land property rights.
Thus, the part of the Constitution dealing directly with property and economic rights contains dubious wording, which allows for controversial interpretation and legislation.

This happened to virtually all private property regulations.

Table 3 below shows the fate of some key economic laws in the entire reform period (1989-1997).

Table 3: Stability of the business legal frame[23]

Law(s) (regulation)	**First published State Gazette No**	**Amendments after 1991**	**Last amendment**
VAT	90/1993	6	26 June 97.
Income tax	132/1950	18	2 June 1997
Decree 56* /Profit tax	4/1989* / 59/1996	14* / 5	2 Apr 1996* / 15 June 1997.
Privatization	74/1994	8	18 July 1997
Foreign investment[24]	47/1991; 8/1992; ?/1997	6	22 July 1997
Implementation rules	**First published State Gazette No**	**Amendments after 1991.**	**Last amendment**
VAT	17/1994	4	17 Dec 1996
Income tax	100/1994	7	6 Aug 1997
Decree 56/Profit tax	15/1989* / 109/1996	19* / 1	28 March 1997
Privatization	68/1992	6	30 May 1997[25]

[23] Bulgarian legal tradition often requires that a law is supported by so-called implementation rules established by the executive administration. Decree No 56 (full title: Decree on Economic Activities) was a late communist era attempt to address the challenges of the economic failure of central planning. Parts of the Decree dealing with the registration, legal form of business etc. were later (1991) replaced by a company law; the Decree itself remained as corporate tax law.

[24]In fact there are three foreign investment acts; the first, the Foreign Investment Law, adopted in 1991 by the Grand National Assembly, established a legal definition of foreign investment, postulated a permit regime and a free repatriation of profits (with a 15% withholding tax), and required US $50,000 value of the investment in order to enjoy the benefits; the second act, the Foreign Persons Economic Activities Investment Encouragement and Foreign Investment Protection Law, was adopted in 1992 and skipped the permits and established new definitions; this act suffered most amendments related to restrictions against foreigners owning buildings and land; In September 1997, Parliament passed a new Foreign Investment Law which discontinues all restrictions, regards portfolio investment and know-how brought in as an investment, and establishes different tax reliefs.

[25] The Privatization Law is to be amended by the end of September 1997 in order to skip mandatory evaluation before auctions, restructure revenues (with 74% instead of the previous 57% channeled to State Reconstruction and Development Fund use to cover foreign debt payments and support credit institutions), adjust privatization responsibilities (allocated according to the size of salable assets), and discontinue some bans on trading equities.

Special cases are laws to restitute urban properties (8 acts adopted in 1992, dealing with physically existing properties – mostly real estate – still possessed by the government, and one act passed in November 1997 to restitute or compensate non-urban immovable properties and equity holdings[26]) as well as the Land Restitution Act. Restitution of urban property is completed up to 80%. In contrast, the Land Property Restitution Act was adopted in 1991 and passed four major amendments (in 1992, 1995, and 1997), channeling the process in opposite directions. As a result, not more than 20% will be duly restituted to former owners and/or their heirs. Restrictions to owners rights' here are the requirement to cultivate land and barriers to trading it.
In the reviewed period (1992 - first three quarters of 1997), restrictions in privatization and post-privatization were numerous as well. Besides the requirements to maintain employment and stick to a contracted "investment plan" mentioned above, regulations contained a number of "procedural" hurdles which do not allow for moving forward sales of public assets, including:

£ a ban on privatization funds selling equities of privatized enterprises and/or their own shares for six months after the last auction (without any firm idea how many auctions would take place or when);
£ a ban on insiders (both workers and managers) and outsiders (other corporate shareholders and creditors) selling their shares until five years after the privatization deal is completed;
£ a ban on voucher privatization funds acquiring more than 34% of the shares of a given enterprise;
£ a ban on creditors accepting any assets other than real estate as collateral;
£ a five-year ban on inside buyers selling their shares or using them as collateral;
£ a ban on foreigners benefiting from management (or employee) buy-out schemes,

...and this list may be continued.
Late 1997 amendments had discontinued the six-month ban on trading vouchers and allow shareholders to sell.
Post-privatization governance seems to be a problem due to dispersed property rights, introduced by mixed (conventional market plus voucher privatization plus retained government share) schemes, which prevent new owners from making changes in the charter of association unless 67% of assets are acquired.

[26]When implemented the total value of the restitruted properties was roughly estimated at 2% of 1993 GDP, the latter act is not implemented yet, and it is difficult to have even an idea on its economic impact.

In the period of 1991-1997 there were many institutional barriers that prevented execution of creditors’ rights[27]. The fragmentation of the credit market brought a vicious circle: in order to secure better payments on loans, banks require higher amount and better quality of collateral; in order to provide such collateral, entrepreneurs must be able to invest, grow and achieve higher returns on capital. Until the end of 1996 there were no regulations on collateral and special pledges. Respective laws are adopted but still not enforced. Others, like deposit guarantee bill, are still in the pipe line. In late 1996 and early 1997 there were developments which allow for major improvement: a general foreclosure law was adopted; supporting are the acts on special pledges and private notaries; under IMF and World Bank strict sponsorship a new bankruptcy of banks regulation was enforced. Although special pledges registry is establishesd, there is no evidence that these pleges have become popular among creditors.

A NOTE ON BANKS

The real banking sector reform in Bulgaria started in 1989 when the communist-era central banking had been swapped for modern two-tier banking system with typical central bank and 59 commercial banks, most of them established from the previous branches of the BNB. The legal framework for the functioning of the banking system was created with the passage of the Law on the Bulgarian National Bank (1991) and the Law on Banks and Credit Activity (1992). The total number of banks in Bulgaria in 1990 was 70.

During the period 1994-1995 eight from nine large banks with assets for more than 30 bln. leva were state-owned. At the end of 1995 these 9 banks (without State Saving Bank) held 74.9 % of all financial assets in the system.

Table 4: Bank Assets Structure

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

Establishment of private commercial banks began in 1991 and this process was especially active until 1993. There was a very liberal regime for licensing of the commercial banks and low start-up capital requirements which ensured easy entry into banking. Additionally there were no special requirements for the origin of the funds used as a start-up capital and many private banks started their activities with borrowed funds. During this period legislative base of the banking in Bulgaria was imperfect and allowed establishment of private

[27] See: *Bulgaria*, Private Sector Assessment, p. 30-33.

banks which goal was to provide credits to their major shareholders and/or to persons and firms, connected with these shareholders. This was a perfect scheme for siphoning money through BNB`s and State Saving Banks refinancing.

Table 5: Commercial Banks in Bulgaria

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

As a result of the low entry barriers into banking sector the number of private banks increased significantly - from 2 in 1990 to 26 in 1995. Their assets to total assets of the banking system were 3.1 % in 1992, 6.4 % in 1993, 15.6 % in 1994 and 22.4 % in 1995. In 1996 private banks`assets to total banking sector assets decreased to 15.2 % due to loss of public confidence in private banks.
In 1993-94 loss-making state banks were more than the private ones and their total losses were larger as well. Nine commercial banks (four large state banks, three small ones and two small private banks) accounted for 79.1% of total losses in the banking system in 1993 and for 87.2% in 1994. In 1995 the large private banks followed suit and the number of loss-making private banks went up.

Table 6: Balance profit and losses of commercial banks(mln.leva)

	1991	1992	1993	1994	1995
Profit	7201	2903	1896	8702	4646
Losses	1845	2291	4172	10056	29181
Net Profit	5356	612	-2276	-1354	-24535
Number of banks with losses	2	6	11	15	23
including private banks and foreign banks	0	0	5	7	15

Commercial banks` losses are largely due to the bad loans. There were two major sources of bad loans in Bulgarian banking sector: the non-performing loans extended to the SOEs in the

pre-transition period, and the credit expansion of the most of the banks, and especially the private ones, after 1990.
One of factors that lead to new “bad borrowing” was the government policy for replacing direct budget subsidies to the real sector with quasifiscal subsidies through new credit injections. There was no political will for closing the loss-makers until mid-1996, and they had to be kept alive through credit amnesties which ever deepened the crisis in the banking sector. The only state-owned bank to avoid new doubtful lending was Bulbank, which finally aggregated 91% of all standard loans in end-1996.

Table 7: Structure of commercial loans 1995 - 1996

Types of loans	Group 1		Group 2		Group 3		
	1995	1996	1995	1996	1995	1996	
Standard loans	51.65	43.67	52.34	33.41	11.16	0.21	
Doubtful loans - A	41.15	33.89	31.87	22.42	85.31	86.04	
Doubtful loans - B	0.61	1.39	5.94	7.59	3.53	6.45	
Uncollectable loans	6.58	11.79	9.85	11.02	0	7.3	
Loans not subject to provisioning	0	9.27	0	25.56	0	0	

* Group 1 includes 7 big state-owned banks, amounting 67% of the banking system in end-1996, with Bulbank and SSB included.
Group 2 includes17 small and medium size banks, amounting 7% of the banking system
Group 3 includes 3 banks with foreign capital and 4 bank branches amounting 2% of the banking system; the remaining 24% stand in all banks under bankruptcy procedures initiated by the BNB and are not included in the table
** Doubtful loans A - in arrears of less than 30 days
Doubtful loans B - in arrears between 30 and 90 days
Uncollectable loans - in arrears of over 90 days

Weak private sector, bad banking management, the over-supply on the banking market, credit risk concentration, negative structure of credit portfolios and increasing share of non-performing credits, decapitalization of the banking system and the following loss of confidence in the banking system, etc. lead to a turmoil in the banking system.
A precondition for the banking crisis was set on the beginning of reforms in 1990 when a process of establishing deeply fragmented banking system began with a large number of small state-owned banks specialized in providing funds to particular branches and regions. Almost all of them inherited significant amount of non-performing credits extended to the enterprises during the socialist-era. To a great extent their further

decapitalization was due to the slow process of bank consolidation.

One of the most serious problems that lead to the banking crises in 1996-1997 was the one with both non-performing loans extended to the SOEs in the pre-transition period, and non-performing credits granted after 1990 by the most of the banks, and especially the private ones. Some 50 % of all loans granted by state-owned banks to non-financial institutions are uncollectible. To a considerable extent this is due to the influence of the state on lending to strategically important state-owned enterprises. Furthermore, for most of the SOEs, the only way for servicing their debts and covering their losses became collecting new loans from banks. The preservation of loss-making enterprises in the public sector was government policy during the whole period.

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

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

Deterioration of banks` credit portfolio also was due to the lack of effective legal framework concerning collection of credits from unfair borrowers and realization of securities. Moreover, no legal procedures for bankruptcy proceedings against insolvent SOEs were in place.

As a result of the deep banking crisis from May 1996 until April 1997 eighteen banks were closed and put under special supervision by the BNB. In May, 1996, the Bank Law was amended and for the first time since the beginning of the reform, a legal procedures for bank bankruptcy were introduced. In 1996, 14 banks which concentrated 24 % of total assets in the banking system were put under conservatorship. This is estimated to be a biggest banking crisis worldwide recently. From 27 private banks existing by the time, the 4 biggest ones were put under special supervision.

33 banks (including State Saving Bank and foreign banks branches) survived, but some of them are small and private and still have to overcome some serious problems concerning their solvency. One of the most serious problems for small banks is to meet new requirement for the minimal level of banking founding capital, which have to reach 10 bln. BGL (approximately $ 5.4 mln.) by the end of June 1998. For most of them the only solution is in attracting foreign investors.

The financial condition of commercial banks has improved to a greet extent since the beginning of 1997. As a result of depreciation of the lev and the brief hyper-inflation the capitalization of banking system has been improved. The depreciation of local currency helped banks to restructure their portfolio. However some banks are still reliant on ZUNK bonds.

Following the new Banking Act replaced previous Banking and Credit Act and the Basle Accords, BNB issued Ordinance 8 dealing with capital adequacy and minimal founding capital requirements. All banks in Bulgaria are obliged to have 8 % capital adequacy ratio at the end 1997, 10 % capital adequacy ratio at the end of 1998 and 12 % at the end of 1999.
Recently banks can be divided into four groups. The first group consists of UBB, Expressbank, Bulbank, Bulgarian Post Bank, SSB, Biochim, Hebrosbank and represent 76 % of banking system assets. At the end of June 1997 their total capital adequacy was 8.3 %. Only two of these banks have capital adequacy ratio below 8 %. Net capital of this group is 187 bln.leva. For the period January-July the banks included in this group reported 67 bln.leva profit and none of them reported losses.
The second group of banks includes Municipal bank, Unionbank, First Investment Bank, Corporate Bank, Bulgarian Commercial and Industrial Bank, International Orthodox Bank, Creditexpress, First East International Bank, Trakiyabank, Bulgaria-Invest Commercial Bank, Teximbank, Credit Bank, Balkan Universal Bank, Central Cooperative Bank, Bulgarian - Russian Investment Bank, International Bank for Commerce and Development. These 16 banks hold 10 % of total banking system assets. Their total capital adequacy was 18 % at the end of June 1997 and only four of them reported capital adequacy below 8 %. Their profit was 17 bln.leva for the first six months of the year. The losses of the banks in this group was below 6 bln.leva.

Four foreign banks and five branches (ING Bank,Bayerische-Bulgarische Handelsbank, BNP-Dresdner Bank, Raiffeisenbank, Xiosbank, National Bank of Greece, Eurobank, Bulgarian Investment Bank and Ionian Bank) form the third group and represent 4.5 % of banking system in Bulgaria.
The four group consists of 10 banks which were put under conservatorship.

Table 8: Banks’ capital adequacy under BNB Regulation No8 on the capital adequacy

	I Group		**II Group**		**III Group**	
	1996 (%)	June 1997 (%)	1996 (%)	June 1997 (%)	1996 (%)	June 1997 (%)
Total capital adequacy ratio	19	8	8	18	15	19
Primary capital adequacy ratio	18	7	13	14	18	14
Assets risk component	24	22	61	45	43	52
Net capital\balance assets	4	3	5	8	-9	7

A long-run problem faced by the Bulgarian banking system seems to be a making an adequate profit from bank activities. At the moment the average profitability of bank portfolios is considerably below the interest rates levels, since part of the banks' assets (bad loans, buildings, etc.) pay no income. In addition banks are very conservative in their lending activities. Banks still consider lending to be a very risky activity because the business environment has not improved significantly, as well as the fact that the execution of creditors' rights is low and banks have faced problems with collecting on non-performing loans. This additionally contracts the quality and variety of bank services which for most Bulgarian commercial banks are extremely restricted and include taking deposits, giving very short-term credits and intermediation in payments in Bulgaria and abroad. It is expected that future development of the capital market will have a serious effect on commercial banks. Development of the capital market can create additional opportunities for banks to diversify their services by new intermediation in trade with securities.
Interest rates have fallen essentially since March 1997. They are likely to remain low in the next six months of year due to the methodology for defining the basic interest rate (BIR). The BNB reports BIR every week at the base of the average yield obtained by the government securities with 3 months maturity at the last auction. Currently, this market is considered to be of largest volume. An alternative possibility to define BIR might be the inter-bank market interest. However, in the nearest future the volume of inter-bank transactions would remain lower than the volume of the short-term government securities market.
At the same time, real interest rate is still negative, threatenning incentives to save which wre very low any how.[28] Clear evidence for this is seen in the fact that in September 1997 currency outside banks exceeds total amount of time and saving deposits.
Lack of opportunities for placement banks' resources is resulting in policies to keep predomonantly high liquid assets – cash, assets on bank accounts and government securities. At the end of August 1997, six largest banks reported BGL 22.8 billion profit. Seven small and medium banks sustained losses. Foreign-majority-owned banks and branches of foreign banks are also loss-making (they hold less than 5% of bank assets and an insignificant part of banking capital).

In 1991 the number of state-owned banks was 70, most of them were small with the statutory capital up to BGL 10 mln. (approximately $ 500 000) with average annual volume of credits up to BGL 250 mln. ($ 12 mln). In the same year Bulgarian National Bank began preparation for banking sector consolidation. The declared objective was to prevent the banking sector from further fragmentation. In 1992 Banking Consolidation Company (BCC) was established. The process

[28]See the above paragraph of savings and investment.

started in 1992 with consolidation of 22 banks in one - United Bulgarian Bank. 12 small commercial banks were merged in Exspressbank. In 1993 throughout merger of Vidin Commercial Bank, Lyaskovetz Commercial Bank and Gorna Orjahovitza Commercial Bank was established Balkanbank. Other commercial bank established through a commercial bank merger was Hebrosbank. It consolidated 8 banks. Also 4 small commercial banks were merged in a new bank, named Sofiabank. With the consolidation of Biochim Bank in 1995 the number of state-owned banks decreased from 70 in 1991 to 11 in 1995.

According to the agreements with the IMF and the World Bank at the end of June was finalized the first deal for privatization of United Bulgarian Bank. As a result 35 % of bank`s shares were acquired by EBRD and 30 % of shares were acquired by American Oppenheimer & Co. The remaining 35 % of shares are in possession of Bulbank. BCC looks for foreign investors for the other five state banks, which have to be privatized by the end of 1998. It is expected the negotiations for privatization of Expressbank to be concluded at the beginning of 1998. The only potential buyer is Daewoo Securities, although Raiffeisenbank had such plans until recently. In process of privatization preparation are Hebrosbank, Bulgarian Post Bank and Bulbank. It is expected that Post Bank will be the next bank on line. According to BCC program a tender for privatization of the bank will be announced in January 1998. Interest to the Bulgarian Post Bank are demonstrating Nomura Bank, The National Bank of Greece and the EBRD. Still there is lower interest to Hebrosbank, in which the share of the BCC is 97.5 % of the capital. A strategy for privatization of the biggest Bulgarian Bank - Bulbank should be ready earlier at the first few months next year and will be offered for sale after the mid-1998.

While agreement with IMF is in place, including a provisional Extended Fund Agreement pending negotiation in 1998, the banks` privatization is not likely to become a reversible process. Meanwhile, the process is politically difficult: banks seem resistant and have already secured political support for delays; the most likely outcome is to have banks sold through intermediaries.

TRENDS IN TRADE: IN SEARCH OF COMPETITIVE ADVANTAGES

If we look at Bulgarian exports prior to the beginnings of economic reform in 1990s, we will realize that it demonstrated the highest share among ex-COMECON countries (today emerging market leaders) to the CMEA market itself. The dynamic is similar, due probably to purely political factors, but as a share of total exports Bulgaria along with then-Czechoslovakia was the last to contract CMEA-export efforts by 1989; other countries had started reducing this trade in 1986. Another difference is that Bulgaria exported mostly to the ex-Soviet Union while other countries traded among themselves. According to the calculations of Roumen Dobrinski, Bulgarian CMEA-trade share in the second half of 1970s and 1980s averaged around 60% of the total. Closest to Bulgaria was Czechoslovakia, with

51-52%, Romania had a less than 30% CMEA-share, while Hungary and Poland were always between 40% and 50%.[29] Dobrinski shows that the accumulation of Bulgaria's foreign debt coincided with a lack of alternative export routes right in 1986, and was related to an attempt to increase export to COMECON countries, an attempt which obviously failed from the very first steps if we convert the turnover into US dollars.[30]

Besides some sporadic attempts to impose protectionists tarrif, in "normal" 1991-1994 years the Bulgarian Economy demonstrated extraordinary openness, as shown in Table 9.

Table 9: International trade flows of Bulgaria as per cent of GDP

Year	Export	Import	Total turnover
1989	34,5	32,3	66,9
1990	23,3	22,7	46,0
1991	42,3	33,3	75,5
1992	45,6	51,9	97,5
1993	34,4	46,8	81,2
1994	41,5	43,1	84,6

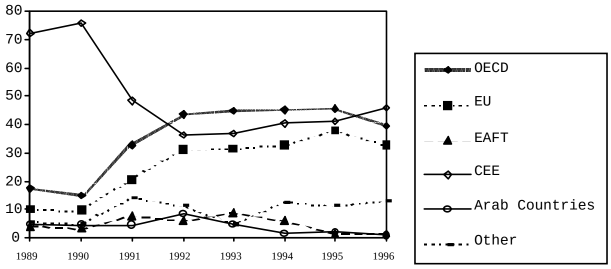
Following a decrease in 1990 the percentage share of foreign trade in the GDP became relatively stable. The data in column 2 indicate that Bulgaria was a highly open economy (for the sake of comparison, in 1994 Switzerland's exports/GDP ratio was 35).[31]
The same is true for groups of trade partners but to a lesser extent. The following two graphs demonstrate the group dynamics in total exports and imports respectively. Structures are very different at the beginning and end of the period, but no reorientation.

Graph 3: Relative share of imports from some groups of countries

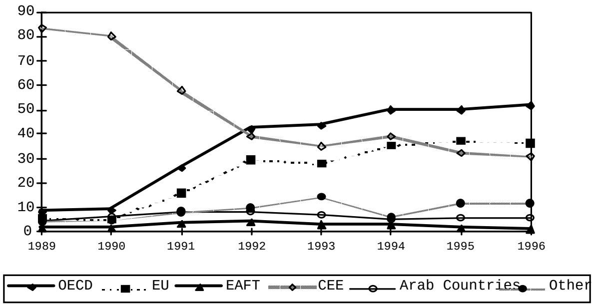
29 *Rumen Dobrinski*, Transition Failures: Anatomy of the Bulgarian Crisis, Vienna, WIIW, 1997, p.7.

30 *Rumen Dobrinski*, op. cit., pp. 8-12.

31 Source: NSI.


80
70
60
50
40
30
20
10
0
1989
1990
1991
1992
1993
1994
1995
1996
OECD
EU
EAFT
CEE
Arab Countries
Other

Graph 4: Relative share of the export to some groups of countries



Data for 1996, as they are shown in Table 8, also suggest that there was no significant shift.

Table 10: Main partners in Bulgarian foreign trade

Country	US$ mln.	Share of exp	Country	US $ mln.	Share of imp.
Total	**3587,9**	**79**		**3701,1**	**85.8**
Italy	471,4	10.4	Russia	1401,3	32.5
Russia	462,6	10.2	Germany	536,2	12.4
Germany	419,8	9.2	Italy	299	6.9
Turkey	368,1	8.1	Greece	188,9	4.4
Greece	321	7.1	France	154	3.6
Yugoslavia	226,3	5	Austria	117,5	2.7
Ukraine	160,1	3.5	Ukraine	110,9	2.6
Macedonia	143,1	3.2	US	107,6	2.5
UK	134,5	3	UK	99.7	2.3
France	120,6	2.7	Turkey	90,7	2.1
US	105,7	2.3	Netherlands	86,4	2
Spain	105,1	2.3	Iran	75,8	1.8
Moldova	87,7	1.9	Switzerland	72,5	1.7
Netherlands	75,9	1.7	Romania	66	1.5
Georgia	75,8	1.7	Czech Rep.	62,5	1.4
Romania	72,4	1.6	Belgium	56,5	1.3
Syrian AR	71,4	1.6	Yugoslavia	53,2	1.2
Belgium	66.2	1.5	Cuba	47	11
Egypt	52,5	1.2	Finland	38,9	0.9
Austria	47.8	1.1	Sweden	37	0.9

Source: NSI

Table demonstrates significant trading partners, i.e. with a share of not less than around 1% share in Bulgaria’s exports or imports.

We may draw the following conclusions. There is no champion of the country’s exports. However, there is a “champion” in the imports, and this is the Russian Federation: against roughly 10% exports there are 32.5% imports. This is due to the import of energy resources and raw materials (see below, Table 12 on commodity structure of Bulgaria’s exports), and proves that the economy has a one-sided supply structure (mineral resources are imported mainly from Russia and the Ukraine, and fuels mostly from Russia.). Bulgaria’s situation reflects the situation in other Balkan countries. Meanwhile, some considerable market are virtually missing: exports to France are roughly 5 times less than those to Germany, UK or Italy. Exports to neighboring countries exceed 17% while imports are at the level of 9% Macedonia is totally missing from the list of significant importers, and Turkey's exports are four time less than imports from Bulgaria. The longest border of the country is with Romania, but exchange with this largest emerging market in the region is far from being active. A CEFTA agreement is expected by end of 1997 and is expected to facilitate one fifth of Bulgarian foreign trade.

Broadly diversified trade with neighboring countries' share equals to a portion of remote ones incurs, presumably, additional opportunity costs.

Table 11: Trade with Balkan neighbors (1992-1996)

	1992	1993	1994	1995	1996
Balkan countries--Imports (BGL mln.)	**12452.5**	**12288.6**	**27350.0**	**40673.7**	**78489.8**
Balkan countries--% of Total Imports	**11.9**	**9.3**	**12.0**	**10.7**	**8.7**
Balkan countries--Exports (BGL mln.)	**23252.3**	**28479.5**	**65882.6**	**98665.6**	**211680.3**
Balkan countries--% of Total Exports	**25.4**	**27.7**	**30.5**	**27.4**	**25.9**
Balkan countries--Net Exports (BGL mln.)	**10799.8**	**16190.9**	**38532.6**	**57991.8**	**133190.5**
Greece--Imports (BGL mln.)	5818.7	4665.8	10884.0	16729.9	30792.7
Greece--% of Total Imports	5.6	3.5	4.8	4.4	3.4
Greece--Exports (BGL mln.)	4173.3	6338.8	16828.4	24760.0	61383.7
Greece--% of Total Exports	4.6	6.2	7.8	6.9	7.5
Greece--Net Exports (BGL mln.)	-1645.4	1673.0	5944.4	8030.1	30591.0
Turkey--Imports (BGL mln.)	1668.5	2113.8	4444.4	6744.4	17900.0
Turkey--% of Total Imports	1.6	1.6	2.0	1.8	2.0
Turkey--Exports (BGL mln.)	5766.6	7826.6	10021.6	25937.0	66900.0
Turkey--% of Total Exports	6.3	7.6	4.6	7.2	8.2
Turkey--Net Exports (BGL mln.)	4098.1	5712.8	5577.2	19192.5	49000.0
Romania--Imports (BGL mln.)	2472.4	2807.9	4327.0	4101.1	13483.8
Romania--% of Total Imports	2.4	2.1	1.9	1.1	1.5
Romania--Exports (BGL mln.)	2603.4	2542.1	3430.1	6391.8	12290.0
Romania--% of Total Exports	2.8	2.5	1.6	1.8	1.5
Romania--Net Exports (BGL mln.)	131.0	-265.8	-896.9	2290.7	-1193.8
Albania--Imports (BGL mln.)	79.3	10.2	34.9	14.3	17.1
Albania--% of Total Imports	0.1	0.0	0.0	0.0	0.0
Albania--Exports (BGL mln.)	1230.6	1054.2	2893.4	4067.8	7051.4
Albania--% of Total Exports	1.3	1.0	1.3	1.1	0.9
Albania--Net Exports (BGL mln.)	1151.3	1044.0	2858.5	4053.5	7034.3
YUG—Imports (BGL mln.)	1386.6	115.1	52.1	203.0	8507.6
YUG--% of Total Imports	1.3	0.1	0.0	0.1	0.9
YUG—Exports (BGL mln.)	4022.7	3603.7	7874.2	5786.7	35420.6
YUG--% of Total Exports	4.4	3.5	3.6	1.6	4.3
YUG--Net Exports (BGL mln.)	2636.1	3488.6	7822.1	5583.7	26913.0
Macedonia—Imports (BGL mln.)	814.4	2154.5	6988.2	11826.0	5295.2
Macedonia--% of Total Imports	0.8	1.6	3.1	3.1	0.6
Macedonia—Exports (BGL mln.)	3701.3	6287.6	22294.7	29257.7	24651.6
Macedonia--% of Total Exports	4.0	6.1	10.3	8.1	3.0
Macedonia—Net Exports (BGL mln.)	2886.9	4133.1	15306.5	17431.7	19356.4
Slovenia—Imports (BGL mln.)	107.6	289.9	502.4	760.1	1434.1
Slovenia--% of Total Imports	0.1	0.2	0.2	0.2	0.2
Slovenia—Exports (BGL mln.)	101.9	232.3	1905.7	1461.2	595.1
Slovenia--% of Total Exports	0.1	0.2	0.9	0.4	0.1
Slovenia--Net Exports (BGL mln.)	-5.7	-57.6	1403.3	701.1	-839.0

Croatia—Imports (BGL mln.)	38.4	80.0	110.9	294.9	1052
Croatia--% of Total Imports	0.0	0.1	0.0	0.1	0.1
Croatia—Exports (BGL mln.)	356.3	347.5	628.3	997.6	2781.3
Croatia--% of Total Exports	0.4	0.3	0.3	0.3	0.3
Croatia--Net Exports (BGL mln.)	317.9	267.5	517.4	702.7	1729.3
Bosnia and Herzegovina--Imports (BGL mln.)	66.6	51.4	6.1	0.0	7.3
Bosnia and Herzegovina--% of Total Imports	0.1	0.0	0.0	0.0	0.0
Bosnia and Herzegovina--Exports (BGL mln.)	1296.2	246.7	6.2	5.8	606.6
Bosnia and Herzegovina--% of Total Exports	1.4	0.2	0.0	0.0	0.1
Bosnia and Herzegovina--Net Exports (BGL mln.)	1229.6	195.3	0.1	5.8	599.3

Source: NSI.

Data on the following table suggest other important insights, proving the above mentioned feature of the Bulgarian economy of being an open one. Even the leading export products involve high import components. The leading foodstuffs export is due to the tobacco component. The balance is categorically positive in energy consummption and sub-product sectors. There is not sufficient data available, but it is likely that Bulgarian foreign trade is rather extensive. Promising is the position in the balance of cement and ceramics, base metals and precious metals. It is likely that, the future of these trades would depend on barriers to access to domestic mineral resources, i.e. on concessions regulation. There are reserve opportunities in livestock and cattle-breeding but investment here requires restructuring in the enforcement of land property rights and a relatively long rate of returns.
Foreign trade under a currency board regime represents a major challenge. If we look at countries in similar conditions,[32] it is obvious that it takes two-three years for an economy to adjust and identify its competitiveness.

Table 12: Bulgarian foreign trade by commodity in 1996

	Total exp.	Share of total exp.	Total imp.	Share of total imp.	Balance
TOTAL	4542,6	100	4313.3	100	229.3
1. Live animals, animal products	130.7	2.9	30.7	0.7	100
2. Vegetable products	110.8	2.4	92.9	2.2	17.9
3. Animal or vegetable fats and oils	17.8	0.4	20	0.5	-2.2
4. Foodstuffs, beverages, tobacco	618.1	13.6	210.4	4.9	407.7
5. Mineral products, fuels	408.	9	1482.	34.4	-

[32] See: *Nissan Leviathan* (ed.), Proceedings of a Conference on Currency Substitution and Currency Boards, World bank Discussion paper N 207, World Bank, 1993; *Argentina*, The Convertibility Plan: Assessment and Potential Prospects, World Bank Report N15402-AR, July 12, 1996, pp. 9-11,18-21.

	9		7		1073.8
6. Chemical products	755.8	16.6	438	10.2	317.8
7. Plastics, rubber, articles thereof	173.8	3.8	162.2	3.8	11.6
8. Hides, skins, leather, articles thereof	36.5	0.8	58.4	1.4	-21.9
9. Wood, articles of wood	76.2	1.7	19.9	0.5	56.3
10. Pulp, paper, paperboard	63.5	1.4	143.1	3.3	-79.6
11. Textiles, textile articles	464.2	10.2	409.4	9.5	54.8
12. Footwear, headgear etc.	107.7	2.4	49.3	1.1	58.4
13. Articles of cement, plaster, ceramics, glass	76	1.7	52.5	1.2	23.5
14. Precious stones, metals, jewelry	17.7	0.4	4	0.1	13.7
15. Base metals, articles thereof	815.6	18	257.2	6	558.4
16. Machinery, appliances, electrical equipment	460.1	10.1	582.2	13.5	-122.1
17. Transport equipment	126.1	2.8	164.4	3.8	-38.3
18. Precise apparatus and instruments, optical goods	19.3	0.4	85.8	2	-66.5
19. Arms and ammunitions	0.3		2.1		-1.8
20. Miscellaneous manufactured articles	63.6	1.4	47.9	1.1	15.7

Source: Ministry of trade and tourism.

THE BUREAUCRATIC FACTOR

In trying to assess the prospects of Bulgarian reform, emerging-market analysts fail to take into account bureaucratic factors. But these were the factors that blocked reforms under the previous administration, and which played a major role during the “Technocratic” (1993-1994) and socialist (1995-1997) cabinets. Focusing only on macroeconomic indicators, one may grasp the results of the reintroduced reforms but lose the ability to foresee developments which could stem from the current government’s role as a privileged market maker. In the past, such developments were: high formal and informal taxation, high capital and transaction costs, and non-transparent rules and decision-making procedures. The government has obtained discretionary powers in virtually all segments of the market, and the administration in Bulgaria has an extraordinary opportunity to control all instances of access to capital and factors of production. The results are known: capital flight, disinvestment, virtually no foreign investment and no incentives to growth.

Besides these purely historical reasons, there are forthcoming areas of reform in which the administration still has to play a decisive role:

1. given the fact that the economic growth and prosperity path has been enforced by the circumstances of economic failures of previous governments, the 1997-1998 government still has

to secure originally not very articulated choice of this path;

2. given the lack of "critical mass" of entrepreneurship and corporate citizenship to support reforms and lead growth, it must broaden public support for the reforms and facilitate the emergence and use of entrepreneurship culture;
3. given constitutional heritage, it has to enforce private property rights, the rule of law and prudent practices in finance and banking services;
4. given the unidentified competitiveness of the Bulgarian economy, the government should maintain liberalization of all walks of economic life except the currency board, and elaborate a vision on Bulgaria's place in the regional and global markets.
5. given the administrative tradition, it should put an end to discretionary and distributive practices of the government.

The current democratic government's predecessors, especially the socialists, believed they would benefit from redistributing resources. Sticking to tradition, they have been replacing SOE managers and boards with their fellow-partisans, stopping privatization to gain from insider trading. Electricity prices, cheap labor and fuel, as well as quasi-fiscal subsidies were believed to maintain competitive prices for Bulgarian exports. Exporters were licensed or controlled by the government, and domestic producers were protected by different tariff barriers. Whoever wanted to cut gains from price differences between domestic and foreign markets had first to please the government. The system worked somehow for twelve months, from February 1995 to February 1996, but was doomed to fall apart. There were clear incentives to take and keep gains outside the country. But Bulgaria has a working, though malfunctioning, democratic rule: all channels to block reforms received a legal foundation. If not profoundly reshaped these foundations will again work against growth and prosperity.

The democrats were elected on the ticket of a reform consensus and have a clear mandate to proceed as fast as possible. They have the backing of both domestic and international public opinion. Apart from a few instances related to central banking and finance – areas closely monitored by the IMF and World Bank – the democrats have the disadvantage of lacking bureaucratic experience: key administrative posts were a preserve for true believers and party-fellows who were not corrupted yet but might be spoiled by the system if it were not abolished.

While macroeconomic dimensions of 1997 and the IMF agreement so far provide grounds for an optimistic outlook there are systemic sources of corruption which need to be addressed.

1. The key tool for direct government officials involvement economic affairs is <u>procurement of "state property rights."</u> Rules here were established by the Council of Ministers' Decree 7 of January 1994, which replaced an older regulation

(Decree 265 of January 1992). Articles 10 and 11 of Decree 7 stipulate that in state-owned enterprises (SOEs) sole proprietor’s rights are to be exercised by the line ministries and committees (those of industry, trade and tourism, agriculture, energy, post and telecommunications, etc.), and by the Council of Ministers (in the case of military industries). In fact, the prime mister and the cabinet are “sole proprietors” of last resort due to their control over the line ministers acts. Line ministers appoint the SOEs’ managers and board members at their discretion. Members of the central administration are not allowed to sit on the boards of more than two enterprises, although there is no limit for members of parliament. There is no competition requirement or any provision to contract out managerial teams or use venture capital schemes. All government line-ups Bulgaria has had in the last seven years have preferred to bring in fellow-partisans, thus paying them back for political services and loyalty. The new government sticks to this tradition by retaining minority share in privatised enterprises, thus keeping administration appointees as board members.

2. Governance of state monopolies suffers from old diseases. Government seems slow in deregulating energy, post, communications, roads and transport. NEC determines on its own what its conditionally fixed costs are, the costs which allow NEC enterprises to function as if there is no consumer. The oil refinery has no outsiders to measure so-called technological losses. Any concrete judgment on corporate governance issues is difficult, due to regulations which declare any information on the major monopolistic enterprises to be a state and national security secret.

3. Another important source of corruption in Bulgaria has been price controls and quasi-fiscal subsidies. Given the currency board regime, the latter have practically no place. The government reduced subsidies to 0.1% of GDP. Price controls on consumer goods were abandoned thanks to high inflation in 1996 and early 1997. However, the democrats declared they will abandon control on electricity prices by 2002. Such policies may hamper prospects to investment in utilities and economic growth already in 1999, a year which seems crucial for long-term growth scenarios (see below section on economic scenarios). At the same time, the new administration re-established price controls in the form of controls over trading contracts. It issued Decree 269 of June 1997, which requires producers and wholesale merchants to determine the final “contractual” (in fact, retail) price of a product. The intention is to eliminate wholesale intermediaries. City police, under joint leadership of trade and interior ministers, have flooded commodity markets asking merchants to “prove” that their contracts are “correct.” This regulation deals with “contractual prices” of only fifteen consumer products, mostly foodstuffs, and it is hardly possible to implement. But the actual damage is that it both induces populist expectations by the public at large and creates a wide-spread source of *petite* corruption. Commodity exchanges and wholesale markets have existed already for six-seven

years. Last year, the socialists adopted a law creating the Government Commodity Exchanges and Wholesale Markets Commission, comprised of nominees of the Council of Ministers but no merchants, and no self-regulatory procedure. The democrats did not amend the regulations but appointed commissioners, and commodity traders to apply for a license.

4. In all above cases there is common denominator: a general etatist philosophy of the new administration. It is especially visible in more sophisticated walks of the economic reform, e.g. in capital market regulations.

5. Control over domestic commodity markets motivates merchants to try to export goods if they can find a better price for them in neighboring countries. “Fighting smugglers” has been the government’s excuse for sticking to complicated customs procedures and delaying the abolishment of tariff barriers, although the latter job is basically completed.

6. In the field of infrastructure, the new government amended the concessions regulations (initially adopted in November 1995 but not enforced). A positive development is that amendments overcome some constitutional restrictions; it would be possible to: acquire a concession on all construction and road facilities built before by the government and on electric distribution networks and mineral, natural and water resources; build new facilities; and obtain a concession to investigate and explore natural resources. The new regulations allow the buyer to exercise concession rights in an interim period until concession contracts are being arranged; these rights are determined by the privatization contract, and the interim period cannot be longer than three months.[33] In addition, the act stipulates procedures omitted in the previous arrangement: 85% of concession revenues are being channeled to the central budget, and the rest remain in a separate off-budget account to cover the costs of concessions; the funds are being spent under the supervision of the Council of Ministers; the term of the concession (not more than 35 years but subject to prolongation automatically) enters in force as determined in the contract; and there is no possibility for newly-established (after the act was adopted) state companies to obtain a concession. Exploration and exploitation consessions on mineral resources are largely still missing or restrictively regulated. What matters, however, in terms of discretion, is the right of the government to provide a concession without an auction or any sort of competition. Three months after the act was adopted, i.e. by November 1, 1997, line ministries are required to propose to the Council of Ministries solutions to all inherited privatization cases where a special concession arrangement is needed. The Concession Act itself leaves a lot of important details (the size and the term of investment, construction rights etc.) to be specified in the concession

[33] Absence of such provisions has been considered one of the key impediments to some major privatization deals, e.g. the Sodi-Devnya deal (largest privatization transaction of US $162 million) was postponed twice due to banned concession on a soda-dash mine, the key supplier to the plant

contract, while containing few or no guidelines for what grounds on which to select concessionaires.

Bulgaria has been very slow in negotiating oil and gas pipe-lines and communication cables which may cross its territory and allow use of the country's absolute advantage of geographic location. Besides some progress in communication networks, pipe-lines were the most disadvantageous case of Bulgaria's reform attempts in the recent years. They have resulted in nothing but internal political tensions and raising Russian (official and private, transparent and hidden) influence on Bulgarian affairs. A key deficiency in this respect was the inability of the Bulgarian government to negotiate with Russia and Greece. The very approach to negotiations has been based on the wrong assumption that these are governments that establish and fulfill agreements; the Bulgarian government was in fact contacting other government institutions which, in their turn, were representing huge companies and/or vested interests. Thus, the Bulgarian position has always been the weaker one, especially given the one-sided resource dependence of the Bulgarian economy on Russia (see import/export ratios with Russia). The result is that in 1996 and 1997 natural gas supplied from Russia to Bulgaria has been on average US $15 per ton more expensive than to Western Europe, while transit distance is shorter.

As in the case with other huge companies and monopolies, e.g. Netional Electric Company, the government has for the time being just replaced board members. Conflicts of interest have been reduced: Neftochim's executive director is no longer executive manager of the major supplier Rosbulneft (a joint venture with Rosneft). But again, as in other cases, newcomers have limited professional experience. They failed to organize auctions for crude oil supplies to the refinery and lost more than two months in orientation, delaying restructuring the management and accounting procedures. At the same time suppliers succeeded in fixing prices and boycotting auction proposals. If the cabinet is at all seeking support for its pipe-line and infrastructure efforts, it is from International Financial Institutions and other government or multilateral organizations The only way to avoid traps of future links behind the front stage is to invite trans-national corporations to initiate, finance and implement projects on Bulgarian territory. Simultaneously, the Bulgarian government still has to learn how to avoid or reduce geopolitical risks by relying on private corporate, but transparent interests. Such learning seems difficult and slow.

The most important institutional constraint is the currency board regime. Another factor which would work against bureaucratic factor is the agreement with IFIs. Both factors will block populist temptations threatening interruption of support to the Bulgaria's balance of payments. Although 1997's scheduled privatization revenue of $350 million is likely to be exceeded thanks to several large deals, new SOE boards may attempt to delay privatization. There are indicators that targeted privatization of 25% of total state assets will not be accomplished without stricter requirements on behalf of IFIs. The bureaucratic factor is likely to bring slow adjustment of the Bulgarian economy to international markets and thus, to diminished prospects for growth and prosperity.

PART TWO
ECONOMIC SCENARIOS: BULGARIAN ECONOMY IN 1997 / 1998, AND BEYOND

INTRODUCTION

There are two notions of the so called Tequila-effects: a) [portfolio] investors pull-out expecting unfavorable developments, and b) impacts of such capital flows from other economies. Here we are trying to examine these and two other scenarios namely: 1. Investors Pull Out; 2. Negative Other Emerging Economies Impact; 3. Growth Prospects and Advantages; 4. Regional Infrastructure: Failures and Provissional Successes. In addition we attempt to evaluate their inter-connection and draw respective recommendations to avoid negative developments. The methodology we use and principles to select scenarios are explained in paragraph 10 of the Annex.

1. INVESTORS PULL OUT (TEQUILA - 1)

The importance for Bulgaria of different notions of Tequila effect stems from the open character of the economy and the role of foreign debt as a constraint to domestic decision-making.

As mentioned before, the stabilizing effect of the currency board regime was felt partially before it was actually introduced in July 1997. The BGL stabilized at the level of 1,500 per US $1 in March and later depreciated with the Deutsche Mark by about 11-12%. Attracted by the prospects of high yields (due to the interest rate of 18.2% a month, political turbulence in late December 1996 and January 1997, and prompt, peaceful and negotiated outcome of the political crisis which opened opportunities for agreement with IFIs to support the country's balance of payments), foreign portfolio investors took the risk and brought about US $300 million into the country, according to IME estimates. This happened in January and early February, but already by April 28 the interest rate (determined by that of 3-month T-bill yields) had fallen to the level of 6.2% monthly, and to 3.59% a month by May 26.[34] Having no opportunity to invest in equities (due to the absence of an institutionalized capital market), they withdrew their investment and left with respective gains of about US $80-120 million in May and June, before the introduction of the currency board.

Thus, Investors Pull Out, or the first aspect of the Tequila effect has in fact happened, on a small scale, without causing any instability. There is no reason why the same might not happen again with more severe impact in the future, and that

[34] 2nd week of September 1997 interest rate is 6.11%.

is why it is important to know why it happened easily this time:

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

Citizens and corporations have bought dollars for everyday use during the winter and kept them, changing several million a day thus not allowing the exchange rate to sky-rocket when investors converted their local currency gains into hard currency ones. This was not credibility in the system which worked, but it shows that the level of savings (the credibility) would have a decisive role in the future. Another factor has to do with the general environment which, in fact, has limited the size of investment.

Future similar effects would depend on the ability of the Bulgarian economy to grow. They are outlined in our third scenario. However, one of the factors to influence growth rate and concern both portfolio and strategic investors is identified liabilities of the Bulgarian economy. Figures reflecting Bulgaria’s foreign debt payments reveal the following picture.

Table 1: Scheduled external debt service by creditors 1999-2004 (USD millions)

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

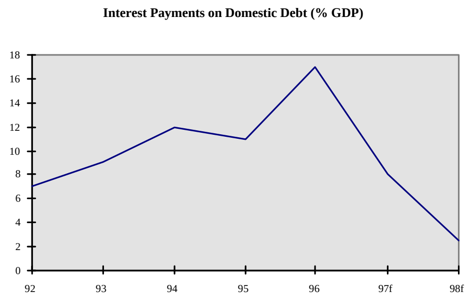
Source: *Andrew Kenningham*, op. cit. p.18

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

An additional factor to be taken into account is the level of domestic debt services. A currency board regime presupposes that there is no essential difference between foreign and domestic debt, except agreed foreign debt payments' (Brady and other provisional debt-restructuring deals) seniority. However, a problem stems from the BGL pegging to the DM: part of the domestic debt is USD denominated and amounts to $950 million; it appreciates its value with the depreciation of the DM against the USD; thus 10% annual DM depreciation (as is the case in 1997) would lead to ten percent increase of the dollar-denominated debt.

Graph 1 shows 1997 domestic debt services at the level of 7% of GDP, but at the end of 1998 payments become low, and if there is modest growth in 1998, the domestic debt can hardly pose a major threat to the currency board regime, given the fact that next year's external balance is covered by new borrowing from IFIs.

Graph 1: GDP/Domestic Debt Interest Payment



Source: *Andrew Kenningham*, op. cit. p.18.

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

Table 2: Current account balance, 1991-97e (USD millions)

	1991	1992	1993	1994	1995	1996	1997q1	1997f
Exports	3737	3956	3727	3935	5345	4724	(1145)	4600
- change		*5.9*	*-0.7*	*5.6*	*35.8*	*-11.6*		*-2.6*
Import	3769	4169	4612	3952	5224	4580	(766)	4150
- % change		*10.6*	*10.6*	*-14.3*	*32.2*	*-12.3*		*-9.4*
Trade Balance	-32	-212	-885	152	122	144	(379)	350
Current Account Balance	-77	-361	-1098	-45	-25.6	-22.3	(235)	350
- as % GDP	-11.7	-12.6	-14.7	-2.5	2.6	1.6	(17)	3.8

Table 3: Current Accounts Under Currency Board (% GDP)

	Years after Introduction of Currency Board					
	0	**1**	**2**	**3**	**4**	**5**
Argentina (1991)	- 0.4	-2.9	-2.9	-3.3	-0.9	-1.8
Estonia (1992)	3.1	1.3	-7.0	-4.6	-10.11	
Lithuania (1994)	-2.1	-2.3	-2.0			

Source: *Andrew Kenningham*, op. cit. p.18

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

2. NEGATIVE OTHER EMERGING ECONOMIES IMPACT (TEQUILA - 2)

Bulgaria is a small but open economy. The fact that it has chosen the Currency Board regime as a stabilization tool is a good protection measure against external shocks. But the currency board system will work as a stability and shock-preventing factor if and only if other economic institutions are intrinsically flexible to adjust to the changing regional (Balkan) and global environments.

In 1997 and 1998 the real challenge in this respect would rather stem from domestic economic policy patterns. If the government fails to:

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

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

Besides its openness, Bulgarian economy remained virtually untouched during October - November 1997 crisis of the global capital market. The explanation is in the underdeveloped nature of the Bulgarian stock market; in the unclear supply and doubtful demand side of this market.

Supply-side is hampered by the limited information disclosure on the stocks offered, or by the low quality of the information. Fixing this problem would require at least six - eight month work of the Securities and Stock Exchange Commission and the Parliament. Also, there is a limited number of resource companies which already have placed shares (Bulgartabak) or are likely to offer shares on the exchange (like, say, BTC). Additional problem is constituted by the fact that potential sellers would rather prefer to avoid entry barriers and use OTC market, this is especially true for the voucher funds, holding about 13% of the assets. FDIs (Solvey, Union Minier etc.) do not seem willing to place equities on the local stock exchange given opportunities to raise funds internationally.

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

Bulgarian economy is likely to remain self-protected from shocks comming from volatility of global stock markets, due underdevelopment and the price is likely to be less FDIs and slower growth.

On the regional (Balkan) level this would mean lost economic opportunities. The latter should be considered in two levels.

The first is a scenario according to which emerging economies in the region fail to proceed with market reforms. This has already happened in Albania after a relatively good start (see tables paragraph 1 of the Annex, Bulgaria and Other Transition Economies) in the early 90s, but accompanied with under-development of financial services. The Yugoslav Federation, despite its potential, has relatively low prospects for economic growth in the coming three-four years. A customs union is scheduled for January 1998 between the Yugoslav Federation and FYR Macedonia, which would mark a new market of about 12 million. It would be a rather self-sufficient market in terms of food-stuffs and basic consumer goods. It is likely that this market will establish protection tariffs against other Balkan emerging markets.

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

£ Bulgaria’s domestic market still enjoys lower prices (the price levels for food and agriculture products will equalize by the end of 1998 or early 1999);
£ lower labor costs;
£ likely stability backed by 1997-1998 balance of payment financing by IFIs while the Yugoslav Federation (not Macedonia) will be lacking such an external constraint to populist economic policies;
£ last but not least, this *petite* common Balkan market is vulnerable to civic unrest and/or disorders.

Bulgaria’s advantages come from a lower starting point and the higher social costs of transition paid by the Bulgarian public (see paragraph 9 of the Annex). Although the hardest time has passed, by the year 2000-2001 Bulgaria will be a provider of an idle but well-trained and educated labor force. By the end of 1998 unemployment is expected to reach 17-18% due to the liquidation of loss-making SOEs.

A special case in point is Romania. It had a reform start similar to Bulgaria in 1997 but it is a market three times bigger (22.2 million), which has attracted more foreign investment in absolute terms (per capita figures are comparable, see paragraph 1 of the Annex) and which is passing through a similar political transition as Bulgaria. in 1997. The advantage of Bulgaria is the more united leadership of the country.

If the “neighbor-failure” scenario develops it would mean that Bulgaria’s political and currency stability are a self-sufficient asset in the short run. The necessary way to convert this short-term asset into a long-term one is to reduce transaction costs and keep them lower than in Romania.

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

A threat related to this scenario is that initial stability is considered to be a self-sufficient institutional advantage.

The second sub-scenario may deserve the name of “neighbor-success.” The peculiarity here is that it could not take place within a neighborhood of isolated countries and economies. In general terms it requires:

- low tariff barriers;
- a competitive market environment;
- free exchange of goods, services, capital and ideas;
- utilized market potential of about 58 million (without Turkey);
- a well-functioning infrastructure;
- easy accessibility to all the sights and corners of the Balkan peninsula,

and ensures long-term growth and prosperity for most or all countries in the region.

To achieve this, a joint strategy is needed to increase competitiveness not only of individual countries but of the region as a whole, which means involving Turkey and its neighboring countries, and to promote infrastructure projects on mutually beneficial ground.

This scenario is deeply rooted in the political and historic backgrounds of the countries in the region, and for this reason is rather unlikely. This does not mean that efforts to proceed along these line are worthless. There is even a chance to succeed, but it will depend on two factors:

1. support of the international community,

2. and, development of the regional infrastructure.

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

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

If this scenario is not realized, Bulgaria would at best enjoy modest growth rates of 3% to 4% per annum. The same would be the result if some mixture of these two sun-scenarios proves more realistic. Then the Bulgarian market will be squeezed between two big neighbors, Romania (22 million) and Turkey (65 million), of which the latter is self-sufficient.

3. GROWTH PROSPECTS AND ADVANTAGES

The economic growth problem appears to be a crucial one in the years after 1998. Some analysts, drawing an analogy between Balkan and East Asian emerging markets, envisage two scenarios: 4.54% annual growth and 7% growth for the next 25 years. The calculation is on the current PPP as an analog to that of Singapore 25 years ago. If it is correct, Bulgaria would enjoy either 15 times growth of GDP per capita or 27 times growth in the coming 25 years.[35]

Table 4: Inflation in 1997

January	February	March	April	May	June	July	August
43.8%	243.7%	12.3%	-0.7%	5.6%	0.8%	3.7%	5.5%

Source: NSI

The first 1997 stabilization results demonstrate surprisingly fast curbing of inflation, a speed which is not known from the experiences of other currency board systems in Central and Eastern Europe. However, on an annual basis inflation is estimated at 536%, with an unclear tendency in the summer months. The effect of DM-depreciation on Bulgarian production competitiveness was eliminated by increased aggregated costs in the economy. This should be regarded as an indicator of a need for structural support for stabilization efforts, probably requiring prompter privatization than that which is targeted for 1997 and 1998 in the government's agreement with the IMF and the World Bank.

In other words, 1997 and 1998 are still important in terms of preparation and confirmation of the economic development path. Without a path being chosen and embarked upon, any long-term scenario should involve speculation on the human factor.

Table 5: Bulgaria 1998-2010: IME forecast

Year	Population	GDP Growth Rate (%)	GDP bln DM	GDP bln USD	GDP per capita DM	GDP per capita USD	PPP deflated GDP DM	PPP deflated GDP USD	Ext. debt payments USD	% of GDP	PPP
1998	8600000	3	16635	8317	1934	967	6973	3486	959	11,53	3,6048
1999	8587500	3	17134	8567	1995	998	6710	3355	1170	13,66	3,3633
2000	8575000	3	17648	8824	2058	1029	6458	3229	1170	13,26	3,1380
2001	8556000	3	18177	9088	2124	1062	6220	3110	1335	14,69	2,9277
2002	8537000	3	18722	9361	2193	1097	5991	2995	1045	11,16	2,7316
2003	8518000	3	19284	9642	2264	1132	5770	2885	993	10,30	2,5485

[35] *Richard Beilock*, op. cit. p. 9-11

2004	8499000	3	19862	9931	2337	1169	5557	2778	1001	10,08	2,3778
2005	8480000	3	20458	10229	2413	1206	5352	2676	n.a.	n.a.	2,2185
2006	8442000	3	21072	10536	2496	1248	5167	2583	n.a.	n.a.	2,0698
2007	8404000	3	21704	10852	2583	1291	4987	2494	n.a.	n.a.	1,9312
2008	8366000	3	22355	11178	2672	1336	4815	2407	n.a.	n.a.	1,8018
2009	8328000	3	23026	11513	2765	1382	4648	2324	n.a.	n.a.	1,6811
2010	8290000	3	23717	11858	2861	1430	4487	2244	n.a.	n.a.	1,5684

In reading the figures in the table it is important to note that, as the National Statistics Institute forecasts, the average annual population decrease is likely to be 19,000 in the period 2000-2005, and 38,000 in 2005-2010. Also, we assume that in the period in question the DM/USD exchange rate would fluctuate around the 2 to 1 level, or if a major deviation appears then its possible negative impact (through US dollar structure of Bulgarian imports) would be compensated through economic (real sector, not monetary) adjustments.

Compared to Asian emerging markets, Bulgaria has no clear statistics as to how much of the population is below the absolute poverty line, and thus it is not possible to speculate on the impact of poverty on growth prospects. It is obvious, however, that PPP is more equally distributed in Bulgaria than in those countries and, presumably, would require policies which ensure that members of the society experience economic growth and prosper “as if together.”

Table 6: Per capita GDP and incidence of absolute poverty: Southeast Asia, 1970 and 1994

Country	Per capita GDP (1994 USD)		Percent of Population in absolute poverty	
	1970	1994	1970	1994
Thailand	420	2210	50	22
Malaysia	820	3520	30-35	41974
Singapore	4300	23360	n.a.	n.a.

Source: *Richard Beilock*, op. cit. p 8.

A scenario similar to that of IME has been proposed recently by Prof. Richard Beilock. It is based on the assumption that Bulgaria has the competitive advantage of a more educated labor force than Singapore, Thailand and Malaysia.

Table 7: Prof. Richard Beilock’s (AUBG) forecast for the next 25 years

Year	GDP per capita (growth rate of 4.54% per annum, constant 1994 PPP of 4.38)	GDP per capita (growth rate of 7% per annum, constant 1994 PPP of 4.38)	*PPP deflated GDP per capita (under 4.54% annual growth)****	*PPP deflated GDP per capita (under 7% annual growth)****
1998	4230	4230	*3481,38*	*3481,38*

1999	4422	4526	*3395,59*	*3475,49*
2000	4623	4843	*3311,92*	*3469,62*
2001	4833	5182	*3230,31*	*3463,76*
2002	5052	5545	*3150,70*	*3457,90*
2003	5281	5933	*3073,07*	*3452,06*
2004	5521	6348	*2997,34*	*3446,23*
2005	5772	6792	*2923,48*	*3440,40*
2006	6034	7268	*2851,44*	*3434,59*
2007	6308	7777	*2781,18*	*3428,78*
2008	6594	8321	*2712,64*	*3422,99*
2009	6894	8904	*2645,80*	*3417,20*
2010	7207	9527	*2580,60*	*3411,43*
2011	7534	10194	*2683,26*	*3630,61*
2012	7876	10907	*2805,08*	*3884,76*
2013	8233	11671	*2932,43*	*4156,69*
2014	8607	12488	*3065,57*	*4447,66*
2015	8998	13362	*3204,74*	*4758,99*
2016	9406	14297	*3350,24*	*5092,12*
2017	9833	15298	*3502,34*	*5448,57*
2018	10280	16369	*3661,35*	*5829,97*
2019	10747	17515	*3827,57*	*6238,07*
2020	11235	18741	*4001,34*	*6674,73*
2021	11745	20052	*4183,00*	*7141,97*
2022	12278	21456	*4372,91*	*7641,90*
2023	12835	22958	*4571,44*	*8176,84*

Source: Richard Beilock, op. cit. p. 9-11.

According to professor Beilock, Bulgaria is likely (whatever the growth rate) to be the most prosperous country of today’s transition Balkans.

In the IME forecast, we are trying to adjust GDP per capita figures in nominal terms to the amount of goods and services one can buy with them. By doing so, we attempt to estimate possible changes in the standard of living that will occur even after optimistically assuming a stable positive growth rate. Calculation of the PPP for the period is based on the assumption that liberalizing international trade and converging price levels go hand in hand.

However, some differences will remain. We assume that in 12-13 years (the term of the forecast) the PPP level in Bulgaria will be equal or at least similar to that in Hungary in 1994, which was 1.55-1.60 (compared to the USA). Also, we assume that it will progressively reach that value, starting from the 1994 figure of 4.38. Using that formula, we calculated the 1998 PPP to be about 3.6.

The main reasons for choosing Hungary are as follows:

1. Comparability in terms of size and population
2. Lack of mineral resources, and therefore comparatively inelastic imports, in both countries
3. Foreign trade counts for a substantial share of the GDP in both countries
4. Lack of domestic credit resources and therefore dependence on foreign investment
5. Both countries are net agricultural exporters; therefore. food prices will remain lower than in other countries even after a complete trade liberalization.

In general, we see Bulgaria now on the track that Hungary was on during the last decade.

Under that assumption, the PPP adjusted GDP per capita decreases from $3486 to $2244. The nominal per capita GDP, at the same time, increases by some 48%, from $967 to $1430. Therefore, tradable goods will become cheaper for local consumers, while non-tradable goods will become more and more expensive. This may, and probably will, lead to changes in the structure of consumption. To conclude, increased GDP per capita does not immediately lead to an improved living standard.

Prof. Beilock’s projection is, in our view, too optimistic in two ways. We shall not comment on his forecast for 4.54% or even 7% annual GDP growth, based on the Southeast Asia case. But it is necessary to test his assumption that the 1994 PPP level will remain steady for the next 25 years. Even now, in 1997, it is far below 4.38 (the 1994 level). All of the measures undertaken after the introduction of the currency board, and the currency board regime itself, require further liberalization of prices and reduction and even abolishment of any projectionist policies. By mid-1997 almost all energy prices were adjusted to international levels (except for central heating), and the prices of most tradable goods are already comparable to those in Western Europe. Moreover, Bulgaria’s medium- and long-term goal is joining the EU, which means abolishment of all barriers to trade and to free flow of capital, resulting in convergence of prices of goods and service.

After deflation at the above-mentioned decreasing PPP rate, Prof. Beilock’s forecast looks far more realistic. The results are shown in column 4 and 5 of Table 7.

4. Regional infrastructure failures and successes

This scenario is interrelated with the second sub-scenario, Other Emerging Economies Impact. Success or failure of Bulgarian economic participation in regional infrastructure development might be crucial not only for regional cooperation and prospects for the “neighbor-success” scenario but for Bulgaria’s individual success in economic and political reforms. Similar would be the impact on FYR Macedonia, pressing the government in Skopje to closer ties with the Yugoslav Federation. As a “young” nation it is not likely to develop relations with Bulgaria on the same basis. For Bulgaria, however, this means skipping all barriers to free trade with Macedonia, making all concessions related to the so-called “national pride” issue in order to ensure better positioning of the economy in the regional context. Whatever the external developments, Bulgaria does not seem in a position to take sides in regional conflicts due to its considerably weaker military spending as a percentage of GDP. If there is something which may induce indigenous security in the Balkans, it is the development of regional infrastructure. While it is difficult to envisage a development of common market institutions, regional infrastructure seems both to be a trade imperative and to be to everybody’s benefit. The necessity of infrastructure projects has received political support from the EBRD, EIB and Southeast European Cooperation Initiative.

The economic argument in favor is that Balkans have an economic structure similar to the Bulgarian exchange with Russia: with almost the entire energy and resource supply in coming from the East; the Balkans are the only European sub-region with a one-sided gas and oil supply. Where does Bulgaria stand in this context?

As mentioned earlier, Bulgaria has been unfortunate in negotiating natural gas prices with Russia.

Some gas and petrol pipelines cross Bulgarian territory: 65 kilometers of gas pipeline on Serbian territory and 40 kilometers on Bulgarian territory are missing to connect Bulgaria’s gas-network with that of the Yugoslav Federation; there is no petrol pipe-line between the two countries; there is a gas pipe-line with Macedonia, Greece and Turkey, going respectively to Skopje, Athens and Istanbul; a gas-pipe-line is missing to link Bulgaria’s network with the Greek port of Kavala; and petrol lines are largely missing.

Road infrastructure is again interrupted on Bulgarian and Yugoslav territory, if we consider the Belgrade -Istanbul (West-East) route (highway is missing between Nis and Sofia, and is unfinished between the Northern Thracian city of Plovdiv and Turkey’s border town of Kapu-Kule; North-South and Black Sea - Adriatic highways do not exist at all, besides parts of the Macedonian road network.

Virtually any kind of infrastructure is missing on Albanian territory. There is no connection between Romanian and Bulgarian gas pipe-lines, nor between Macedonian and

Yugoslavian ones; a gas pipe-line goes from Belgrade to Bosnia but there is no link to Croatia (Croatia is supplied from the Adriatic via Slovenia).

Electricity supply networks have been established according to the COMECON "division of labor," and are attached to Russia and Central Europe, but not as part of inner-Balkan infrastructure. Meanwhile, in 1992 Poland, the Czech Republic, Hungary and Slovakia established an inter-government coalition to link themselves to the West-European electricity transmission network, which was accomplished two years ago. Balkan countries have hardly tested the waters for negotiations on electricity transmission reorientation and inner-Balkan links.

Optic cable nets between Bulgaria and all neighboring countries have been established in 1996 and 1997.

It is obvious that an economic growth scenario embedded in regional infrastructure would mean extraordinary investment opportunities. Previous failure may be converted into success. However, given poor initial conditions and monopolistic legislation and structures, projects in any of the fields do not seem feasible earlier than 1999. This is exactly the year when the Bulgarian economy would need its substantial investment boost.

Lack of domestic resources in Bulgaria and other Balkan transition economies may be compensated for through foreign corporate financing. Just recently, the AMBO Consortium ("AMBO" stands for Albania-Macedonia-Bulgaria Oil pipe-line) announced its plans to build a crude oil pipe-line between the Bulgarian port of Bourgas and Vlora in Albania. The investment idea behind the project is simple: in 4-7 years the Black Sea is to be flooded with crude oil on the East side, but on the West side the only way to the Mediterranean is via the Bosporus; companies that invested in the Caspian area (the Baku and Tengiz oil fields), Chevron, Mobil, Lukoil and some others, will bring the oil to the Russian Black Sea port of Novorossiisk and Pati in Georgia, but still have to take it out of the Bosporus to the West. On the same grounds lies the entire importance of the Balkan region, and economies here could succeed or fail in mediating meta-regional infrastructure.

RECOMMENDATIONS

A) Concerning Investors Pull Out scenario:

As soon as general credibility in the Bulgarian banking system is restored, alternative investment opportunities should be established through the development of capital market institutions. Although the total amount of capital flows into the global emerging economies last year reached almost US $240 billion.[36], The Bulgarian share in it is negligible (see foreign investment and economic comparison

paragraphs in the Annex). Bulgaria may benefit from its virtual absence from the investors map in previous years, but given the size of the economy any unfavorable conditions could hamper growth prospects.

B) Concerning Negative Other Emerging Economies Impact and Regional Infrastructure Failures and Successes:

Trade and customs fights in the region may worsen the investment climate, block cross-country exchange and reduce prospects for growth. Individual countries' industries are doomed to remain small, non-competitive and vulnerable to bigger capital pressures unless there occurs natural enlargement of their markets and economic potential. Equally, local capital and people are doomed to leave the countries of the region, unless macro-stability and prospects for growth are established. It is not possible to follow the path of competitiveness without fulfilling the classical pro-investment market requirements. Strategy to enhance competitiveness and use advantages would come through business exchange and cooperation; they cannot be imposed from outside or from above. For the same reason, internal and cross-country partnership between governments and businesses is needed. International institutions may facilitate the implementation of this vision.

Instrumentation of the positive side of this scenario would require:

- negotiations to reduce barriers to trade;
- prompt privatization and issue of formal private property titles in individual countries;
- elimination of financial and capital markets fragmentation within individual countries;
- sound monetary policies and strong bank supervision;
- facilitation of foreign banks' access to local markets;
- adoption and enforcement of anti-trust regulation;
- reducing barriers to entry and exit, both on the individual country and regional levels;
- fiscal and decision-making decentralization;
- transitional infrastructure projects;
- investment in human capital.

C) Concerning Growth Prospects and Advantages

Most of the above-mentioned policies apply here as well. If implemented, they are expected to contribute to a high rate of growth. High rates of growth may lead to a repetition of the Estonian example, which in the last two years has reached double-digit rates of economic growth and the currency board regime has less freedom to react to provisional unfavorable conditions restricting the money supply boosted by foreign

[36] "Fragile, handle with care" (the Economist survey on banking in emerging markets), Economist, April 12, 1997, p. 6.

investment. Factors which would act against such development are expected to be slow administrative reform and difficult conditions on the regional level. The best strategy is to pursue high growth rates and prepare currency board exit policies. At any event however, the currency board should be considered both as a long-term institutional solution which prevents populist temptations and as a stability instrument against negative political developments in the region.

INSTEAD OF CONCLUSION:

FACTORS TO REDUCE COUNTRY RISKS IN THE SHORT-TERM

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

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

To these we may add a “bureaucratic factor:” the Bulgarian government may still attempt delays in privatization, reduction of transaction costs and enforcement of private property and contracts, but the economy has no room for maneuvering.

Annex: Economic information

1. Bulgaria and Other Transition Economies

Table 1: Selected CEE countries' 1991-1996 real GDP growth (%)

Country	1989	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Bulgaria	0.5	-9.1	-11.7	-7.3	-2.4	1.8	2.6	-10.0	-4.0
Estonia	-1.1	-8.1	-7.9	-14.2	-8.5	-2.7	2.9	3.3	4.0
Lithuania	1.5	-5.0	-13.4	-37.7	-24.2	1.0	3.1	3.0	4.0
Macedonia		-9.9	-12.1	-21.1	-8.4	-4.0	-1.5	3.0	5.0
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0	5.5
Romania	-5.8	-5.6	-12.9	-8.8	1.3	3.9	6.9	4.3	-2.5
Russia			-13.0	-14.5	-8.7	-12.6	-4.0	-6.0	1.5
Slovakia	1.4	-2.5	-14.6	-6.5	-3.7	4.9	7.4	6.8	5.0
Slovenia	-1.8	-4.7	-8.1	-5.4	2.8	5.3	3.9	3.5	4.0
Czech Republic	1.4	-0.4	-14.2	-6.4	-0.9	2.6	4.8	4.0	4.0
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	0.5	2.5

Source: EBRD, Transition report update, April 1996, Transition report update, 1997

Table 2: CPI average annual percent change in selected CEE countries (1989-1996)

Country	1989	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Bulgaria	6.4	26.4	339	79	64	122	33	311	690
Estonia	6.1	23.1	304	954	36	42	29	16	12
Lithuania	1.5	5.0	345	1,161	189	45	36	13	13
Macedonia			115	1,935	230	55	9	1	3
Poland	251.0	585.8	60	44	38	29	22	19	15
Romania	1.1	5.1	223	199	296	62	28	57	100
Russia	2.0	5.6	144	2.318	841	203	131	22	17
Slovakia	2.3	10.8	58	9	25	12	7	5	6
Slovenia	1.306	550.0	247	93	23	13	9	9	8
Czech Rep.	2.3	10.8	52	13	18	10	8	9	8
Hungary	17.0	28.9	32	22	21	21	28	20	18

Source: EBRD, Transition report update, 1997

2. Instability of the Bulgarian Transition Government

Each new government experimented with new ideas. Table 3 shows the frequency of government changes and the respective political party affiliations of presidents and prime ministers.

Table 3: Sequence of Bulgarian central governments: 1989-1997

Event/month	President	Cabinet (PM)	President/PM's political affiliation	event/person/ year/period
BCP Coup (Nov.'89)	Mladenov	Atanasov	BCP	Mladenov: Nov. '89-July"90 Atanasov: Feb.'87-Feb."90
Constituent Assembly elections (Jun '90)	Mladenov	Lukanov	BCP/BSP	BSP wins; Lukanov: Feb.-Oct '90[37]
Parliamentary appointed president*	Zhelev	Lukanov	Zhelev: UDF Lukanov: BSP	Zhelev: Aug. '90-Jan.'92
Coalition	Zhelev	Popov	Popov:	Popov: Dec. '90 -

[37] According to the Bulgarian Constitution, a PM in resignation acts as incumbent head of the administration.

(Dec.'90)[38]			unaffiliated	Oct.'91
General & municipal elections (Oct.'91)	Zhelev	Popov	Popov: unaffiliated	UDF wins; Oct. '91
Presidential elections (Jan.'92)	Zhelev	F. Dimitrov	UDF (minority government)	Zhelev wins: Jan. '92 -Jan.97 Dimitrov: Nov.'91-Oct.92
Experts' cabinet	Zhelev	Berov	Berov: unaffiliated	Dec. '92-Sept. '94
Caretaker cabinet	Zhelev	Ms. Indjova	Ms. Indjova: unaffiliated	Sep. '94-Jan. '95
General elections (Dec.'94)	Zhelev	Videnov	Videnov: BSP	BSP wins; Videnov: Jan. '95 to Dec. '96
Presidential elections (Oct./Nov. 96)	Zhelev	Videnov	BSP	Stoyanov wins; Jan.'97-[39]
Caretaker cabinet	Stoyanov	Sofianski	UDF	Feb.'97-May'97
General elections (Apr.'97)	Stoyanov	Kostov	UDF	UDF wins; Kostov: May 97-[40]

The average life-span of Bulgaria's transition cabinets has been less then 11 months, and this is taking into account sometimes important internal reshuffling in different cabinets. Table 17 below shows what this meant for the stability of economic regulations. It is obvious that with one exception of eleven months' minority democratic government, the country was ruled by different forms of coalitions involving socialists, or by socialists themselves from 1990. The socialists, however, did not enjoy any period of simultaneous control over the presidency, legislature and executive administration. The political meaning of this fact is that voters never allowed the socialists to unilaterally run the country. This has helped Bulgaria's democratic system to create a judiciary according to multi-party constellations, and proved to be an important achievement. In 1995 and 1996 alone, the Constitutional Court declared 32 acts of Parliament to be wholly or partially unconstitutional; a good 75% of the discontinued provisions were in violation of private property rights. At the same time, Bulgaria has passed through nine sets of executive administrations, and relatively long periods of weak and non-reformist governments. As is shown in the analysis of recent political trends, before early 1997 only the socialists had had full majorities in the legislature. What matters now in terms of economic policy prospects is that voters for a second time give a full mandate to the democrats, that this is happening after an unquestioned failure of the socialists, and that this vote comes after an interim period of the UDF-affiliated cabinet of Mr. Sofianski.

[38] Negotiated due to lack of constitutional procedures.
[39] Five year mandate.
[40] Four year mandate.

3. 1992-1996 DYNAMICS OF THE BULGARIAN MACROECONOMIC SITUATION

Table 4: Selected macroeconomic indicators: 1992 - 1996[41]

	1992	1993	1994	1995	1996
Nominal GDP (BGL mln.)	**200832**	**298934**	**550514**	**867691**	**1660237**
Real GDP Growth (%)	**-7.3**	**-1.5**	**1.8**	**2.1**	**-10.9**
Dollar Exchange Rate (BGL/USD, year average)	**23.34**	**27.65**	**54.25**	**67.17**	**175.82**
Inflation (CPI, %)	**79.5**	**63.9**	**121.9**	**32.9**	**310.9**
GDP per capita--BGL	23516	35284	62243	103222	198538
GDP per capita--USD	1008	1276	1147	1537	1129
Industrial output--Share of GDP (%)	40.5	35.0	32.1	33.6	32.6
Agricultural output--Share of GDP (%)	12.0	10.6	12.3	13.9	11.7
Services--Share of GDP (%)	47.5	54.4	55.6	52.5	55.7
TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Industrial output--Growth (%)	-8.2	-6.2	6.0	-5.4	-8.3
Agricultural output--Growth (%)	-14.5	-30.2	9.5	14.5	-18.1
Services--Growth (%)	-20.7	0.6	-3.1	-0.7	-6.5
Private Sector--Share of GDP--Industry (%)	4.3	6.4	7.1	9.4	9.2
Private Sector--Share of GDP--Agriculture (%)	6.9	7.7	10.2	11.1	9.2
Private Sector--Share of GDP--Services (%)	15.3	23.8	25.0	27.8	29.0
Private Sector--Total Share of GDP (%)	**26.5**	**37.9**	**42.3**	**48.3**	**47.4**
Money supply--M1 (mln. lv.)	37833	48303	75131	107886	236628
Money supply--Broad Money (mln. lv.)	158567	234072	418009	583663	1310275
BNB's Forex Reserves (USD bln.)[1]	0.9	0.7	1	1.2	0.5
Unemployment (%)	15.3	16.4	12.8	11.1	12.5
Budget Deficit (% of GDP)[1]	5.3	11	6.6	5.7	10.3
Budget Expenditures (% of GDP)[1]	n.a.	n.a.	44.7	41.7	46.9
Domestic Debt (% of GDP)[1]	n.a.	31	52	38	23
Foreign Debt (USD bln.)[2]	12.1	12.5	10.4	10.5	9.7
Debt Service Ratio[1]	n.a.	16.3	12.6	10.4	17.3
Average Monthly Salary in the Public Sector--BGL	2047	3231	4960	7537	13269
Real Income (previous year	107.6	95.2	88.8	91.3	68.5

41 Source: NSI, except for 1 (*Andrew Kenningham*, Bulgaria: Leveraging off the Deutsche Mark (Economic Outlook and Fixed Income Investments), Merrill Lynch, July 1997) and 2 (OECD Economic Surveys: Bulgaria 1997, p.58).

=100)						
Total Imports (BGL mln.)	104281.2	131523.1	227010.3	380012.1	905612.9	
Total Exports (BGL mln.)	91532.9	102877.4	216194.4	359663.6	818315.0	
Net Exports (BGL mln.)	-12748.3	-28645.7	-10815.9	-20348.5	-87297.9	
Net Exports as Share of GDP (%)	-6.3	-9.6	-2.0	-2.3	-5.3	
Terms of Trade Index	n.a.	108.8	100.8	97.6		93.9

4. External debt and the Brady deal: Background

External debt is one of the major problems faced by the Bulgarian economy at present. It is considered to be a serious obstacle to economic transformation in the country. At present, external government debt amounts to US $9.861 billion, which exceeds the annual GDP of the country. Out of this amount, a little bit over US $3.0 billion are credits from official creditors, and the rest from private creditors. The high debt is not only a source of significant disturbance for the economy, but also reduces opportunities for autonomous macroeconomic policy and makes the government susceptible to pressure from its official creditors, in particular the IMF and World Bank.

In March 1990 Bulgaria declared a moratorium on servicing its external debt. A year later it started negotiations with the creditors from the London Club. After three years of negotiations, in July 1994 Bulgaria signed a Brady deal for reduction and restructuring of its debt to the London Club. Thus it reduced its US $8.16 billion debt to Brady bonds with a face value of US $5.1 billion. Twenty percent of the debt was bought at 25 3/16 cents per 1 dollar debt. Three types of bonds were issued: Discount Bonds (DISCs), Front-Loaded Interest Reduction Bonds (FLIRBs) and Interest Arrears Bonds (IABs). All types of Bulgarian Brady bonds are callable at par at any coupon date. Bulgaria can repurchase bonds at any time via public offerings or open market transactions, if there has not been prior payment default on any of the Brady bonds.

A special clause envisages additional interest of 1/2% to be paid for the Discount Bonds under certain circumstances. This will be enforced if the GDP exceeds the Bulgarian GDP in 1993 by over 25% for two consecutive years.

Two of the Bulgarian Brady bonds can be used as a payment instruments in privatization deals. The regulations are considered to be comparatively liberal, with few restrictions. DISCs are swapped at par value and FLIRBs at 50% of their par value.

There is practically no internal market for Brady bonds, due to existing bans in the foreign exchange regime. Bulgarian Brady bonds are traded mainly by non-Bulgarian financial institutions. Most Bulgarian banks have limited opportunities for access to the international market and do not have any significant Brady bonds portfolio. The largest holders of Brady bonds are Bulbank, The Bulgarian-Russian Investment Bank and some banks for which bankruptcy procedures have lately been opened. External trade in Bulgarian Brady bonds is totally dominated by trade of Latin American bonds, and there is some divergence only in cases of extreme risk of default, as in the second half of 1996 and the beginning of 1997.

A scheme was invented for evading restrictions on citizens’ investment in Brady bonds. They are now hindered by both restrictive regulations and high nominal face value of the papers. The scheme is called “Foreign exchange deposits, collateralized with Brady bonds.” These allow for citizens virtually investing in Brady bonds that are part of the banks' portfolios. The risk of the investment remains with the banks, which pay a fixed interest rate, related to the income on the Brady bonds.

Bulgaria is not only a big debtor, but it also has to collect almost US $3 billion in debts, mainly from developing countries and ex-CMEA countries. The debt from Iraq alone exceeds US $1.6 billion. Libya is second on the list, with US $360 million. The major debtor, Iraq, recognized its debt in 1991, but the imposed embargo prevented its servicing. Flexible schemes for collateralizing the debt against new credits, cessions, or triangle operations are the probable fate of this debt. Collecting these receivables is a priority now, given the problems in financing debt servicing.

The Brady deal allowed for a significant reduction (48%) in the debt to the London Club creditors, making it one of the mast favorable to the debtor country Brady deals signed so far. Still, in the middle of 1996, for the first time after the moratorium on foreign debt payments in 1990 there was a consistent threat that the unfavorable macroeconomic situation in the country and deficient foreign financing might result in a default on servicing the Brady bonds – something which would be a precedent in Brady bond history. Signing an agreement with the IMF turned out to solve the immediate threat. State reserves were diminished to the utmost minimum after payments in the beginning of 1997. The fate of the forthcoming payments will be determined by support from international financial institutions and incomes from the privatization process – the only reliable financial sources in the near future.

Table 4. Gross Foreign Debt as of December 1996 (mln. USD):

Indicator	mln. USD
Gross foreign debt (A+B)	9860.9
A. Long-term debt	8545.5
guaranteed by the state	8269.2
not guaranteed by the state	276.3
I. Official creditors	3056.1
International financial institutions (inclusive of the debt to IMF, WB, EU, EBRD, EIB)	1689.3
Bilateral (inclusive of the debt to the Paris club)	1366.9
II. Private creditors	5489.4
Bonds (inclusive of the Brady bonds and the bonds issued by Bulbank)	5213.1
Commercial banks	402.0
Other private creditors	61.4
B. Short-term debt	1315.4
guaranteed by the state	1011.0
not guaranteed by the state	172.2
I. Creditors from the former CMEA	964.8
II. Commercial banks	175.9
III. Other private creditors	174.7

Table 5: Bulgarian Brady bonds

	Discount Bonds	**Front Loaded Interest Reduction Bonds**	**Interest Arrears Bonds**
Date of issue	28 July 1994	28 July 1994	28 July 1994
Maturity date	28 July 2024	28 July 2012	28 July 2011
Par value	USD 1.850 bln.	USD 1.658 bln.	USD 1.611 bln.
Interest payments	6-month LIBOR+13/16	Years 1-2: 2% annually; 3-4: 2.25%; 5: 2.5%; 6: 2.75%; 7: 3%; 8-18: 6-month LIBOR+13/16	6 months-LIBOR+13/16
Payment dates	Semiannually, on 28 January and 28 July	Semiannually, on 28 January and 28 July	Semiannually, on 28 January and 28 July
Amortization	Bullet	8 years grace period, followed by 21 equal semi-annual installments, starting in July 2002	7 years grace period, followed by 21 semi-annual installments, starting in July 2002: Years 1-6: 1% Years 6-11: 3% Years 12-16: 6% Years 17-21: 9%
Collateral	Principal secured by US zero-coupon bonds; 12 month interest rolling guarantee on 7%	Principal secured by US zero-coupon bonds; 12 month interest rolling guarantee until 2001 - 2.6% initially, income on collateral retained until it covers 3%	none
Denomination	USD 250 000 and integral multiples thereof; USD 1 000 multiples for transfer of beneficial interest	USD 250 000 and integral multiples thereof; USD 1 000 multiples for transfer of beneficial interest	USD 250 000 and integral multiples thereof; USD 1 000 multiples for transfer of beneficial interest
Form	Registered and	Registered and	Registered

	bearer’s	bearer’s	
Debt equity conversion	100% of par value recognized as payments in privatization deals	50% of par value recognized as payments in privatization deals	none
Prices as of March 1997	63-1/8	45-5/8	61-1/8

5. PRIVATIZATION PROGRESS: BACKGROUND

The privatization process in Bulgaria is very slow. Its delay was one of the main reasons for the aggravated economic crisis in 1996. However, there are some indicators that privatization will be accelerated in 1997, not only in the real sector but in the bank system too.

The privatization process in Bulgaria began after Parliament passed the Privatization Law in May 1992. In practice, privatization started in 1993, when the first deal was made. Privatization includes cash privatization of state-owned and municipality-owned firms, as well as restitution of both types firms to their original owners and the Mass Privatization Program. Municipalities are mostly involved in privatizing small-scale enterprises (they own about 90% of all small-scale enterprises). Small-scale privatization takes place mostly in construction, tourism, trade, transport and other services. Responsibility for the cash privatization of state-owned enterprises is divided among the branch ministries and committees and the Privatization Agency.

The progress of privatization in Bulgaria may be evaluated only by the number of the concluded deals or by the proceeds from them. Unfortunately, information is not yet available about the share of privatized fixed assets. However, according to some opinions their share was less than 10% by the end of 1996.

The Bulgarian experience with privatization can be divided into two periods:

1993 - July 1996: Slow and Small Privatization

Privatization in this period was largely limited to small firms. In the very beginning of the period this was due to the large amount of time needed for the preparation of large-scale deals and because the normative base in the privatizing sphere was not adopted by that time yet. The delay of large-scale privatization after 1995 was due to the tacit reluctance of the socialist government to accelerate it (in spite of the elaborated annual programs). By the end of July 1996, 4,128 enterprises (898 state-owned and 3,230 municipality-owned) were privatized. The bulk of them are small-scale ones (about 95%).

The share of GDP produced by the private sector (both privatized and new enterprises) increased from 35.4% in 1993 to 44.7% in 1995.

August 1996 - February 1997: Willingness for Acceleration

The socialist government tried to accelerate the privatization process after the second half of 1996 as a way to cope with the aggravated economic crisis and because of the requirement of the IMF to implement a vigorous restructuring program. During this period some relatively big deals were made (the sale of “Sheraton-Sofia,” “Sodi-Devnya,” “Plama” in Pleven, etc.) and privatization procedures were started for others (BTC, “Chimco” in Vratsa, etc.).

In this period (up to March 21, 1997), 1,302 enterprises (252 state-owned and 1,050 municipality-owned) were privatized.

The mass privatization process had been launched – its first tender was made in November 1996, and the second in March 1997. It is provided that the final tender will be made by October 1997, which means that the acquired shares from the people and the privatization funds may be sold six months after that (this according to recent legislation, which probably will be changed by the next parliament). The participation of the people, who are eligible to claim their mass-privatization vouchers, was below that expected: about 45% (about 2.9 million people).

£ The total financial effect from the cash privatization of state-owned enterprises in the 1993 - March 1997 period is BGL 284.174 billion (about US $1.600671 billion), of which: BGL 87.814 billion (about USD 518.368 million) = contacted payments; BGL 68.341 billion (about USD 341.597 million) = undertaken corporate liabilities; BGL 9.646 billion (about USD 98.545 million) = paid corporate liabilities; and BGL 118.374 billion (about USD 642.161 million) = contracted investments.

£ The predominant types of selling during the period 1992-1996 were sales to working teams (about 37% of the total); auctions (about 37% of the total); direct negotiations with potential buyers (about 14% of the total); and tenders (about 10% of the total).

£ Only about 1.3% of the privatization deals were concluded with foreign physical and juridical persons.

£ 18.4% of arable land had been transferred from the ownership of state and collective farms to its original owners by the end of 1996

Data on Total Financial Effect - 1993 - November 30,/ 1997 (in Mln. US$)

	1993	1994	1995	1996	1997	Total
Direct financial effect, incl.:	**72.185**	**232.81**	**181.919**	**427.874**	**487.404**	**1390.891**
Payments contracted	44.233	144.252	113.702	184.764	460.812	947.763
Corporate liabilities undertaken	12.702	32.956	57.553	218.297	25.463	346.971
Corporate liabilities paid	15.249	55.602	10.665	13.512	1.129	96.157
Indirect effect (Investments contracted)	**58.971**	**201.738**	**151.914**	**170.561**	**781.775**	**1364.959**
Total effect	**131.156**	**434.548**	**333.833**	**587.134**	**1269.17**	**2755.850**

Source: *Privatization Agency*

6. 1997 Privatization

Data on cash privatization Jan.01.1997 - Sept.12.1997

	Privatization Agency	Other state bodies under art. 3*	Total
1. Finalized deals with state and municipal property - total			1226
1.1. Number of deals with state-owned companies - total	53	293	346
1.1.1. Manager-employee's buyouts	23	186	209
1.1.2. Others	30	107	137
1.2. Number of deals with municipal bodies			880
2. Financial result - total (in billion BGL)	680.616	110.891	791.508
2.1. Direct financial effect	611.443	77.298	688.741
2.1.1. Direct payments	591.434	61.413	653.147
2.1.2. Corporate liabilities undertaken and paid	20.009	15.584	35.593
2.2. Investments contracted for the period up to the end of 1997 (in billion BGL)	69.173	33.594	102.767
3. Employment	16493	10322	26815
3.1. Retained jobs	15690	5653	21343
3.2. Newly created jobs	803	4669	5472

Source: *Privatization Agency*

Number of deals contracted by state bodies - January 1993 - 30 November 1997

Year	**State bodies under Art. 3**		**Line Ministries and Gov. Committees**		**Privatization Agency**	
	Enterprises	Separate Assets	Enterprises	Separate Assets	Enterprises	Separate Assets
1993	21	41	17	34	4	7
1994	88	77	67	62	21	15
1995	105	204	84	156	21	48
1996	158	357	110	259	48	98
1997	241	210	196	185	45	25
Total	613	889	474	696	139	193

Source: *Privatization Agency*

Number of deals by sectors - January 1993 - 30 November 1997

Trade	405	27.0%

Industry	331	22.0%
Agriculture	272	18.1%
Construction	146	9.7%
Transport	140	9.3%
Tourism	127	8.5%
Others	81	5.4%
Total	1502	100%

7. BULGARIAN INDUSTRIALIZATION

Two periods of industrial development

There are two clearly discernible periods in the history of Bulgarian industry. The first period covers the interval between the end of the nineteenth century, when Bulgaria became an independent state, and 1945. The second period is between 1945 and 1989.

During the first period Bulgaria was a typical agrarian country. Industry accounted for 5.5% of GDP up to the 1930s. Agriculture accounted for more than 50% of GDP.

The Bulgarian economy registered high real growth between 1935-1945. Industry increased by 41.2% within this period. It was the highest growth in comparison to the other branches of the economy, and changed the branch structure of output.

Table 5: GDP by branches (%)

	Agriculture	Arts & crafts	Industry	Transport & communication	Trade	Banking & insurance	Others
1930	55.9	7	5.5	2.4	6.5	3.9	18.8
1945	54.1	6.1	9.4	3.6	9.9	2.4	14.5

Source: Dr. Asen Tchakaloff (In Bulgarian)
The National Income and Outlays of Bulgaria
Sofia, 1946, p.116

Industrialization started in Bulgaria in 1935. There were two factors which lay behind the high real growth in the period 1935-1945. First, the combination of high world prices for grain and food crops between 1935 and 1938. Second, rearmament in 1934 led to a higher growth of industry, especially textiles, leather-working, and the rubber industry, after 1934.

Industrialization

Industrialization was the key word after 1945, up to 1989. The big metallurgical and chemical plants were built within 30 years. Industry accounted for the better part of domestic product.

Table 6: Percent of GDP by branches

Year	Industry	Construction	Agriculture & Forestry	Transport & Communication	Trade	Other	Total
1988	70.3	8.2	10.1	5.4	4.1	1.9	100

Source: *National Statistical Institute*

Recent developments

Bulgarian industry experienced its sharpest decrease in 1990 and 1991. Machine building, electronics, and the chemical industry accounted for most of the decrease in output.
The liberalization of prices at the beginning of 1991 was the first step toward a market economy. Since then the successive governments have failed to introduce hard budget constraints on industrial enterprises. Instead they have broadened the number of industrial goods subject to price controls in order to reduce the inflation rate. Administrative price setting had a very harmful effect on industry. More than sixty percent of imports are for intermediate consumption. The controlled price of outputs and world prices of inputs deteriorated the financial position of those industrial enterprises which import their inputs. The mismatch between domestic and world prices underpinned increased arrears to suppliers of the biggest oil-processing plant in the Balkans, Neftochim Corp. Recently, the refinery has been working at fifty percent of its capacity.

Table 7: Industrial output (BGL mln., prices 01.91)

	1989	1990	1991	1992	1993	1994	1995	1996
January	7932,1	7394,4	4973,0	3361,7	3083,7	3125,0	3578,5	3833,3
February	8796,8	8337,1	4173,7	3339,0	3268,7	3351,9	3956,7	3810,7
March	10344,7	9425,8	5197,9	3638,5	3476,5	4213,0	4452,5	4092,3
April	9684,7	8995,7	4820,9	3615,7	3459,2	3812,4	4015,6	3798,7
May	8794,5	8076,3	4254,4	3148,3	3334,5	3627,6	4175,8	3892,6
June	9195,1	7820,5	3905,0	3202,1	3356,7	4142,2	4314,9	4305,4
July	7953,6	6963,6	4045,8	3090,0	2812,6	3609,8	4240,2	4047,0
August	7488,5	6453,6	3553,5	2812,0	3073,0	3548,7	4197,0	3885,1
September	8137,4	6666,3	3701,8	3233,7	3093,3	4383,0	4432,8	3762,6
October	8176,6	7282,3	4282,0	3744,7	3180,3	3946,3	4488,1	3988,3
November	8009,9	7164,7	4281,5	3505,8	3809,9	4136,2	4654,7	4236,3
December	7107,0	6161,1	4140,8	4672,2	4241,4	5058,5	4282,3	4318,1

Source: NSI and IME assessment

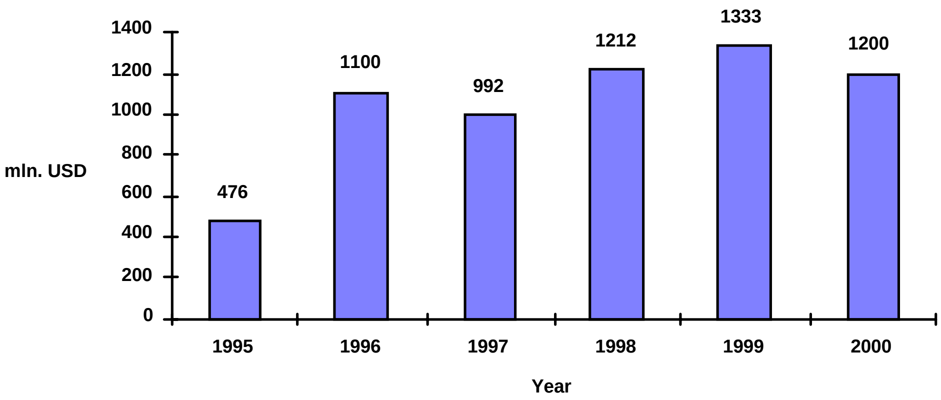
Industrial output did not achieve its 1989 level. Capacity utilization is at about sixty percent, according to the National Statistical Institute. The prospects for Bulgarian industry are closely correlated with the success of macroeconomic stabilization, which is to be implemented in May 1997. Provided that the economy achieves stability, the prospects for Bulgarian industry are much brighter than they now seem.

Table 8. Bulgarian external debt servicing in 1997

c	**Payments in mln. USD**
London Club	250
European Union	400
Paris Club	around 200
CMEA banks	100
Others	40
Total:	**992**

Source: IME

Bulgarian Foreign Debt



Source: IME

Bulgaria has never been considered the most attractive of the Central and East European countries with regard to investment opportunities. It is far behind countries such as Hungary, the Czech Republic and Poland. A few important factors have contributed to the low level of interest from foreign investors: political instability, legislative instability, corruption at all levels of administration, slow privatization procedures, poor telecommunications, underdeveloped financial institutions and capital market, and the overall unfavorable macroeconomic environment.

These factors inevitably hindered the inflow of capital to Bulgaria, and limited investment in the country for the past six years to a total of US $831 million. A significant proportion of this money was directed towards traditional and well-developed branches, such as machine building, the chemical industry, textile industry, food-stuff industry, tourism and transport. There is investment interest in telecommunications (the monopoly Bulgarian Telecommunications Company is offered for sale), mining, and other sectors. The biggest foreign investors in the country are Germany (28% of total investment), Holland (10%), Great Britain (7.75%), USA (6.7%), Switzerland (6.35%), Greece (6%), Austria (5%), and others.

Compared to other CEE countries, the legislative framework of foreign investment in Bulgaria is liberal, without any serious legal barriers. The Law on Encouraging and Protection of Foreign Investment deals with the most important issues. Foreign legal and physical persons are generally granted a national treatment for operation in the country. Foreign investment needs to be registered by the Ministry of Finance, and in some cases by the Securities and Exchange Commission. It is divided into three groups: portfolio investments (on tradable financial instruments), long-term credits, and direct investment (in all other cases).

In order to be recognized by the law and hence to be subject to its protection clauses, a foreign investment must exceed US $ 50,000. The property rights of foreign investors are guaranteed by law and by the Constitution. There are virtually no restrictions on the transfer of profits and capital, except for in cases when Brady bonds were used as a payment instrument in a privatization deal.

There is only one serious restrictive measure, namely the ban on owning agricultural land. Investment in a limited number of strategic branches is subject to a special authorization by a specialized body.

Bulgarian law envisages several types of opportunities for investment in the country: privatization, green field investment, various forms of cooperation, joint ventures and portfolio investment. Privatization is divided into cash and mass privatization. The latter is implemented through investment vouchers, used as payment instruments. Privatization funds serve as intermediaries in this process and offer foreign investors the opportunity to participate in the process of mass privatization.

The greater share of investment has been made through cash privatization. The biggest privatization deals have so far been the sale of one of the leading European carriers, SOMAT, the chemical plant Sodi-Devnya, and a few big hotels and breweries. Some of the leading companies that have already invested in Bulgaria, are Internationale Spedition Willi Betz GmbH, DAEWOO, Danone, Solvay, Interbrew, Kraft Jacobs Suchard, Nestle S.A. Westdeutsche Algemeine Zeitung, Ytong Holding, and Rover. The latter withdrew its investment in a car-building plant in 1996, due to “unfavorable macroeconomic environment and government policy to foreign investors”. This is a common problem for foreign investors. The positive news is that Rover is expected to return to the Bulgarian market, which may be a recognition of an improved investment climate.

Foreign investment in the banking sector was limited to the purchase of minority shares in several Bulgarian state-owned banks and the opening of branches of Raiffeisen Bank, ING Bank, BNP-Dresdner Bank, National Bank of Greece, Xios Bank and Ionian Bank. Given the low credibility of the Bulgarian banking system, foreign banks in the country enjoy a rapidly increasing, although still low, market share. EBRD is expected to implement a project for investment in the United Bulgarian Bank.

The most widely used method applied for the transfer of ownership is direct negotiation with potential buyers. The Privatization Agency often considers the business plan, investment commitments and protection of employees as important factors in addition to the price and the liabilities undertaken. The new program of the Privatization Agency envisages a wider use of other means of sale, such as auctions and public sale of stocks. The latter is dependent on the start of the operation of the Bulgarian Stock Exchange, which is expected in mid-1997.

Payment can be performed through different means: cash; external debt bonds (Brady bonds); or bonds issued under the Law on Settlement of Non-Performing Credits. The bonds are very attractive to investors, as they can be purchased at prices far below the recognized payment value. The usage of Brady bonds, however, is limited to up to 50% of the transaction cost.

Table 9: Foreign investment in Bulgaria by country

Country	Sum (in USD)	Number of deals	% of total volume
Germany	232 665 232	322	28.00%
Holland	85 649 640	87	10.31%
Great Britain	64 382 525	140	7.75%
USA	55 402 896	201	6.67%
Switzerland	52 922 049	95	6.35%
Greece	49 535 226	1104	5.96%
Austria	42 021 724	202	5.06%
Luxembourg	32 101 370	20	3.86%
Belgium	31 249 347	98	3.76%
Cyprus	31 212 507	146	3.76%
Russia	30 688 407	510	3.69%
Korea	22 759 199	12	2.74%
France	18 668 126	98	2.25%
Ireland	17 595 394	15	2.12%
Others	64 065 865	5149	7.71%
Total:	830 919 507	8199	100.00%

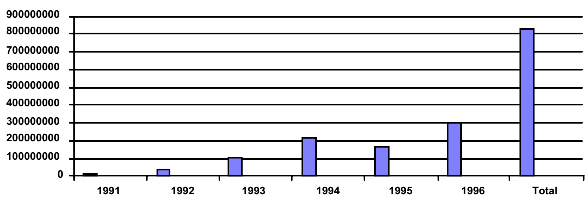
Source: *Privatization Agency*

Table 10. Foreign investment in Bulgaria by branch

Branch	Sum (in USD)	% of total volume
Industry	201 418 000	24.24%
Food-stuff industry	122 140 000	14.70%
Financial sector	113 127 000	13.61%
Tourism	77 784 000	9.36%
Transport	73 130 000	8.80%
Communications	18 932 000	2.28%
Others	224 388 000	27.10%
Total:	830 919 507	100.00%

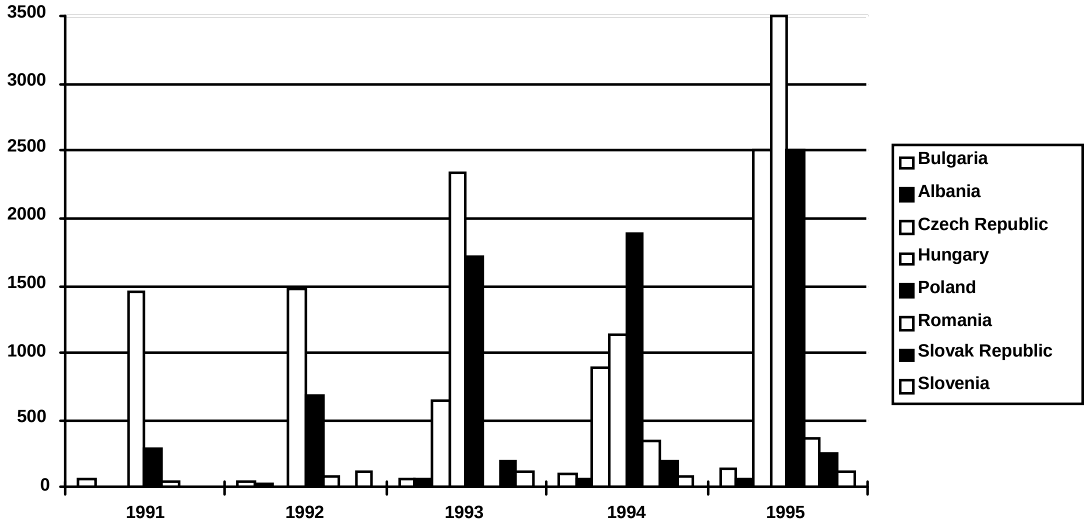
Source: *Privatization Agency*

Foreign investment by year



Source: *Privatization Agency*

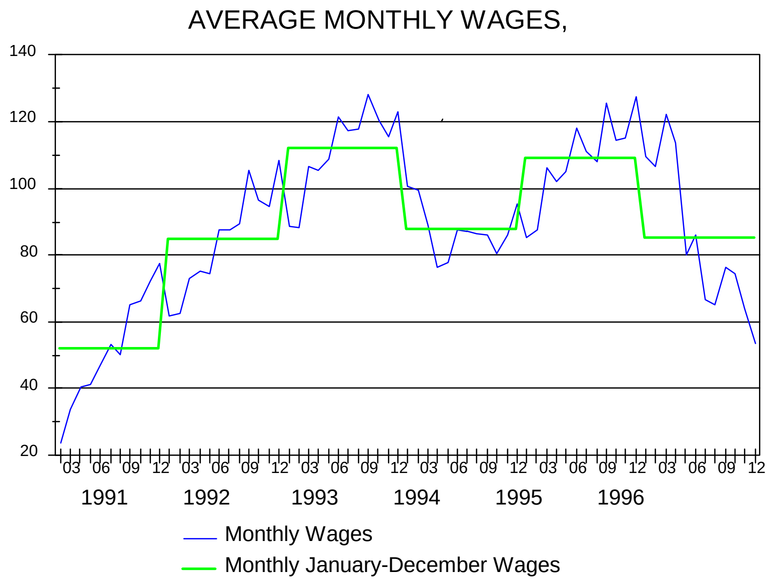
Foreign Investment in Central and Eastern



9. SOCIAL COSTS OF TRANSITION

In 1996, six years after the initial attempt to implement market-based stabilization in Bulgaria, the economy fell into a deep crisis, which heavily affected the standard of living of Bulgarians. In 1996 the share of households with income below the subsistence-minimum rose to 54% of the total number of households, or by 30 percentage points compared to 1990. Respectively, the share of households with income below the social-minimum increased from 41% in 1990 to 73% in 1996. The inequality of income distribution deepened in the last years – the ratio between incomes of wealthiest and poorest groups in Bulgaria rose from 3.5 in 1990 to 5.8 in 1996.

Bulgarian households' income has declined by 65.6% since 1990. The share of wages and pensions in total household income remained predominant and was approximately 70% in 1996. Property income and income from entrepreneurship, which are the only sources of income without real erosion, continue to be only a small part of total income (6% in 1996) and cannot change the overall negative tendency.



Wages and pensions were seriously eroded by inflation in the last years. The average monthly wage in real terms in 1996 was just 42% of its 1990 level. The sharp depreciation of the lev in 1996 and the first months of 1997 drastically reduced wages in dollar terms. From about $110 in 1995 the monthly dollar wage fell to $20 in the first months of 1997. (Its level was almost the same in February 1991 when initial price liberalization took place.). With respect to the monthly dollar wage in 1996, Bulgaria ranks last among the transition economies and is the only one to have had such a sharp reduction. The average monthly pension has declined by 65% over the 1990-1996 period. In the beginning of 1997 its equivalent in dollars was just $10.

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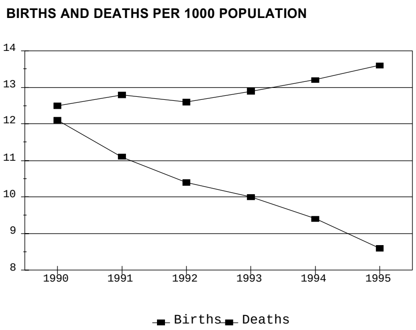
The decline in income was directly reflected in the deteriorating structure of household expenditures. Food purchases as a share of total expenditures grew from 36.3% in 1990 to 47% in 1996. The relative shares of expenditures on clothing and footwear, education and leisure declined during the above mentioned period. The structural changes in household expenditures adversely affected the amount and quality of final consumption.
The sharp reduction in 1996 in real GDP (around 10%) had a negative impact on employment. The unemployment rate started to rise in mid-1996, and reached 12.5% in December, among the highest in the transition countries. Taking into account the needed structural changes to restore long-term economic growth, it will be not surprising if the unemployment rate in 1997 continues to increase.
The severe drop in the standard of living in recent years is reflected in the demographic indicators – the death rate increased and at the same time the birth rate fell. As a result the natural increase of the population worsened from -0.4 per 1,000 in 1990 to -5.0 per 1,000 in 1995.



The decline in living standards led to the erosion of the credibility of the Government and vast political instability in the beginning of 1997. The ability of politicians, led by President Stoyanov, to avoid widespread unrest and to revive people’s confidence in government institutions is encouraging evidence for the depth of the democratic process in Bulgaria.

10. METHODOLOGICAL FOUNDATIONS AND SCENARIOS

Transition economies are essentially economies of disequilibrium and uncertainty. In assessing long-term prospects for such economies, one should put more weight on political risk factors. In other words, from the sets of typical country risk factors,[42] those related to the role of government and external (geopolitical) environment are expected to play a decisive role and, therefore, must attract more attention. For the same reason, it is important to define what a successful reform policy is.

In general terms, such policies require an economic growth orientation of the government and relative absence of welfare sentiments.[43] The objectives of the reform do not differ from those in other emerging markets, e.g., in Latin America, and include: macroeconomic stability, external viability, reducing the role of the public sector, and achieving private sector-led growth. More concretely, a long-run successful economic transition policy should, at a minimum, include establishment of the following:[44]

1. a stable and convertible currency, and stable financial institutions;
2. rule of law, irrevocable private property rights and an entrepreneurship-friendly environment;
3. easy access to capital, and, broadly speaking, to factors of production, for foreign and domestic investors; broad-range, prompt and transparent privatization; a sound capital market and financial institutions;
4. a set of contract-enforcing institutions; uncorrupted police, magistrates, courts and central and local government administration;
5. a set of competitive and transparent conditions for private provision of formerly public services in the fields of social safety nets, education, health care and infrastructure.

Of the five above-mentioned criteria Bulgaria has only just recently (in fact since July 1997) met the requirement for a convertible and stable currency thanks to the introduction of the currency board regime. As is shown in Table 1, the dynamics of key economic indicators for the last five years suggest a downward trend. The achievement of the rest of the

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42 More specifically, we assume that these factors fall into five groups: a) debt indicators: debt/GDP ratio, debt service ratios, debt structure, secondary (country's) sovereign debt market, etc.; b) internal indicators: current account as percent of GDP, import/export fluctuations; structure of exports, terms of trade, etc.; c) internal indicators: structure of investment, GDP per capita, inflation, etc.; d) domestic political risk indicators: reforms' continuity and government commitment to reforms, stability of the economic environment, entry and exit barriers, transaction costs, property rights and contract enforcement, etc.; e) international risk indicators: probabilities of war, external shocks, blocked trade routes, market protectionism, etc.

43 See: *Richard Beilock*, What Exists is Possible, pp. 7-8.

44 See: *Richard Beilock*, op. cit., p. 7; *Anders Aslund*, The Role of the State in the Transition to Capitalism, *John H. Moore* (ed.), Legacies of the Collapse of Marxism. 190-191.

points on the list is still in the future, and the stability of the currency has to be supported by a range of policies, promised but not yet implemented. This adds an even heavier “political” accent on any speculation about the prospects of the Bulgarian economy. In other words, when we consider different 2scenarios we must pay attention to a) policies that facilitate or hamper provisional developments; b) domestic initial conditions and demographics; and c) possible regional developments.[45]

[45] *Jeffrey Sachs*, “The limits of convergence: nature, nurture and growth,” *The Economist*, June 14, 1997

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