

OECD ECONOMIC SURVEYS



1999

SPECIAL FEATURES
Commercial banking
Corporate governance
Competitiveness

BULGARIA

CENTRE FOR CO-OPERATION WITH NON-MEMBERS

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CENTRE FOR CO-OPERATION WITH NON-MEMBERS (CCNM)

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1998-1999

BULGARIA

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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BASIC STATISTICS OF BULGARIA

1997 unless otherwise noted

THE LAND	Area (sq. km)	110 994
	Agricultural area (percentage of total)	55.5
THE PEOPLE	Population (thousands, end-year)	8 283
	Inhabitants per sq. km (end-year)	75
	Average annual population growth (percentage, 1991-1997)	-0.6
	Inhabitants in major cities (thousands, end-1995):	
	Sofia	1 117
	Plovdiv	344
	Varna	301
	Bourgas	199
	Registered employment (total, thousands)	523.5
THE PARLIAMENT	Labour force survey unemployment (percentage of labour force)	15.0
	National Assembly (unicameral)	240 seats
	Political parties (number of seats on 1st January 1998):	
	Union of Democratic Forces	136
	Bulgarian Socialist Party	57
	Movement for Rights and Freedoms	20
	Bulgarian Business Bloc	13
	Euroleft	14
PRODUCTION	GDP (US\$ billion)	10.5
	GDP per capita (US\$)	1 267.6
	Structure of GDP (per cent):	
	Agriculture and forestry	23.3
	Industry	26.2
	Services	39.6
	Other	10.9
PUBLIC FINANCE	Gross fixed capital formation (percentage of GDP)	11.3
	(percentage of GDP)	
	Consolidated budget revenue	32.9
	Consolidated budget expenditure	35.5
	Domestic debt	16
FOREIGN TRADE AND FINANCE	(US\$ billion)	
	Exports of goods and services	6.3
	Imports of goods and services	5.7
	Gross gold and foreign currency reserves	2.6
	Official foreign debt	9.7
THE CURRENCY	Monetary unit: lev	
	Currency units per US\$: end-December 1998	1 675

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Assessment and recommendations

In 1996 and early 1997, Bulgaria suffered a major economic crisis

At the time of the last OECD Economic Survey in early 1997, Bulgaria was suffering a full-blown economic and political crisis. Inflation, government debt, and the budget deficit were spiralling out of control, commercial banks and financial markets had essentially collapsed, and foreign reserves for defending the national currency were exhausted. Although the government was aware of the importance of an agreement with international financial organisations to avoid prolonged economic and social turmoil, internal political struggles and civil unrest hindered the negotiation process. The 1997 Survey linked this crisis to a combination of difficult initial conditions and delays in critical structural reforms, while also highlighting some problems in macro-economic policy.

A March 1997 agreement with the IMF on a comprehensive stabilisation and reform programme was of critical importance

In March 1997, a new caretaker government proved strong and determined enough to reach an agreement with the IMF on a comprehensive stabilisation and economic reform programme. This commitment was reinforced from a strong political mandate from elections held in April 1997. In addition to ambitious targets for structural reform and fiscal consolidation, a central feature of this programme was the replacement of active monetary policy with a currency board to defend a fixed exchange rate of 1 000 lev to the DM. In this context, recent economic policies have represented an important qualitative break from the past in many respects.

Recent progress in stabilisation and reform has been very impressive relative to the past

Given the former desperate economic situation described above, the success in macroeconomic stabilisation and fiscal consolidation since the second half of 1997 appears particularly impressive. While annual CPI inflation approached 600 per cent in 1997, it fell to negligible levels in 1998. Ambitious targets for fiscal consolidation have been more than satisfied, while the consolidated budget deficit was eliminated altogether in 1998. GDP has shown some signs of recovery. Interest rates fell quickly after the introduction of the currency board, and have subsequently remained quite low for a transition economy like Bulgaria. The reserves of the currency board have almost doubled since its introduction. Some areas of structural reform have also witnessed important progress. The pace of privatisation picked up notably in 1997 and 1998. The subsidisation of loss-making enterprises, often realised in the past through “soft” commercial credit, has been greatly reduced. The commercial banking system is being rebuilt on the basis of new and much sounder principles. Most price and trade regulations have been liberalised. The overall success achieved during 1997 and the first half of 1998 provided the foundation for a new comprehensive 3-year programme that has been endorsed and supported by the IMF. This medium-term programme reiterates a strong commitment to continued reform, and proposes to maintain the currency board and existing exchange rate, the peg of which was transferred to the Euro on 1 January 1999 at the same cross rate to the DM, for the indefinite future.

The achieved level of stabilisation provides the opportunity to address still substantial needs in restructuring and institution-building

Macroeconomic stabilisation has provided Bulgaria with an important window of opportunity to make up for lost time in structural reform. The unfortunate delays of previous years impose a heavy remaining burden of necessary restructuring and institution-building. A large number of enterprises in Bulgaria still report losses and accumulate arrears, while market-based institutions to facilitate bankruptcies, liquidations, and more effective corporate governance are still largely absent. The effectiveness of policies to rectify this situation and accelerate the restructuring process will have a decisive impact on future prospects for growth and continued stability. This includes the maintenance of a healthy and stable environment for investment and

entrepreneurship, the strengthening of the rights of creditors and shareholders, and strong initiatives in privatisation.

The current turmoil on international financial markets does not appear to threaten stability in Bulgaria in the near future, and the strong continued commitment to the macro-policy regime is wise

Despite the turmoil that has affected capital flows to emerging market economies since late 1997, the macro-policy regime and overall financial stability in Bulgaria do not appear to be threatened in the short run. Quite low domestic interest rates on state securities, due in part to bidding from highly liquid and risk-averse domestic banks, have contributed to keeping foreign short-term capital inflows at quite low levels. Potential instability from volatility in capital flows is therefore not a primary concern at this time. Although the current account has moved into deficit, the balance of payments support provided by the IMF agreement should be sufficient to ensure an approximate overall external balance in the near future under current policy commitments. Given the benefits of the currency board for supporting macroeconomic stability and the transparency of economic policy, the continued strong commitment of the government to maintaining this regime and exchange rate is wise. For the medium-term, some key variables for determining the sustainability of the macro-policy regime include the pace of export growth, the degree of success in attracting foreign investment, and the effectiveness of policies to control wage growth in poorly-performing state firms. The implementation of the latter policies was problematic in 1997 and 1998.

But the crises in some other emerging market economies may still be having an important impact on the speed of restructuring

While short-term stability in Bulgaria does not appear threatened, the crises in a number of other emerging market economies may still be having an important impact on the current account and inflows of foreign investment, thereby affecting the speed of recovery and economic restructuring. A strong reorientation of exports toward OECD countries in recent years has limited the direct impact of the Russian crisis. But CIS countries still accounted for over 17 per cent of Bulgarian exports in 1997, suggesting that this impact is not negligible. Future currency depreciation in Russia and other affected countries may also have a medium-term impact on Bulgarian competitiveness, particular in areas of strong export competition such as metals and chemicals. Perhaps most important, the fallout from the

crisis makes more challenging the attraction of foreign direct investment, a critical ingredient in the Bulgarian strategy for accelerated restructuring and investment growth. At this point in time, Bulgaria stands to benefit greatly from any overall improvement in the attitudes of international investors toward emerging markets.

Progress in fiscal consolidation has exceeded expectations, while government debt service now appears manageable

The introduction of a currency board necessitated strong supporting measures for fiscal consolidation. The achievements in this area have exceeded initial expectations. A consolidated budget deficit of over 15 per cent of GDP in 1996 was reduced to 3 per cent in 1997, and entirely eliminated in 1998, representing one of the most significant accomplishments of the economic programme. The primary explanatory variable for such rapid progress in fiscal consolidation was a major reduction in interest payments on domestic government debt. Such payments had reached as high as 17 per cent of GDP in 1996. The reduction came about as a consequence of three primary factors: a very rapid fall in domestic interest rates, the devaluation of lev-denominated state debt through high inflation in early 1997, and a restructuring of some government debt. The government is continuing a strategy for the gradual retirement of domestic debt, which fell from close to 70 per cent of GDP at the end of 1996 to under 15 per cent by the end of 1998. The burden of foreign debt remains substantial at close to 80 per cent of GDP, while annual servicing requirements on official foreign debt will be roughly US\$700 million in coming years. While this debt service is currently manageable, the attraction of foreign loans beyond provisions in the IMF-supported programme could be difficult.

Tax revenue has increased notably, although partly due to temporary factors

Higher state tax receipts have been another important explanatory factor for the success of the fiscal consolidation programme. Part of the higher tax revenue in the second half of 1997 and 1998, however, was due to temporary factors that artificially boosted the profitability of firms and banks. Potentially more permanent factors, including tougher tax administration and rules, appear to have also played a role, although the assessment of their relative contribution is difficult at this point in time. Following

changes in the registration procedure in 1998, enhanced state revenue from the VAT has been particularly impressive.

More attention to social policy in the 1999 budget is important, but at least approximate budgetary balance will need to be maintained

The budgetary balance achieved in Bulgaria also reflects the fact that social expenditures have been squeezed to rather low levels relative to most other transition economies. Given considerable needs in social assistance in Bulgaria, the political sustainability of this position is questionable. Accordingly, the 1999 budget is considerably more ambitious than its predecessor, providing for substantially higher state revenues and social expenditures relative to past budget laws. In the area of social policy, important major initiatives are aimed at rescuing and reforming the struggling social security and health systems. The presence of the currency board and high government debt, however, requires that at least approximate budgetary balance be maintained. The government has announced its commitment to adhere to such a balance.

Living standards in Bulgaria remain low

The standard of living in Bulgaria remains low compared to most other eastern European countries. The economic crisis, which reduced real income, devalued savings deposits, and increased unemployment, created additional hardship for a large part of the population. This is visible in demographic as well as economic statistics. While living standards have shown some improvement since mid-1997, they still remain below pre-crisis levels. Despite several factors that make an assessment of the degree of poverty and unemployment in Bulgaria difficult, these problems appear to be indeed very important and may require a greater amount of attention for social assistance and retraining programmes in the future.

The recovery in output has been slow, which is not surprising in the Bulgarian context

While progress in stabilisation has facilitated the rebounding of GDP from the abysmally low levels reached at the height of the crisis in early 1997, output still remains well below pre-crisis levels. Since the partial recovery in the second half of 1997, GDP has been rather flat. Given the particular conditions of the Bulgarian economy, together with the nature of recent measures for economic

stabilisation and structural reform, the lack of a strong upward trend in output is not surprising. In addition to lower real domestic income and demand, a collapse in commercial credit to the non-financial sector since mid-1996 has made conditions more difficult for many firms. Prior to the economic crisis, Bulgarian industrial firms had operated under a very high degree of bank financing relative to firms in other transition countries. By contrast, most enterprises now typically operate under severe liquidity constraints. This includes enterprises that formerly financed substantial losses through “soft” credits.

A difficult and painful process of restructuring must precede sustainable growth

Roughly half of Bulgarian state-owned industrial enterprises reported losses in 1998, reflecting substantial remaining needs in restructuring. Some current areas of export concentration may not be supported by genuine comparative advantage, as suggested by reported declines in exports in 1998 relative to 1997. Future restructuring, while necessary for the viability and competitiveness of the economy, will thus unavoidably involve numerous failures, liquidations, and temporary social costs. Policies that can help facilitate this process or alleviate temporary social costs are therefore of particular value at this time. In the current situation, GDP growth is a very limited measure of progress toward achieving sustainable growth in the future. The unsustainable growth of 1994 and 1995 offers a lesson in this regard.

Agriculture has benefited considerably from changes in policy since mid-1997

Agriculture has benefited considerably from a change in policy orientation since mid-1997. While agriculture represents a potential area of comparative advantage for Bulgaria, it has suffered throughout the transition period from numerous problems, including severe price and trade regulations and delays in completing land restitution. A combination of policy errors that repressed domestic grain prices, while at the same time leaving a window of opportunity for exports, culminated in “grain crisis” in early 1997, necessitating emergency imports to feed the population. A number of positive policy changes since mid-1997 can be noted: the land restitution process has received new momentum, grain and other agricultural prices have been

liberalised to a large extent, and export taxes and quotas have been removed on almost all products. These changes, as well as fortuitous weather conditions, have aided a significant recovery in agriculture since the economic crisis. The continued recovery in agriculture will depend on a speedy completion of the restitution process and the development of land markets. The government should also seek to build a reputation of honouring its commitments to farmers concerning the conditions of loan contracts.

Policies to address problems in low liquidity and investment in Bulgarian firms should concentrate on the development of financial markets and the creation of a more attractive environment for private investors

The scarcity of new commercial credit to the non-financial sector since mid-1996 can actually be associated with a number of positive changes relative to the past, including far less implicit subsidisation of loss-making or rent-seeking activities and a greater imperative for loss-making enterprises to restructure. But there are important costs as well, which can be associated with restricted activities or failures of possibly viable enterprises due to very severe liquidity constraints. Investment also remains low. The question of how more liquidity or investment resources could be made available for potentially competitive firms is an important, but delicate and complicated issue. While the government may feel tempted or pressured to alleviate these problems through administrative measures or state investment programmes, there exist several reasons why an optimal strategy should place more emphasis on the development of market financial institutions and the creation of a more attractive environment for private domestic and foreign investment. The significant uncertainty and hazards in identifying promising projects and trustworthy borrowers represent primary reasons why commercial banks are reluctant to lend to the non-financial sector, and the state possesses little advantage in confronting such problems. On the contrary, the politicisation of the investment process would likely create additional distortions. In virtually all market countries with poorly-developed financial sectors, retained earnings represent the only significant source of investment finance for most firms. This should also be the case for Bulgaria for several years to come, although the attraction of foreign direct investment can also be a key source of finance for some enterprises. Policies to help alleviate the hazards to commercial lending, as discussed

below, could help expand profitable opportunities for short-term lending, thereby creating an important source of liquidity for exporters and other profitable firms.

Despite important progress, institutions for bankruptcy and liquidations remain weak

Bankruptcies and liquidations were virtually non-existent in Bulgaria until the economic crisis of 1996-97. While progress has been made recently in this area, remaining weaknesses in these institutions hinder the restructuring process and account for an important part of the above-mentioned hazards to commercial lending. A key reform initiative of recent years directly targeted a number of important loss-making industrial enterprises and banks for liquidation, while other firms were isolated from commercial credit. The implementation of this programme has been largely successful and associated with a number of important bankruptcies, though it required the special intervention of the state. Bankruptcies of medium or large firms initiated by creditors or suppliers are still quite rare, despite very high outstanding enterprise arrears on commercial and other debts. Furthermore, the claims of creditors or shareholders are often not satisfied even in the event of bankruptcy due to severe bottlenecks in the liquidation process. The streamlining and activation of bankruptcy and liquidation procedures, together with a greater protection of the rights of creditors and shareholders, represents one of the most critical areas for economic policy. Restructuring, financial market development, effective corporate governance, and foreign investment all depend greatly on a resolution of these problems.

The nature of corporate governance also presents serious obstacles to restructuring

The nature of corporate governance in Bulgaria also presents serious obstacles to the restructuring process. In particular, the underdeveloped state of credit and equity markets implies the absence of a market mechanism for the disciplining and removal of ineffective management. Such institutions are needed to support appropriate managerial incentives, as well as to facilitate the replacement of those managers in Bulgaria who do not possess the requisite entrepreneurial skills or initiative for successful restructuring. While ministries have been very active in regularly replacing management during the transition period, it is not clear that this process has improved managerial efficiency.

In addition, the privatisation process, which includes a large number of management-employee buyouts, is gradually depriving ministries of the authority to intervene in this way. Problems associated with the predominance of insider control in Bulgarian firms can be gradually alleviated through measures to support the development of financial markets, as discussed further below.

The privatisation process, which had stalled for many years, has received new momentum

After a promising start in the very first years of economic transition, the privatisation process in Bulgaria subsequently stalled. As of the spring of 1996, an estimated less than 4 per cent of state assets had been transferred to private hands, a figure that was mirrored in quite low cumulative per capita direct foreign investment (less than US\$70). The acceleration of the privatisation process has therefore received primary emphasis in recent reform programmes. Important initiatives of late 1996 included a special “emergency” list that placed a number of the most valuable Bulgarian firms up for immediate sale and the launching of a voucher-based mass privatisation scheme. Subsequent privatisation programmes have remained ambitious, including the announcement in 1998 of an overall target of having 70 per cent of (former) state assets transferred to private hands by the end of 1999.

Recent results in privatisation have been impressive, although conditions became more difficult in 1998

While the results of privatisation in recent years have typically fallen short of the very ambitious announced targets, they still appear impressive relative to the past. This particularly concerns 1997, when receipts from cash privatisation exceeded those of all previous years combined. The pace of cash privatisation of large-scale enterprises has slowed somewhat since 1997, however, following the finalisation of a number of major deals and adverse changes in attitudes of foreign investors toward emerging markets. Under these circumstances, Bulgarian authorities have continued to privatise quickly, frequently relying on management-employee buyouts.

***Administrative
problems
in privatisation
are still important***

Despite notable improvements, the privatisation process continues to suffer somewhat from administrative and other problems. While the multiplicity of approaches to privatisation in Bulgaria reflects an understandable goal of maximising flexibility, this has also sometimes contributed to confusion and strained the capacity of public administration in co-ordination and implementation. Investors participating in the privatisation process in Bulgaria regularly complain of an over-centralisation in decision-making in public administration, confusion over criteria used to evaluate bids, and favourable conditions granted to employees relative to outside buyers. A current innovative programme that delegates privatisation deals to outside (foreign) consultants has so far yielded very modest results, perhaps due to problems in the corresponding contracts and their implementation.

***Foreign direct investment
is of high value
to Bulgaria***

Foreign direct investment has served as a major engine for the acceleration of restructuring and establishment of effective corporate governance in many transition economies. The potential benefits to Bulgaria from foreign investment are particularly high, given significant remaining needs in restructuring, problems in corporate governance, weak financial institutions, and the importance of balance of payments constraints under the fixed exchange rate. The strong emphasis placed on attracting foreign investment in recent government programmes is therefore justified. Balance of payments data reveal a significant slowdown in inflows of foreign direct investment in 1998 relative to 1997, which was related in part to a generally less favourable environment on international financial markets.

Stability and clarity in rules and conditions affecting foreign investors, together with progress in privatisation and financial market development, can help to attract greater FDI

Foreign direct investment is closely tied to privatisation and the development of financial markets. In addition to the problems in privatisation and financial market institutions noted above, foreign investors have also complained often in the past about the high level of instability and unpredictability in the country. Part of this concerns macro-economic and political instability, for which the outlook has greatly improved in the last few years. But this complaint also refers to tax and other special rules under which foreign investors have operated. These rules have continued to change in recent years, including a major decision in 1998 to revoke special privileges that had been granted previously to certain foreign investments and businesses. This particular decision, ironically, may actually serve an important purpose for improving the environment for foreign investment. The simplification and equalisation of conditions faced by all investors, both foreign and domestic, can hopefully support a greater amount of stability and transparency in the future. For investors, who are obliged to make outlays in the present under the expectation of returns only in the future, stability and clarity in rules and conditions are of primary importance. This should therefore be a particular policy priority for the government.

The SME sector can play a potential valuable role in providing a source of employment and growth at a time when many large enterprises face restructuring

The experience of other economies in transition also demonstrates an important possible role for new small private businesses in absorbing workers and other resources from larger struggling firms, fostering entrepreneurship, and building competitive industries. The current severe liquidity constraints in the enterprise sector, combined with stubbornly high unemployment and the promise of significant future shakeouts, indicate the prime potential importance of the SME sector in Bulgaria. Indeed, new private businesses, along with industrial exporters, played a major role in the moderate economic expansion in 1994 and 1995. The economic crisis brought difficult times to the SME sector for a number of reasons, however. Recent measures that eliminate the eligibility of many SMEs for VAT refunds, while apparently boosting tax revenue, may have added an additional burden to the operation of smaller entrepreneurs. While the recent changes in tax laws are understandable, the Bulgarian government should still maintain a general

priority for a healthy overall environment for the operation of SMEs and entrepreneurs. Of primary importance are predictability and transparency. This depends on the maintenance of simple and stable conditions relating to taxation, licensing, and contractual laws. Such businesses can provide a genuine source of economic growth and employment in the near future during the time in which many large enterprises continue to face the imperative of fundamental restructuring.

Policies for the restructuring of the banking sector have been effective

The activities of commercial banks were central to explaining the crisis of 1996-97. By mid-1996, the entire banking system in Bulgaria was devastated. Commercial banks had aggregate negative net worth and extremely low liquidity, while the government no longer had the resources to bail them out. Policies adopted since that time have been effective both in preventing a literal collapse of all commercial banking in the country and in providing the foundations for a rebuilt banking sector on the basis of new and sounder principles. Bank incentives have improved dramatically. Operating commercial banks appeared well-capitalised and solvent in the second half of 1997 and 1998. While assets remain concentrated in larger, mostly state-owned, banks, an ambitious programme foresees the rapid privatisation of these banks, preferably to foreign investors. Two large banks have already been privatised.

The revival of commercial lending will inevitably take time

Since the crisis, commercial banks have invested primarily in relatively safe and liquid assets such as foreign and domestic government securities. A number of institutional problems require attention for promoting the revival of commercial banks as effective financial intermediaries. Policy discussions on this topic have often focused on the nature of new and quite restrictive banking regulations. While marginal adjustments in bank regulations, such as those made at the end of 1998, may indeed have a positive effect on the activities of banks in the real economy, it should be realised that it will inevitably take time for institutions to develop to support profitable lending. This includes the strengthening of creditors' rights, the development of skills for project evaluation, risk assessment, and monitoring, and the fostering of competition in the industry.

In addition, the presence of a currency board, and the absence of central bank refinance, implies that Bulgarian banks should, in fact, operate under higher liquidity and lower risk than would otherwise be the case.

Measures to increase the rights and leverage of banks over firms in default on loans can have multiple benefits for institutional development

Commercial banks suffer first and foremost from a very weak protection of their rights as creditors. This concerns the ability to collect collateral, discipline the management of firms in default on loans, or effectively pursue bankruptcy and liquidation through the courts. Measures to increase the rights and leverage of banks over firms in default can have multiple benefits for the development of credit markets, corporate governance, and the financial health of the banking system. First, a greater ability of banks to collect their claims has an obvious direct effect on the expected profitability of commercial lending. Second, such measures can reduce the hazards faced by banks in the identification of potentially profitable projects and trustworthy borrowers. If managers of enterprises are aware that banks have power to discipline them, or even initiate their removal through the courts in the event of default, the average quality of the pool of applicants for commercial loans will increase. Third, the process by which management can be disciplined or removed in the event of default on commercial loans can provide at least one market-based source of outside corporate governance. This can be particularly important during the time that equity markets are underdeveloped. Genuinely viable firms with effective management that currently suffer from severe liquidity constraints stand to profit as much as commercial banks from such measures.

The supervision and regulation of commercial banks will remain challenging in the near future

Developing institutions to support a profitable role for banks as financial intermediaries assumes even greater importance in light of the current trend toward a decline in bank profit margins under current “safe” investment strategies. The growing profit squeeze will hopefully have the positive effect of inducing banks to expand their activities in the real sector of the economy, developing better skills for project appraisal, monitoring, and the pursuit of claims in the event of default. But the current weak institutional environment, together with problems in the competence of some bank management, also raises the possibility that

some banks may not succeed in coping with this formidable task. Thus, the supervision and regulation of commercial banks promises to be very challenging in the near and medium-term, particularly in the absence of an option for bank refinance. A number of failures or merges is a distinct possibility. Despite the apparent current high liquidity and capitalisation of most banks, the very close monitoring of the activities and portfolios of commercial banks by the BNB should remain of the highest priority.

***Competition
policy remains
important
to Bulgaria***

The legacy of central planning can be associated with a particularly high level of concentration in Bulgarian industry. The implied challenges for competition policy may have actually been compounded in the first years of economic transition, due in part to delays in privatisation, collusive relationships among firms, banks, and government organs, and the concentration of a large amount of economic activity in small number of business groups. In spite of these difficulties, the Commission for the Protection of Competition (CPC), founded in 1991, has actually been quite active during economic transition, if judged by the number of petitions filed and accepted for investigation. At the same time, the activities of the CPC have been heavily skewed towards “unfair” trade practices and contract enforcement problems, issues that are normally settled through the judicial system, while hard core anti-competitive behaviour has received less attention. This has motivated a new Competition Law that aims at rectifying this situation. Given the inherited environment in Bulgaria, the enforcement of fair competition and the prosecution of corrupt activities deserve special attention.

***The degree
of future
co-operation
among major
political factions
will also be
important to the
reform process***

From the very start, the transition process in Bulgaria has suffered greatly from political instability, bitter political rivalries, and a very high turnover of civil servants and enterprise managers following numerous changes in government. This latter phenomenon is perhaps one of the main reasons why public administration in Bulgaria suffers so much from a shortage of competent personnel and an over-centralisation in decision-making. In this light, a general consensus among all major political factions in Bulgaria in 1997 on the expediency of a currency board and

comprehensive reform programme was an important accomplishment, and political stability has been re-enforced through the emergence of a strong majority supporting the present government. But there is still room for strengthening political co-operation in the reform process. It should be kept in mind that the speed with which Bulgaria can build a foundation for sustainable economic growth also depends on the degree to which general co-operation among major political factions in the country can be maintained.

Summing up

Bulgaria has made remarkable progress since the time of the last OECD Economic Survey in early 1997. The country is now experiencing a prolonged period of economic and political stability that is unprecedented in the transition period. In addition, this stability does not appear threatened in the near future. The new three-year agreement with the IMF and other IFIs provides balance of payments support that should be adequate to meet Bulgaria's needs. While the 1999 budget is rather ambitious, the government has declared its determination to restrict spending further if expected levels of tax revenue do not materialise. The achievements in macroeconomic stabilisation give Bulgaria a valuable opportunity to address substantial remaining needs in restructuring and institutional development. In the near future, it is natural to expect the recovery in output, living standards, and financial markets to be a slow and difficult process. The attraction of substantial foreign direct investment, continued rapid privatisation, measures to accelerate the bankruptcy process and develop financial markets, and the fostering of a vibrant SME sector can help to accelerate restructuring and alleviate the implied temporary social costs. The development and maintenance of an effective social safety net promises to be a challenge. The degree of success in economic policy achieved since mid-1997 gives hope that the Bulgarian government will continue to meet the enormous challenges that lay ahead.

I. Macroeconomic performance and policy

After more than a year of rapid currency depreciation, high inflation, spiralling government debt, and output decline, the macroeconomic situation in Bulgaria has shown dramatic improvement and stability since the introduction of a comprehensive reform programme in mid-1997. This programme, which includes the support of the IMF and other international financial institutions, involved the introduction of a currency board, strong measures for fiscal consolidation, and a number of targets for structural reform. By 1998, CPI inflation had declined to negligible levels, budgetary balance was achieved, domestic interest rates declined remarkably, and output has shown some signs of recovery. In the light of these positive results and a remaining strong commitment of the government to further reforms, a new Stand-By arrangement was successfully negotiated with the IMF in mid-1998. This arrangement will provide important additional balance of payments support through the year 2001. The government has also reiterated its commitment to maintaining the currency board and current exchange rate, which was converted to the Euro on 1 January 1999, for the indefinite future.

While the achieved macroeconomic stability in Bulgaria does not appear threatened in the short run, policy challenges remain significant. The revival in output and exports has been sluggish, reflecting both a scarcity of new commercial credit and a substantial amount of restructuring still needed for achieving sustainable growth. Recent strong improvements in tax collection, which have aided the process of fiscal consolidation, have been supported by several temporary factors, while social pressures on the budget continue to mount. The current turmoil on international financial markets has complicated the key policy objective of attracting high levels of foreign investment for the acceleration of restructuring and the alleviation of balance of payments constraints. Balance of payments constraints could conceivably limit the pace of economic recovery in the near future and eventually, in the medium term, pose questions for the monetary policy regime. This chapter examines the macroeconomic performance of Bulgaria since 1996, summarises the important achievements, and seeks to identify the most important future challenges to economic policy.

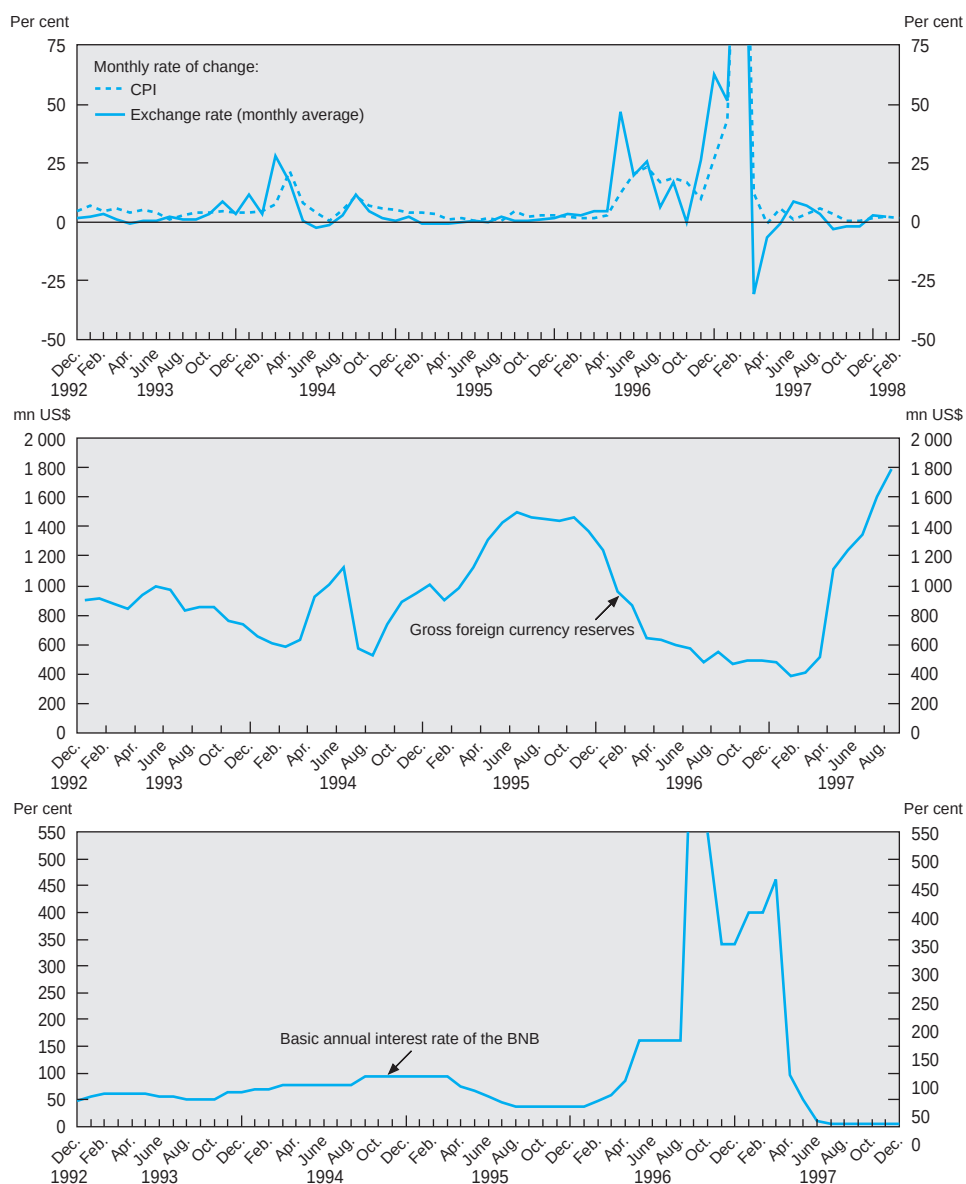
The roots of the economic crisis of 1996 and 1997

The previous 1997 *OECD Economic Survey of Bulgaria* documented how a combination of difficult initial conditions, delays in structural reforms, the weak regulation of commercial banks, problems in macroeconomic policy, and corruption culminated in the economic crisis of 1996-97. Difficult initial conditions included a former strong dependence of Bulgaria on the CMEA market and high government and commercial debt, much of which was denominated in US dollars. Due to the dependence on the CMEA, Bulgaria experienced a larger trade shock and output decline in the early 1990s than elsewhere in Central and Eastern Europe. This has implied greater challenges in restructuring toward international competitiveness. The high level of dollar-denominated debt plagued efforts aimed at fiscal consolidation and stabilisation. On several occasions, the depreciation of the domestic currency increased the burden of servicing dollar-denominated domestic and foreign debt to the point of exacerbating fiscal imbalances, depleting reserves, and creating further pressure for devaluation. Finally, somewhat weaker geographic, historic, and cultural links with Western Europe than a number of other central and eastern European countries make competition for foreign investment and economic integration somewhat more of a challenge.

In addition to difficult initial conditions, delays in key reforms and policy errors are also to blame for the disappointing record of economic transition in Bulgaria before 1997. Progress in structural reform was quite slow relative to most other transition countries. On the eve of the recent crisis, the vast majority of industry remained in state hands and the process of land restitution was in virtual limbo. Political and economic instability, a high degree of corruption, and administrative inefficiency frustrated potential domestic and foreign investors, as mirrored in quite low levels of direct foreign investment. Bankruptcies or liquidations of loss-making state-owned enterprises were virtually non-existent. Commercial banks operated under highly distorted incentives, both administering implicit subsidies to loss-making state-owned enterprises and expanding credit to the private sector in an irresponsible manner. Administrative price controls on basic food products actually increased steadily between 1992 and 1996, causing costly distortions in the associated markets.¹

The efficacy of both monetary and fiscal policy was seriously compromised in this context. By the end of 1995, both were oriented toward bailing out increasingly decapitalised commercial banks. Monetary authorities continued to refinance distressed banks, while servicing requirements on bonds issued for the recapitalisation of banks had a crippling effect on the state budget. Despite the fact that Bulgaria succeeded in generating a primary budgetary surplus of over 7 per cent of GDP from 1994 to 1996, the burden of interest payments kept deficits higher than 5 per cent of GDP each year. As many of these interest payments were indexed to the basic interest rate of the National Bank (BNB), the

Figure 1. Financial instability



1. Gross foreign currency reserves include BNB foreign currency assets on current accounts and deposits with banks abroad, holdings in SDRs and Bulgaria's reserve position with the IMF.

Source: BNB and OECD.

government kept pressure on the Bulgarian National Bank (BNB) to reduce this rate in order to avoid a debt spiral. But attempts to reduce significantly the base interest rate had a destabilising effect on money demand in 1994 and 1995, in both cases triggering a flight from the lev, capital outflows, a rapid depletion of official reserves, and an exchange rate crisis (Figure 1).

During the 1996-97 economic crisis, annual CPI inflation accelerated to 311 per cent in 1996, followed by full blown hyperinflation in early 1997. The lev depreciated from 71 to over 3 000 to the US dollar from the end of 1995 to early 1997. In the absence of foreign reserves, monetary authorities stood helpless to intervene in defence of the currency. The budget deficit and short-term debt spiralled out of control, with interest payments on government domestic debt alone reaching 17 per cent of GDP in 1996. By the second half of 1996, the financial crisis had spilled over into the real sector of the economy. After exhibiting marginal growth in 1994 and 1995, GDP fell by an estimated 10 per cent in 1996, and another 7 per cent in 1997. Measures to stiffen controls on the prices on a number of basic food products were followed by shortages, further fuelling social discontent.

Table 1. **Basic economic indicators**

	1995	1996	1997	1998
GDP growth (in %)	2.9	-10.1	-6.9 ¹	4.0 ³
Fixed capital investment growth (in %)	16.1	-21.2	-22.1	-
Inflation (CPI Dec./Dec.)	33.0	310.8	578.6	1.0
Unemployment (% of labour force, ILO definition) ²	14.7	13.7	15.0	16.0
Basic effective interest rate of the BNB (end period)	38.6	342.0	6.8	5.3
Consolidated budgetary balance (% of GDP)	-6.6	-16.6	-2.6 ¹	0.9 ¹
Trade balance ⁴ (million US\$)	121	187.6	380.4	-200.0 ³
Current account				
Balance (million US\$)	-26	16	427	-170 ³
% of GDP	0.0	0.1	4.0 ¹	-1.4 ³
Gross foreign reserves (end of period) million US\$	1 236	751	2 482	3 051

1. Preliminary.

2. November estimates 1996, 1997, 1998. October estimate 1995. (Household survey data.)

3. Projections.

4. FOB-FOB (from balance of payments).

Source: BNB, Ministry of Labour and Social Policy, Ministry of Finance, NSI and OECD calculations.

Measures to confront the crisis

The eruption of the financial crisis in the spring of 1996, following mounting pressures in 1995 and early 1996, served as a wake-up call to the government,

which had formerly held a somewhat complacent attitude toward the pace of economic reform and growing problems in the banking sector. Emergency negotiations were held with international financial institutions on the subject of a new programme that would press the pace of economic reform, possibly backed by external assistance. This led to the drafting of a comprehensive “Action Plan” in mid-1996, which was supported by a preliminary agreement with the IMF. Among the measures in this plan, enterprises responsible for the majority of losses in the economy were placed on two lists, the Liquidation List and the Isolation List. Those on the former list were subject to immediate closure and liquidation, while those on the latter list were prevented from obtaining new bank credit and subject to future liquidation in the absence of positive cash-flow. Important measures, which are discussed in Chapter II, restricted refinance policies, shut down a number of problem banks, and empowered the National Bank to toughen and enforce banking regulations. An “emergency list” was drawn up for the immediate privatisation of 18 of the most valuable Bulgarian enterprises, with priority given to sales to foreign investors.

Ultimately, this policy package did not prove sufficient to prevent a further economic deterioration in 1996 and early 1997. In February 1997, the Socialist-dominated parliament, which had been insisting on the formation of a government of national unity, finally yielded to demands for early elections and the appointment of a caretaker government of opposition leaders empowered to conclude negotiations with the IMF. The caretaker government succeeded in this task, reaching a major agreement with the IMF and other IFIs in March on a comprehensive stabilisation and reform programme. This, together with the strong political mandate from a landslide victory of the United Democratic Front in the April 1997 elections, proved critical in restoring confidence and credibility to government policy. While some of the measures taken in mid-1996 did represent an important first step in addressing fundamental problems in the Bulgarian economy, the severity of the crisis and magnitude of responsibility required a strong political and social consensus that was achievable only after the change in government.

The preliminary agreement reached between the Bulgarian government and the IMF in March 1997 had the immediate effect of calming expectations and restoring an important degree of stability to the chaotic situation. A centrepiece of this programme was the establishment of a currency board regime to support the commitment of a fixed exchange rate. The details of this arrangement are outlined in Box 1. Additional measures, most of which are analysed below and in future chapters, included a restructuring of domestic government debt, enhanced budgetary discipline, and incomes policies. It also highlighted a number of targets for enterprise restructuring, privatisation, and the liberalisation of trade regulations and most prices, particularly those on agricultural and food products. From the time of the March 1997 agreement, the National Bank (BNB) began adjusting

Box 1. The currency board arrangement in Bulgaria

Since 1 July 1997, a currency board has been in operation in Bulgaria. A currency board represents an extreme example of a fixed exchange rate monetary policy regime. It has also been introduced as a stabilisation device in Argentina, Estonia, and Lithuania. A currency board replaces active monetary policy with a simple rule-of-thumb by forbidding the Central Bank from holding any domestic assets. The Central Bank (currency board) holds only foreign assets, usually in an amount greater than the value of domestic currency in circulation, and commits to buying and selling foreign or domestic currency at the fixed exchange rate. The supply of domestic currency is therefore automatically regulated by demand at the existing exchange rate and, under the condition of full foreign currency backing, the supply of foreign currency reserves always remains adequate to defend the exchange rate. As the Central Bank holds no domestic assets, it cannot regulate the money supply through open market operations or the extension of domestic credit. Commercial banks still retain the power to expand credit, however. The conditions of a currency board put obvious pressure on the government budget and commercial banks. Commercial banks are unable to obtain refinancing to manage liquidity. The government must finance any deficits through commercial borrowing, which could be very costly in the event that commercial banks are not liquid.

Bulgaria opted for the DM as the reserve currency used to back up the domestic money supply, which reflects primarily a strategic medium-term goal of joining the EU. Bulgaria's arrangement also includes two slight deviations from a "pure" currency board regime as partial safeguards for the state budget and commercial banks. First, access to IMF funding was granted to the management of the National Bank (BNB) for the possible extension of a "loan" to the Ministry of Finance. As the source of the funding is the IMF, however, this condition does not violate the fundamental principles of a currency board. Second, a "Banking Department" has been maintained in the National Bank. The Banking Department possesses a limited refinancing facility that is designated for use only in the presence of an emergency (systemic risk). The size of the refinance facility is determined by the net worth of the National Bank, equal to roughly the amount of foreign reserves in excess of that necessary to fully back the currency, commercial bank reserves and the deposits of the government. The banking department also controls the one remaining monetary policy instrument of reserve requirements. As with the refinancing facility, there appears to be an implicit agreement that adjustments to reserve requirements should not be used as a discretionary policy instrument. These requirements have not changed since the introduction of the currency board.

Another specific condition of the currency board arrangement in Bulgaria is that the government holds the majority of its surplus accounts with the Issue Department of the National Bank, as opposed to with commercial banks or other institutions capable of holding domestic assets. This is meant to increase monetary stringency and the transparency of the government position *vis-à-vis* foreign creditors. The government has announced its intention to maintain indefinitely the currency board and the existing exchange rate, which was converted to the Euro at the same cross rate of 1 000 lev to the DM on 1 January 1999.

monetary policy in preparation for the currency board, discontinuing lending to the government and bank refinancing, while phasing out interventions on the domestic market.

For the period of April 1997 to June 1998, this package was backed by an IMF Stand-By Arrangement of SDR 371.9 million (US\$530 million), a commitment from the World Bank of US\$290 million, and some other pledges by the EU and official donors. Given the degree of success in economic policy and stabilisation achieved in the year following the introduction of the reform package, the Bulgarian government successfully negotiated a further 3-year agreement with the IMF, which made available SDR 627.6 (US\$864 million) in special drawing rights over the period of 1999 to 2001, subject to regular reviews. This package also included significant funding commitments from other official sources. Bulgaria officially projects to receive roughly US\$600 million in balance of payments support in 1999, and US\$500 million in each of 2000 and 2001.

Stabilisation and the balance of payments: the sustainability of the macro-policy regime

Under a currency board regime, the money supply is not subject to regulation through the usual monetary policy instruments. For this reason, money supply growth and inflation in Bulgaria since the introduction of the currency board have been very closely linked to developments in the balance of payments. Monthly variations in inflation have also reflected changes in administratively-controlled prices of a few key goods, notably those for energy and utilities.² The medium-term prospects for growth and stability under the current regime will depend significantly on the degree to which Bulgaria can avoid either substantial balance of payment deficits or an excessive real appreciation of the currency through inflation under the existing exchange rate.

The currency board proved a powerful tool for stabilising the economy in 1997. After inflation had accelerated to over 200 per cent in the month of February alone, the formation of a new government and the preliminary agreement with the IMF had an immediate stabilising effect on expectations. Monthly inflation fell to 12 per cent in March, and even turned negative in April. The average effective interest rate on government securities fell from over 400 per cent in March to less than 100 per cent by April, and to under 6 per cent after the currency board was established in July. The choice of 1 000 lev to the DM as an exchange rate peg was a topic of some controversy in mid-1997. Some analysts argued that the lev should be devalued even further to ensure competitiveness over a longer period, particularly following the significant growth of nominal wages in the first half of the year. The prevailing opinion maintained that a further devaluation would simply lead to stronger inflationary pressures. Indeed, even at

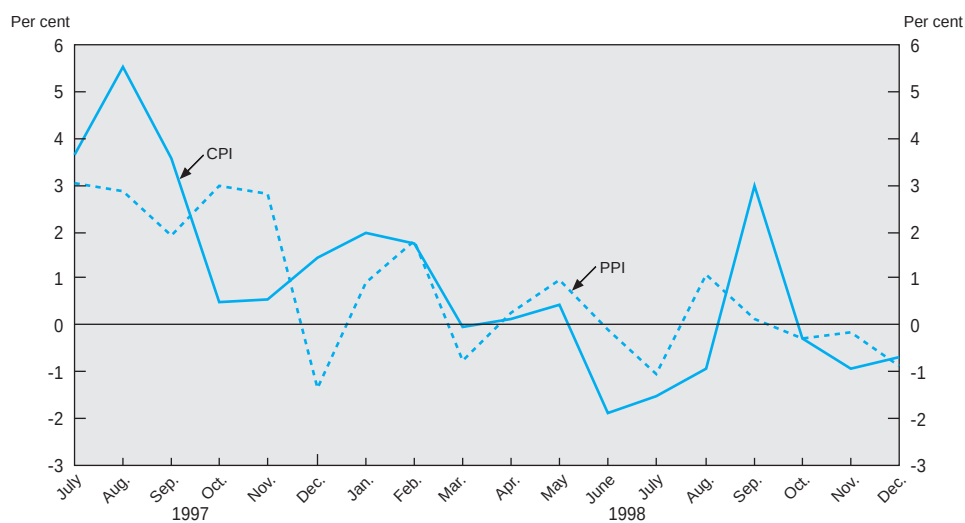
1 000 lev to the DM, inflation proved higher than projected in the second half of 1997. Average monthly CPI inflation in the second half of 1997 amounted to 2.6 per cent, bringing total inflation for the year to 579 per cent. By contrast, 1998 witnessed a dramatic slowdown in inflation, with the CPI index registering at only 1 per cent, and monthly inflation actually turning negative for a number of months during the year (Figure 2).

The initial high inflation and its subsequent slowdown are mirrored in the balance of payments. Significant capital inflows, following the initial IMF agreement in the spring of 1997, and a relatively strong current account in early 1997, were associated with a rapid accumulation of official reserves, an expansion of currency in circulation, and brisk inflation (Figure 3). Since the fourth quarter of 1997, however, the current account moved into deficit and capital inflows other than official loans have been negligible. In fact, according to preliminary data for the first three quarters of 1998, net (portfolio and direct) foreign investment was negative (US\$48 million). In addition to changes in the balance of payments, the liberalisation of the prices of some basic food stuffs appears to have contributed somewhat to inflation in the second half of 1997, as indicated by the fact that the CPI index for food products in the second half of 1997 was 17.5 per cent, a bit higher than that for services (16.2 per cent) and non-food products (12.3 per cent).

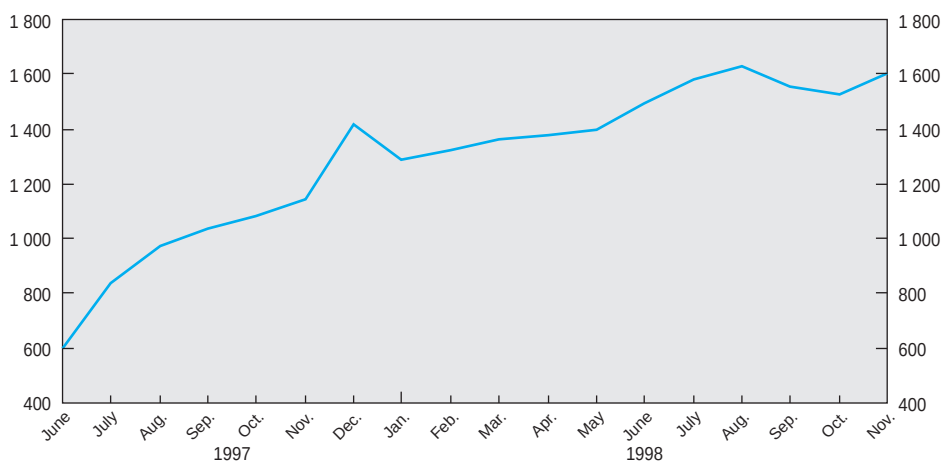
A fall in demand for foreign goods and services, consistent with a devalued lev and lower income, contributed to a record current account surplus of US\$427 million in 1997. The dollar value of imported goods and services fell by 3 per cent, while exports grew by 1 per cent, thereby increasing the overall trade surplus from US\$188 million in 1996 to US\$380 million in 1997. Another factor that contributed to the higher current account in 1997 is a doubling of net transfers, some of which consisted of food aid during the "grain crisis" of early 1997.

Data for the first half of 1998 show the dollar value of Bulgarian imports increasing (+8.6 per cent relative to the first half of 1997), despite price declines on a number of key imported commodities, most notably oil and gas from Russia.³ A particularly low level of imports during the crisis in the first quarter of 1997 appears to be the primary explanation for the increase. In addition, as described below, import duties with other European countries were lowered at the beginning of 1998. In spite of the success in stabilisation, the dollar value of exports actually fell from US\$2.4 to 2.2 billion in the first half of 1998 relative to the same period in 1997. Several factors may have been responsible for this decline. Probably most important, a higher value of the dollar and changes in world prices decreased the dollar value of exports volume somewhat, with price movements being particularly unfavourable for Bulgarian exports of copper, some other metals and chemicals. Second, the crises in Russia and Asia have adversely affected the demand for some Bulgarian exports. The real appreciation of the currency may have also affected exports to some degree, although the magnitude of this effect is difficult to assess.

Figure 2. Monthly CPI and PPI inflation



Source: BNB.

Figure 3. Currency in circulation
Billion BGL

Source: BNB.

Table 2. **Selected balance of payments indicators**

	Million US\$				
	1996	H1 1997	H2 1997	1997	H1 1998 ¹
Current Account	15.9	239.2	187.5	426.7	-38.3
Trade balance	187.6	355.3	25.1	380.4	-32.4
Exports	4 890.2	2 424.4	2 515.3	4 939.7	2 214.3
Imports	4 702.6	2 069.1	2 490.2	4 559.3	2 246.7
Service balance	120.1	-29.1	195.4	166.3	35.0
Receipts	1 365.9	521.2	816.3	1 337.5	567.9
Payments	1 245.8	550.3	620.9	1 171.2	532.9
Income balance	-396.1	-176.3	-180.4	-356.8	-151.7
Receipts	181.0	114.6	96.1	210.6	120.2
Payments	577.1	290.9	276.5	567.4	271.9
Net transfers	104.4	89.4	147.5	236.9	110.7
Capital Account	-660.4	504.9	450.6	955.5	324.8
Direct Investment	137.5	315.1	189.7	504.8	109.6
Net portfolio invest.	-129.3	177.9	-45.0	132.9	-77.9
Change in government debt (incl. IMF)	-63.9	112.0	200.1	312.1	181.5
New loans	270.3	218.1	421.4	639.5	647.3
Principal paid	334.2	106.1	221.3	327.4	465.8
Non-government debt (net)	-139.4	-23.6	-37.0	-60.6	23.8
Net Loans received (assets)	338.2	129.6	9.5	139.1	-15.4
Other (including deposits and currency)	-803.5	-206.1	133.3	-72.8	103.2
Changes in official reserves	-751.2	862.4	777.7	1 640.1	429.0
Errors and omissions	-106.7	118.3	139.6	257.9	142.5

1. Preliminary estimates.

Source: Bulgarian National Bank and OECD calculations.

The effect of the crisis in Russia and the CIS on Bulgaria has been moderated by a strong re-orientation of Bulgarian exports toward OECD countries in recent years. But the impact on exports may be more significant than widely-believed. While Russia alone accounted for only 8 per cent of Bulgarian exports in 1997, an equally great amount (9 per cent) of exports were designated for other CIS countries, most notably Ukraine and Georgia. These countries have also been affected by the financial turmoil. By preliminary estimates, the share of exports to the entire CIS region declined to under 14 per cent during the first three quarters of 1998.

The capital account has also weakened since the second half of 1997, especially concerning inflows of foreign investment. Capital inflows had been relatively strong in the first half of the year (US\$493 million), following the initial IMF agreement. In the second half of 1997, however, this figure declined to 145 million (see Table 2). The turnaround in foreign portfolio investment is particularly striking. Significant inflows of portfolio investment in Bulgarian (mostly in ZUNK⁴ bonds) began following the new government and IMF agreement in

Table 3. **Bulgarian exports by country of destination: 1996-1998**

As a percentage of total exports

Destination	1996	1997	1998 (I-IX) ¹
OECD countries ²	51.6	57.8	62.6
<i>of which:</i>			
European Union	39.1	43.2	50.3
EFTA ³	1.0	0.9	0.8
Other OECD	11.5	13.7	11.5
CEFTA ⁴	3.5	3.4	4.9
CIS and Baltic States	19.0	17.4	13.4
<i>of which:</i>			
Russia	9.8	8.0	6.0
Other non-OECD	25.9	21.4	19.1
Total	100.0	100.0	100.0

1. First nine months of 1998.

2. OECD doesn't include Czech Republic, Hungary and Poland.

3. EFTA, European Free Trade Agreement includes Iceland, Norway, Switzerland, and Lichtenstein.

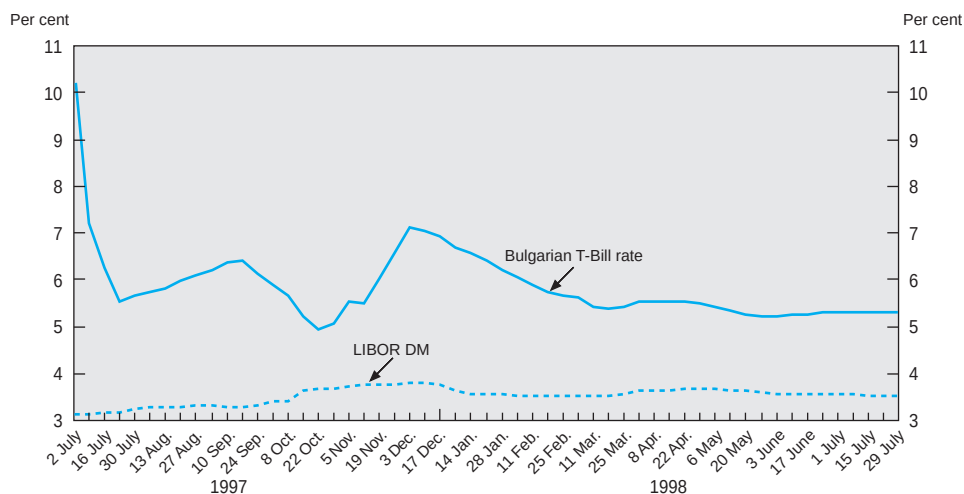
4. CEFTA, Central European Free Trade Area includes Czech Republic, Hungary, Romania, Slovakia and Slovenia.

Source: National Statistical Institute.

March 1997, continuing through the initial month of the currency board. But they subsequently turned negative for the remainder of the year and into 1998. For the months of April to July 1997 alone, net portfolio investment was registered at roughly US\$200 million, but decreased by this same amount between August 1997 and July 1998. High domestic interest rates and the expectation of imminent stabilisation after the announcement of the IMF programme attracted speculative capital. But interest rates fell very quickly to levels that no longer attract international portfolio investors (Figure 4). The interest differential between annualised yields on 3-month Bulgarian securities and the 3-month LIBOR for the DM fell steadily from 6.9 to 1.6 per cent between July 1997 and May 1998, partly due to a strong demand for government bonds by highly liquid and risk averse domestic banks (see Chapter II). Higher-than-expected inflation in the second half of 1997 also generated lower-than-expected real returns on Bulgarian assets for many investors. The relative absence of foreign portfolio capital in Bulgaria at the present time has tightened balance of payments constraints, on the one hand, but has also sheltered Bulgaria somewhat from the current turbulence on international financial markets. Sharp falls in the prices of Bulgarian securities in the fall of 1998 did not appear to have been accompanied by large capital outflows.

Foreign direct investment is examined in detail in Chapter III, where it is shown that a large share of the receipts in the first half of 1997 can be attributed to the conclusion of deals associated with a special “emergency” cash privatisation programme that was launched in the second half of 1996. After the introduction of the currency board, these inflows accelerated to a reported

Figure 4. **3-month Bulgarian T-Bill rate and the 3-month LIBOR for the Deutschemark**

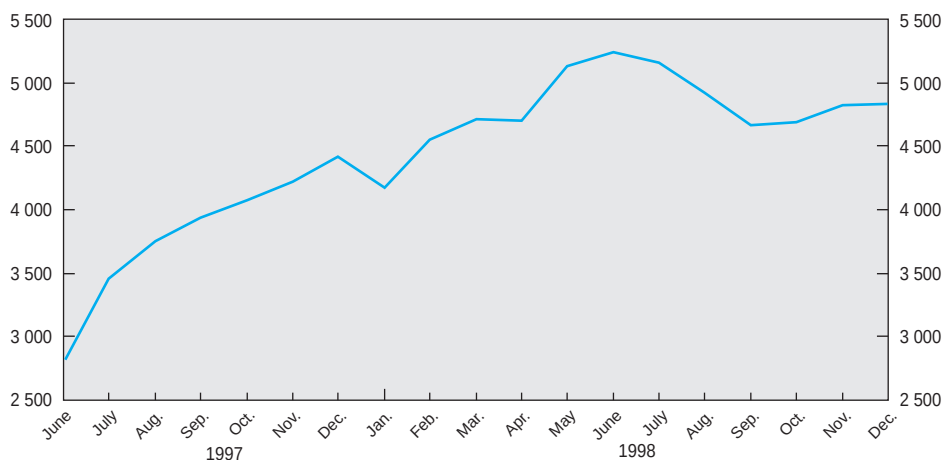


Source: BNB and Reuters.

US\$48.1 million for the month of July alone due primarily to the sale of a large cement plant. Inflows of foreign investment, foreign loans, and the restoration of demand for domestic currency after the implementation of the currency board were the primary factors that accounted for the accumulation of approximately DM 1 billion in foreign reserves in the third quarter of 1997 alone. From 1 July to 31 December, the gross assets of the currency board increased from DM 2.8 billion to 4.4 billion, while the value of currency in circulation moved from DM 599 million to DM 1.4 billion. Gross assets and currency in circulation have increased much more slowly in 1998 (Figure 5). Periodic servicing of the foreign debt and receipts of foreign credit have been responsible for most of the yearly fluctuations in reserves, while the positive overall growth of reserves in 1998 reflects new inflows of official external finance.

Receipts of external funding, mostly in the form of loans, appear to be more than sufficient to cover Bulgaria's needs to finance the balance of payments in 1998. Receipts of external support of close to US\$750 million appear sufficient to cover Bulgaria's balance of payments gap, as indicated in a slight accumulation of foreign reserves. The servicing of the foreign debt amounted a little more than US\$1 billion in 1998, and should remain in this range over the next few years. The medium-term programme of the Bulgarian government anticipates current

Figure 5. **Gross assets of the Currency Board**
Million DM



Source: BNB.

account deficits in the range of US\$400 million to 500 million, or close to 3 per cent of GDP, as opposed to US\$500 million to 600 million in official external support that Bulgaria hopes to receive. A weaker-than-expected current account would make these constraints rather tight, however. Thus, an important part of the medium-term programme is an additional expected inflow of foreign investment during this period.

The speed at which the Bulgarian economy can grow under the current macro-policy framework will depend on export growth and the attraction of foreign investment to relieve balance of payments constraints. In the event of a significant future overall balance of payments deficit, given the fixed exchange rate, any real exchange rate depreciation could be realised only through disinflation. In such a circumstance, certain prices and nominal wages would likely be sticky downwards, causing potential problems. For example, the disinflation of the first nine months of 1998 may have actually had a mixed effect on competitiveness due to the fact that nominal wages did not fall along with prices. The other option for the correction of the balance of payments would be import contraction through recession. Thus, given the current difficult environment for the attraction of foreign investment, the current account becomes more important as a potential constraining factor on Bulgarian economic activity.

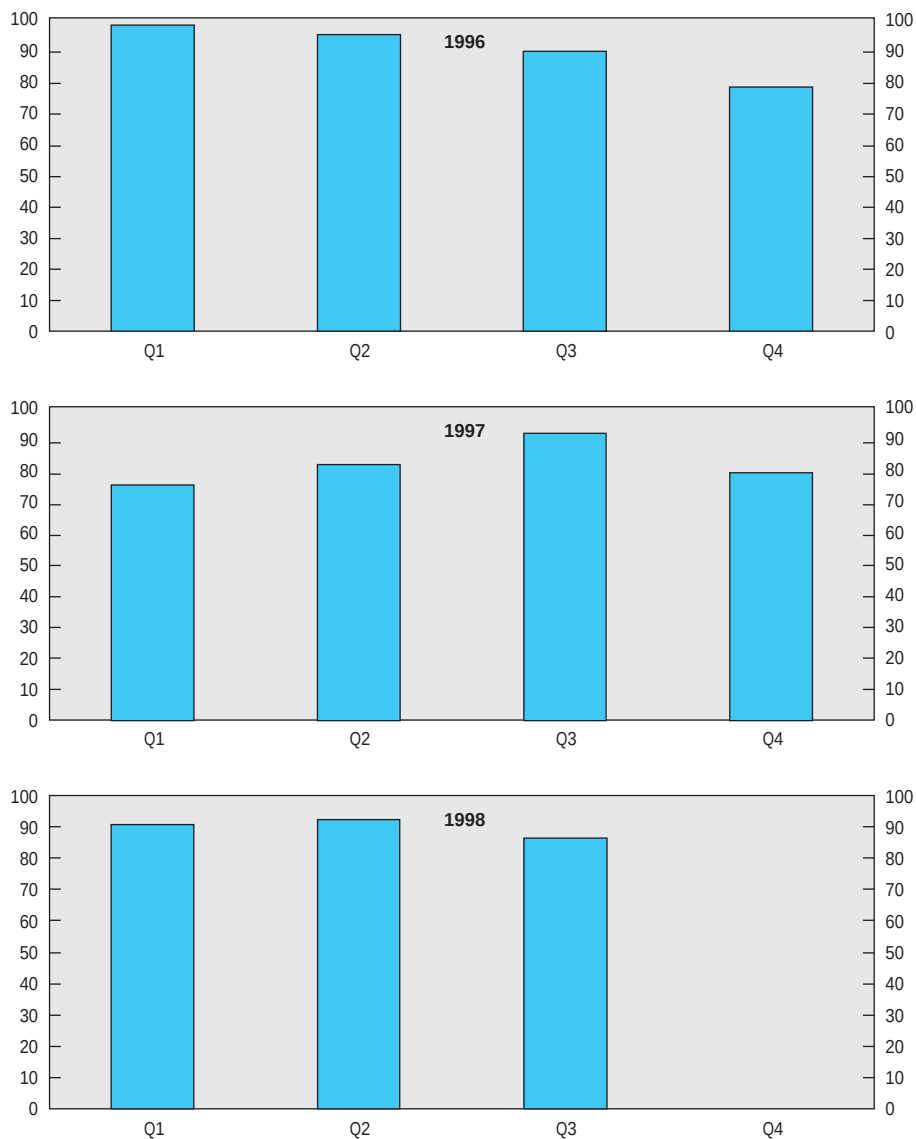
Due to the high share of loss-making enterprises in the state sector, the government has attempted to implement incomes policies as a means of controlling wage growth. These measures have so far had very limited success. A decree in the spring of 1997 allowed only those state-owned enterprises exhibiting net profits and no delinquency on tax payments to increase wages without restrictions.⁵ After May 1997, the absence of arrears on bank credit and payments to suppliers was added as a condition. Even in cases of arrears, however, profitable as well as loss-making firms showing improvement in their financial results retained the right to increase wages by 70 per cent of inflation. Enterprise based studies have shown, however, that these restrictions were not effectively implemented in 1997, and that problems have continued into 1998.⁶ As many of the violating firms are insolvent, the absence of effective institutions for bankruptcy and liquidation leaves little disciplinary power in the hands of the state. In addition, many poorly-performing enterprises exploited inflated balances (profitability) in the context of the rapid inflation of early 1997 to increase wages without violating the guidelines. Given the problems that have been identified above, the effectiveness of wage controls may need to be improved. At the same time, more severe measures that would punish wage growth in genuinely profitable enterprises may not be desirable due to the implied adverse effect on incentives.

Output and investment: the impact of the crisis and prospects for recovery

The economic crisis of 1996-1997 interrupted the modest recovery that had been recorded in output from mid-1994 through the first half of 1996. During this period, economic growth had come from two primary sources: predominantly state-owned export-oriented industrial firms, mostly in metals and chemicals, and a growing private sector consisting of new small firms in services, trade, agriculture, and construction. Figure 6 illustrates the steep decline in GDP by quarter following the eruption of the exchange rate crisis in the spring of 1996. This figure shows quarterly GDP in 1996, 1997, and 1998 relative to corresponding pre-crisis levels from the same quarter in 1995. Gross domestic product began to fall steadily in 1996 relative to its 1995 quarterly levels, sliding down to 10 per cent lower by the third quarter. By the fourth quarter, the real sector was in crisis. GDP was only 79 per cent of fourth quarter output in 1995, and fell further to 76 of the corresponding 1995 level in early 1997. GDP recovered somewhat by the end of the third quarter of 1997, but has since remained rather flat. Positive annual GDP growth in 1998 owes primarily to the particularly low level of output in the first quarter of 1997 at the apex of the crisis.

As indicated below in Table 5, the effect of the crisis on fixed capital formation (investment) appears to have been even greater than on output. The share of fixed capital investment in (declining) GDP fell from an estimated

Figure 6. Real quarterly GDP levels in 1996-1998 relative to 1995
1995 = 100¹



1. For Q_i , 1995 = 100, where $i = \{1, 2, 3, 4\}$.

Source: NSI and OECD.

Table 4. **The dynamics of GDP by sector**

Real value added: previous year = 100

	1992	1993	1994	1995	1996	1997
Agriculture and forestry	85.2	69.8	109.5	114.5	92.6	126.2
Industry and construction	93.6	93.8	106.0	94.6	88.2	86.9
Industry	89.9	93.4	106.9	92.0	87.1	90.6
Construction	112.5	92.7	99.7	102.2	79.2	64.0
Other	127.9	103.5	110.8	106.5	121.2	—
Services	73.1	100.6	96.9	104.0	90.7	76.4
Transport	103.9	108.5	103.1	139.8	100.0	108.6
Communication	102.9	108.0	100.9	132.5	108.1	93.1
Trade	80.8	100.4	107.6	102.1	78.5	62.9
Other services	65.6	99.1	93.3	98.3	93.0	74.7
Gross domestic product	92.7	98.5	101.8	102.9	89.9	93.1

Source: National Statistical Institute.

Table 5. **Real indices of consumption and investment**

1991 = 100

	1991	1992	1993	1994	1995	1996	1997
Consumption	100.0	96.9	93.5	89.2	87.5	81.7	69.3
Non-government consumption	100.0	101.0	100.2	97.6	97.1	95.7	80.7
Government consumption	100.0	85.1	74.5	65.6	60.2	42.8	37.9
Gross fixed capital formation	100.0	92.7	76.5	77.3	89.8	70.8	55.1

Source: National Statistical Institute and OECD calculations.

15.3 per cent of GDP in 1995 to 13.6 per cent and 11.3 per cent of GDP in 1996 and 1997, respectively. As shown in Table 4, construction reportedly fell by as much as 36 per cent in 1997, after declining by 20 per cent in 1996. The exact measurement of investment activity, particularly outside of the state sector, has long been problematic in Bulgaria. But a general strong decrease in such activity in 1996 and 1997 appears likely. For reasons discussed below, arresting the decline in investment may very well prove a more difficult task than that of reviving output.

The spillover of the financial crisis into the real sector appears to have derived primarily from two factors: the shock to domestic demand from the sharp fall in income and a dramatic contraction in commercial credit to the non-financial sector. Recorded expenditures on consumption in the fourth quarter of 1996 and first quarter of 1997 were roughly 20 and 30 per cent lower than their respective values in the previous year.⁷ In the presence of low domestic demand, output in

the export-oriented sectors of metals and chemicals suffered much less than did most other branches of the economy. While aggregate industrial output reportedly declined by 10 per cent in 1997, the dollar value of exports remained at the same level as the previous year. It should be noted, however, that exports in the first quarter of 1997 may have been bolstered somewhat by sales of inventories after the collapse of the lev.⁸ The effect of demand on output is also reflected in a decline in the share of services relative to (tradable) goods during the crisis period (Table 4).

The severe scarcity of new commercial credit to the non-financial sector since the second half of 1996 also contributed to the output decline. The sharp decline in credit followed the tough programme adopted for the banking sector in mid-1996. At that time, a radical reversal of National Bank policies reduced bank refinancing to insignificant levels and eliminated the former strong incentives in commercial banks to expand credit (see Chapter II). Another measure explicitly cut off all commercial credit to large-scale enterprises that were included in the Isolation and Liquidation Programme (see Chapter III). In the first half of the 1990s, compared to most other transition economies, Bulgarian firms operated with a much greater dependence on bank finance for their operations, as

Table 6. **Real industrial output**

Previous year = 100

	1996	1997	Share in 1997
Crude coal, oil, and gas	105.0	86.4	2.3
Mining and extraction of metals	128.1	96.1	2.4
Other mining and extraction	98.7	90.3	0.6
Food, beverages, and tobacco	101.9	82.7	16.9
Textiles	104.4	96.6	3.3
Manufacturing of wearing apparel (except fur)	123.4	99.2	2.2
Leather and footwear	111.8	87.8	1.3
Wood and wood products (except furniture)	98.3	102.2	1.1
Pulp and paper	91.0	86.3	3.1
Coke and refined petroleum products	112.6	70.6	11.8
Chemicals and chemical products	119.5	91.0	10.3
Rubber and plastic products	95.6	81.4	2.1
Other non-metallic mineral products	115.4	87.1	3.5
Metallurgy (production of metals)	99.3	108.5	11.5
Metal products	95.6	102.4	9.3
Machines and equipment	106.4	85.4	3.2
Transportation equipment	94.8	84.1	2.0
Other industrial production	97.7	80.9	1.1
Energy: electricity, gas and steam	101.6	106.6	12.0
Total	105.1	90.0	100.0

Source: National Statistical Institute.

Table 7. **The composition of Bulgarian exports**

As a percentage of total industrial exports

	1995	1996	1997
Metals	19.6	17.7	21.3
Chemicals and plastics	18.4	20.0	18.5
Textiles and footwear	12.8	14.8	16.2
Machinery and tools	14.1	15.2	14.6
Food, beverages, and tobacco	21.9	18.7	14.2
Minerals and fuels	8.3	9.0	10.2
Wood, paper, earthenware, glass	4.8	4.6	4.9
Total	100	100	100
<i>Memorandum (US\$ value of commodity exports)</i>	<i>6 926</i>	<i>4 890</i>	<i>4 914</i>

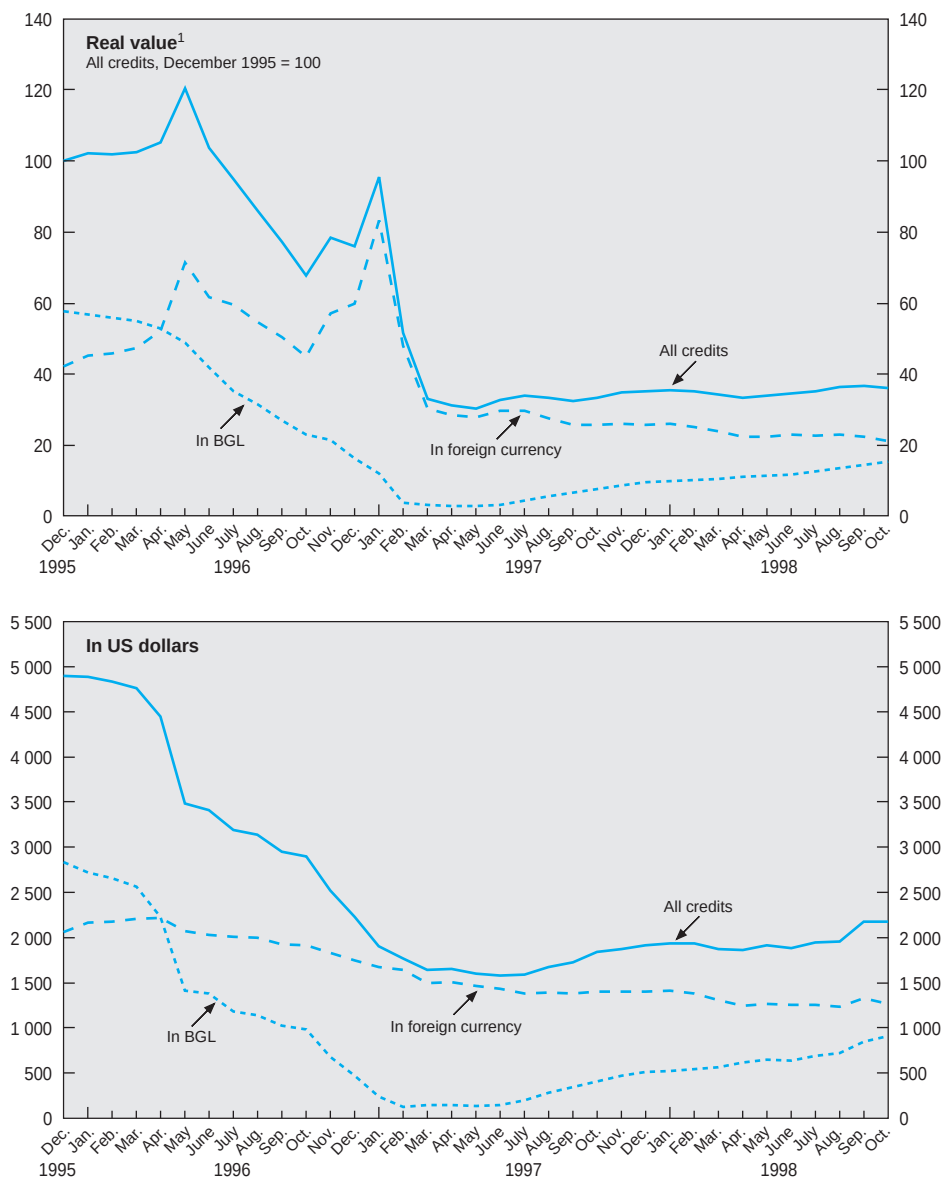
Source: National Statistical Institute.

evidenced by a very high share of (new) commercial credit in GDP.⁹ Figure 7 shows the decline in commercial credit to the non-financial sector both in real and in US dollar terms. Outstanding credit denominated in lev was devalued rapidly by inflation in the second half of 1996, while the value of outstanding dollar credit remained roughly constant. Since the fourth quarter of 1996, credit to the non-financial sector has remained quite stable, with new loans remaining at low levels (see Chapter II). The constant value of dollar-denominated credit reflects a high share of loans inherited from the past.

As illustrated in Figure 7, the real value of commercial credit (deflated by the CPI index) to the non-financial sector increased by 3.6 per cent in the first four months of 1996, but then experienced a steady and sharp fall in the second half of the year. By October 1996, the real value of such credit was only 68 per cent of that of 1 January. The rise in real credit after October was not due to new loans, but to an increase in the real value of foreign currency credits following a sharp depreciation of the currency. The real value of credit to the non-financial sector fell further with inflation in 1997 and has since remained at less than 40 per cent of its 1996 value. As discussed in Chapter II, a large part of the moderate pickup in lev-denominated credits in the second half of 1997 can be associated with agricultural credits supported by state guarantees. Preliminary data from the second half of 1998 do indicate a possible moderate increase in other new commercial loans, however.

According to official figures, output in the private sector actually increased somewhat in 1997, its share in gross value added moving from an estimated 56 to 66 per cent. This owes primarily to the effect on private sector statistics from the mass privatisation of a large number of industrial enterprises

Figure 7. **Outstanding commercial credit to the non-financial sector (real and dollar values)**



1. Deflated by monthly CPI.

Source: BNB.

(see Chapter III). In fact, it appears that output declined in new private small and medium-sized firms along with the fall in the state sector. As indicated in Table 8, areas where new small firms are concentrated, such as construction, trade, and services, all registered sharp declines in private sector activity in 1997. In industry, however, value added in the private sector roughly doubled, owing primarily to the above-mentioned re-categorisation of enterprises. Labour force statistics also show a reclassification of a large number of employees in the public sector in March 1997 to the private sector by December of that year.¹⁰

Table 8. **Real value added in the private sector**

Previous year = 100

	1992	1993	1994	1995	1996	1997
Total private sector	117.8	114.6	108.3	121.6	95.4	102.2
Agriculture and forestry	115.0	76.8	115.8	107.0	93.6	130.0
Industry and construction	133.6	147.7	116.2	133.1	101.9	149.4
Industry	100.8	233.5	110.1	176.3	104.8	201.8
Construction	179.7	152.5	126.1	123.3	84.9	65.7
Other	127.9	103.5	110.8	106.5	121.2	–
Services	115.4	122.4	103.7	124.3	94.1	79.7
Transport	239.8	169.7	119.3	191.6	85.9	119.4
Communication	–	1 800.0	113.6	457.6	249.9	101.0
Trade	187.0	132.0	122.1	119.2	78.6	64.1
Other services	98.0	115.4	97.0	120.6	101.6	81.4

Source: National Statistical Institute.

The events of 1996 and 1997 created difficulties for many small private firms for several reasons. As mentioned above, the new private sector also received a large share of new commercial loans in 1994-mid-1996 before the credit crunch. In addition, these firms may have been hit even harder by the shock to domestic demand, as exports were concentrated in larger industrial enterprises. It is also well known that a number of small private firms were used in the past by state enterprises as a means of “siphoning off” resources through transfer pricing, an opportunity that has declined significantly along with state subsidies.¹¹ In 1998, changes in taxation and tax administration also did not favour some small businesses. These measures included a crackdown on unregistered small businesses and the elimination of the eligibility for VAT refunds for firms with small turnover.

As indicated in Table 4 above, agriculture experienced a rapid recovery in 1997 relative to the disastrous year of 1996. Bulgarian agriculture had been in crisis even before the turmoil of 1996-1997. A combination of factors were responsible: the collapse of CMEA markets, severe price and trade regulations, a highly problematic and disruptive land restitution process, and the virtual absence of competition in wholesale markets. A combination of policy errors, beginning in 1995, which severely repressed domestic grain prices while at the same time offering a window of opportunity for exports, helped to produce a "grain crisis" in 1996 and early 1997. This necessitated official arrangements for emergency imports of grain to feed the population.

Since mid-1997, the government has taken strong measures to reform and liberalise agricultural markets. Important progress in land restitution is summarised in Chapter III. Grain and other agricultural prices were partially liberalised in 1997. As of 1998, export taxes and quotas have been removed for all but a few agricultural products (live animals and hides). A licensing regime for foreign trade operations involving agricultural products was eliminated as of 1 January 1999. The government has also been actively promoting the development of agricultural wholesale markets. Five livestock markets began operation in 1998 with help from a EU-PHARE project, and the European Bank for Reconstruction and Development (EBRD) is currently supporting a project for wholesale markets in fruits, vegetables, and flowers. Despite substantial European barriers to foreign trade in food products, agriculture appears to represent a possible area of genuine comparative advantage for Bulgaria.

The 26 per cent growth in gross value added in agriculture and forestry in 1997, due primarily to a bumper harvest, changed the situation of grain shortage to one of surplus. The situation may have actually evolved into a "poverty of riches" in 1998. The government did not explicitly commit itself to a minimum purchase price for grain as it had in 1997. Nevertheless, to ensure ample grain supplies and protect the incomes of farmers, the government, through its *Zemedelie Fund*, did issue a number of loans to farmers that were to be repayable after the 1998 harvest in grain at BGL 230 000 per tonne, an amount equal to the minimum purchasing price in 1997. But another big harvest in 1998 and low international grain prices created problems for the implementation of this commitment. After spending BGL 76 billion in 1998 to support grain prices, the government subsequently ceased to intervene on the market. Despite the contractual agreements, the *Zemedelie Fund* reportedly evaluated grain only at the implicit price of BGL 110 000 a tonne, roughly corresponding to the prevailing market price of grain. Some farmers were reportedly threatening not to produce wheat in 1999.¹²

Bulgaria has recently taken several general steps aimed at integrating itself further into world markets. In accordance with WTO obligations and a new foreign trade regime, import duties were decreased in 1998 by close to 10 per

cent, moving the average level of protection for Bulgarian imports to roughly 16 per cent in 1999.¹³ The medium-term economic programme of 1998 introduced further measures that are consistent with Bulgaria's medium-term ambition of accession to the EU. This includes the removal of all remaining export taxes except those on timber, the further gradual reduction of tariffs, and the elimination of so-called import surcharges. Further gradual capital account and foreign exchange liberalisation is also envisioned.¹⁴ As of 1 January 1999, Bulgaria became an official member country of the Central European Free Trade Agreement (CEFTA), which includes the Czech Republic, Poland, Romania, Slovakia, Slovenia, and Hungary. Under CEFTA arrangements, 80 per cent of all non-agricultural goods trade duty free between these countries, while the remaining 20 per cent also usually trades under special lower duties. A free trade agreement was also reached with Turkey, under which 90 per cent of all non-agricultural goods are not subject to duties. Similar negotiations are also under way with other countries, including the Baltic states, Morocco, the Former Yugoslav Republic of Macedonia, and Israel. The further liberalisation of the Bulgarian trade regime should be beneficial to exporters and consumer welfare. Under the currency board, however, an excessive weakening of the trade balance in this context is likely to be countered by strong downward pressure on income and aggregate demand. With a goal to strengthening exports, the government and Ministry of Trade and Tourism are in the process of developing institutions for export promotion, including state guarantees for export insurance (The Bulgarian Export Insurance Agency) and the creation of a special Bulgarian Export Promotion Centre (with EU-PHARE support).

Given the former very high dependency of many Bulgarian firms on commercial credit, the possible strong impact of the credit crunch on output is understandable. The low level of institutional development of financial markets, corporate governance, and bankruptcy in Bulgaria makes an immediate strong revival in commercial credit to the non-financial sector highly improbable. Still, some of the obstacles to economic recovery may be of a short-term nature. Bulgarian firms may be still experiencing high transaction costs in their efforts to adapt to operating under much lower liquidity. Some of the adjustment costs from the large-scale turnover in firm management in 1997 (see Chapter III) may also be transitory. A partial revival of very short-term credit, particularly for profitable foreign trade operations, is also a possibility (see Chapter II).

The experience of more advanced transition countries in the region supports the conclusion that small private businesses and foreign direct investment represent two very promising sources for achieving and sustaining economic growth in the near future in Bulgaria.¹⁵ For those industrial firms that do not receive substantial foreign investment, some improvements in efficiency and restructuring could follow from the tightening of financial constraints and an increased threat of liquidation for loss-makers. At this stage of transition, however, a very limited short-run effect should be expected from privatisation of large

industrial firms that does not involve the strong outside participation of entrepreneurs or foreign investors. Without such participation, there is little reason to expect greatly improved managerial incentives or better access to external funding in newly-privatised firms.

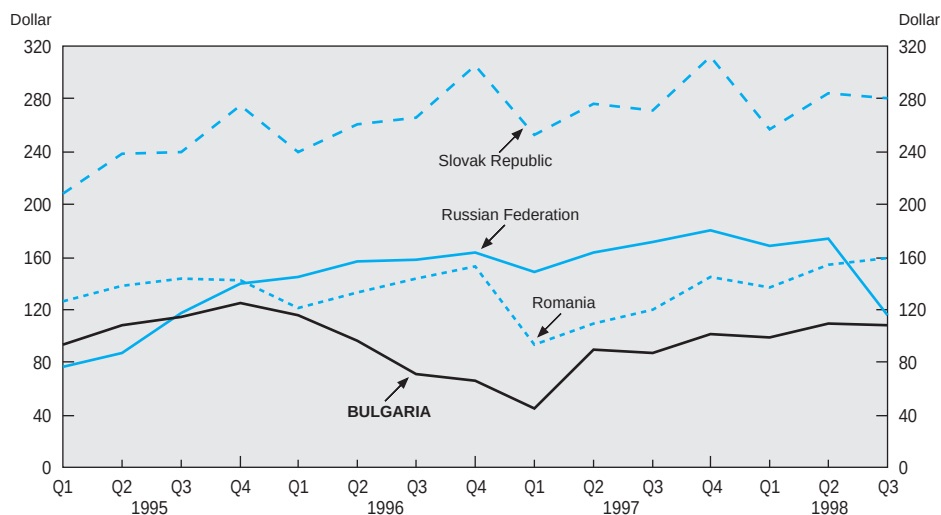
As emphasised above, given the tight balance of payments constraints, an economic revival in Bulgaria will probably require a strong export orientation. The former high degree of implicit subsidisation through commercial banks in Bulgaria complicates the assessment of the potential export competitiveness of Bulgarian industry. A partial analysis of the profitability of exports in the 1997 *OECD Economic Survey of Bulgaria* offered mixed results, but concluded that the sustainability of growth based on the structure of exports in 1994 and 1995 was unlikely.¹⁶ Certain export-oriented sectors, particularly steel, will unlikely be able to operate at a profit in the medium term. A comprehensive study of competitiveness by WIFO and WIIW also produced mixed conclusions for Bulgaria. Although Bulgaria possesses an advantage in human capital and relatively low labour costs, exports may be currently too concentrated in resource-intensive industries.¹⁷

Despite the real appreciation of the currency and partial recovery in real wages, labour costs in Bulgaria appear to remain low in general compared with most other transition economies. By most measures, the Bulgarian labour force has a rather high level of education and training. Among eastern European transition countries, only Romania has wages at levels comparable to Bulgaria (see Figure 8). Changes in labour costs in Russia since the depreciation of the rouble could be a potential threat to competitiveness, however, as Bulgaria and Russia share export concentrations in metals and chemicals. Dollar wages in Russia have fallen well below those in Bulgaria in the second half of 1998. The currencies in other countries in the region have also come under increasing pressure in 1998. Therefore, in the absence of compensating increases in productivity, future significant real appreciation or wage growth in Bulgaria could present serious difficulties for Bulgarian exporters. As discussed above, attempts by the government to limit wage growth in state-owned enterprises since the introduction of the currency board have so far had very limited success.

Problems in corporate governance present a strong obstacle to growth, investment, and the rebuilding of credit markets in Bulgaria. Poorly developed capital markets and bankruptcy institutions leave little scope for the replacement of inefficient management other than through sales to outside entrepreneurs and foreign investors. The large number of recent management and employee buyouts, while possibly strengthening the incentives of existing employees, may have still even further cemented current management to firms in the short run (see Chapter III).

A rather high tax burden, together with rapidly changing tax rules and legislation, are often cited as a significant hindrance to successful business and profitable investment in Bulgaria. The most important taxes are the VAT (a 20 per

Figure 8. **Average dollar value of gross monthly wages in Bulgaria and selected transition economies**



Source: NSI and OECD.

cent rate), profit and municipal corporate taxes (average 37 per cent), social security contributions (40-50 per cent of the wage bill), and income taxes. Until the revision of depreciation allowances to account for past inflation in 1998, the actual burden of the profit tax was, in fact, much higher. Numerous and often unpredictable special exemptions or fees have also been common. The medium-term programme of the government has, as of January 1999, decreased the VAT rate from 22 to 20 per cent and reduced the marginal profit tax rate for the highest bracket. An additional 6 per cent tax on the wage bill for financing a new fund for national health insurance is introduced, although its burden is to be compensated by decreases in other social insurance contributions and the income tax. Important measures have also eliminated most special exemptions and broadened the tax base.

The medium-term economic programme of the Bulgarian government projected GDP growth of 4.5 per cent in 1999, building to 4.8 and 5.1 per cent in 2000 and 2001, respectively. Subsequently, the growth projection for 1999 was reduced to 3.7 per cent. Given the current difficult situation in many Bulgarian firms described above, together with the absence of a significant upward trend in output since the second half of 1997, these goals appear optimistic. Although growth in 1998 should be in this range, this can be attributed partly to abnormally

low output in the first half of 1997.¹⁸ Surveys of the National Statistical Institute point to falling profits and more pessimistic attitudes among Bulgarian industrial firms in mid-1998 than mid-1997. Reported sales of industrial enterprises declined steadily in the second half of 1998.¹⁹ The medium-term programme foresees a major pick-up in investment. But domestic financial markets cannot yet be expected to provide these funds and attracting a large amount of direct foreign investment in the current environment may be difficult. The medium-term programme does include a commitment of rather substantial resources (2.5 per cent of GDP per year through 2001) for infrastructural investments. In fact, part of this programme was already launched in the second half of 1997. The benefits of this programme may be rather limited in the near future, however. If Bulgaria does succeed in achieving such high growth rates, this growth will most likely come from a boom in new private business or a substantial improvement in the international and Bulgarian investment climate. But the conditions to support such developments are not yet in place.

The budget, fiscal policy, and government debt: from crisis to consolidation

The absence of active monetary policy under a currency board places pressure on the government budget and fiscal policy. As the National Bank (Issue Department) is unable to hold domestic assets, budget deficits can only be financed through commercial borrowing, external borrowing, or the sale of state assets. This poses the theoretical danger of a debt and interest rate spiral that could quickly threaten the entire macroeconomic policy regime. It is therefore fortunate that Bulgaria has succeeded in rapidly strengthening its fiscal position. This owes partly to a special set of measures, including a restructuring of some domestic debt, external support for the budget, and the creation of a special “Fiscal Reserve Account”. The budget deficit was reduced well below target in 1997 and eliminated in 1998. In the context of the currency board regime, the achievement of fiscal consolidation in Bulgaria is one of the most important accomplishments of the Bulgarian government.

A number of important extra-budgetary funds hindered the transparency of Bulgarian fiscal policy before the adoption of the programme of March 1997. This particularly concerns the State Fund for Reconstruction and Development (SFRD), which housed a number of off-budget subsidies and investments. Since the introduction of the currency board arrangement, these and other extra-budgetary funds (other than the Social Insurance Fund that was combined with the state budget) have been placed together with other resources into a “Fiscal Reserve Account”. The Fiscal Reserve Account accumulated from BGL 1 115 billion on 1 July 1997 to 1 703 billion by the end of year, and was also approximately in this range at the end of 1998. The majority of fiscal reserves of

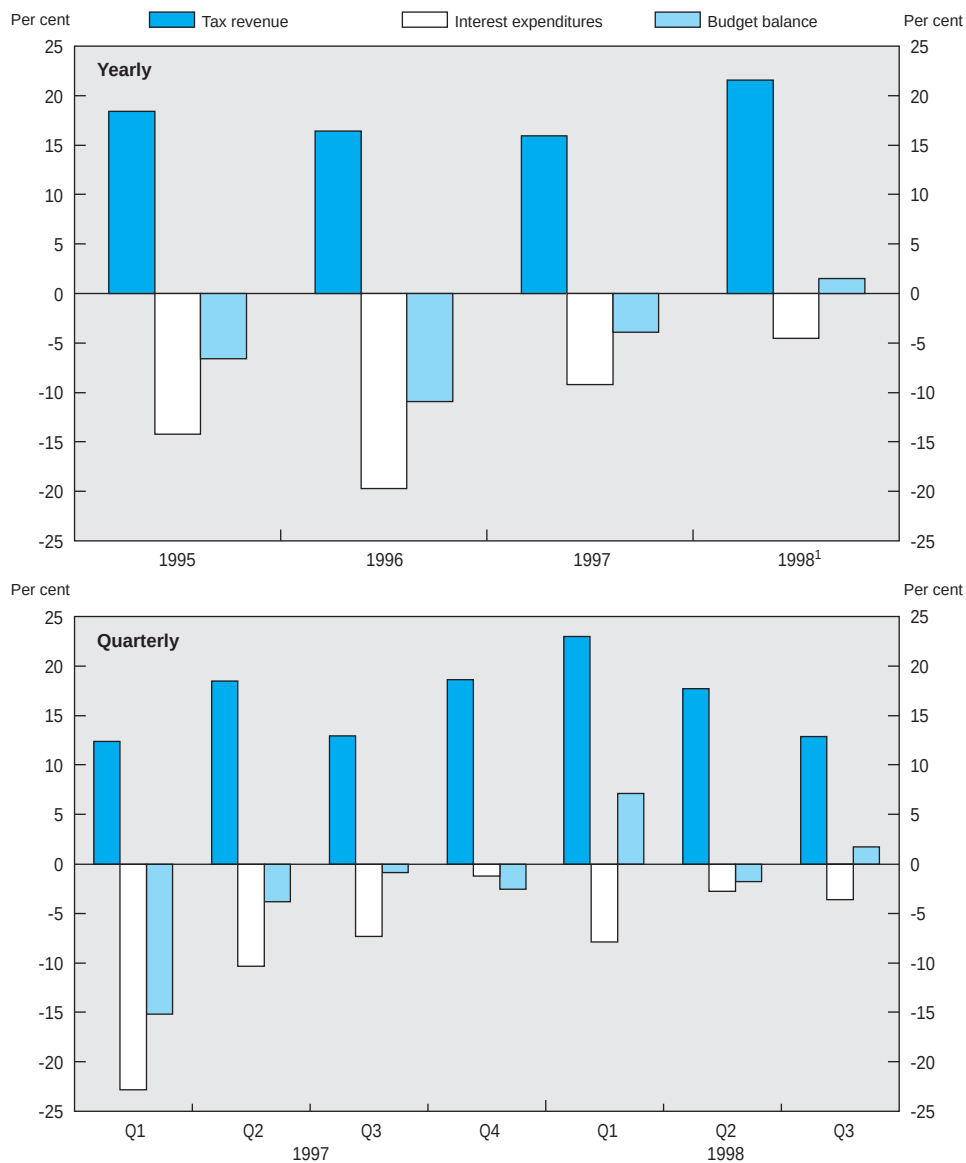
the Ministry of Finance are held at the BNB Issue Department. The new agreement of mid-1998 with the IMF calls for the explicit elimination of the SFRD, the other relatively large Energy Resource Fund, and some other smaller funds, with their former revenue sources and expenditures being explicitly incorporated into the state budget. This decision has been approved by the Bulgarian Parliament.

Figure 9 and Table 9 illustrate the rather dramatic transformation from severe and growing fiscal imbalance at the end of 1996 and early 1997 to fiscal consolidation and budgetary surplus by the first quarter of 1998. The consolidated budget, which includes extrabudgetary funds, showed a surplus of 0.9 per cent of GDP in 1998. The sharp fall in budgetary expenditures on debt service was particularly critical for the achievement of budgetary balance, although improvements in tax collection have also been important. As mentioned above, Bulgaria had been generating primary budgetary surpluses of over 7 per cent of GDP since 1994. This was associated with a generally low level of social and other non-interest expenditures relative to most other transition countries. An important question for the future budgetary situation in Bulgaria, given social and political pressures, is the degree to which this can or should be maintained. The fact that Bulgaria had already succeeded in operating with a strong primary budgetary surplus in the past aided the initial political and social feasibility of achieving overall budgetary balance following the reduction in the burden of interest payments.

The decline in domestic interest rates, as well as a longer maturity of state debt, has been of prime importance for deficit reduction. The rapid decline in interest rates on state securities was both a cause and effect of success in fiscal consolidation. Interest expenditures by the state as a share of GDP declined from 20 per cent at the end of 1996 and first quarter of 1997 to 1.2 per cent in the fourth quarter of 1997. Due primarily to the demands of foreign debt service, interest payments have remained around 4 per cent of GDP in 1998. The vast majority of the decline in interest payments concerns domestic debt, which had much shorter maturity than the (larger) foreign debt. The maturity of government debt also profited from an operation of mid-1997 that replaced BGL 626 billion of claims on the government held by the National Bank, and an additional BGL 500 billion is US bonds to be held as collateral for servicing Brady Bonds that become due in 2019, with a direct long-term credit made available through IMF drawing rights.²⁰

Increases in tax revenue have also been significant. Tax revenue targets in the 1997 and 1998 budgets were significantly overfulfilled, while the share of (consolidated) tax revenue in GDP increased from 26 per cent of GDP in 1996, to 28 per cent in 1997, and to a preliminary estimate of 32.3 per cent in 1998. The upward trend in both 1997 and 1998 was supported, to some degree, by the high balance sheet profitability of Bulgarian enterprises and financial institutions in

Figure 9. Tax revenue, interest expenditures
and central budgetary balance
As a percentage of GDP



1. Numbers for 1998 are preliminary.

Source: Ministry of Finance.

Table 9. **The consolidated state budget**

As a share of GDP

	1995	1996	1997	1998 ¹	1999 ²
I. Total revenue	36.8	34.0	32.9	37.1	35.4
Tax revenue	29.1	26.4	28.0	32.3	31.4
Non-tax revenue	7.5	7.5	4.5	4.8	4.0
Assistance	0.1	0.1	0.4	0.2	0.0
Extrabudgetary funds and accounts	0.0	0.0	0.0	-0.3	0.0
Revenue from state and municipal property sales	0.1	0.1	0.1	0.1	0.0
II. Total expenditure	43.4	50.6	35.5	36.2	38.1
Wages and salaries	4.7	3.5	3.6	4.4	4.5
Social expenditures	10.6	9.1	8.9	10.5	10.8
<i>of which: Pensions</i>	8.0	7.0	6.3	8.0	8.1
Maintenance/Operating	6.8	5.8	7.9	7.3	8.8
Defence and security	3.6	3.0	3.6	4.0	3.8
Producer subsidies	1.3	6.3	1.1	2.0	1.4
Interest	14.1	21.2	8.4	4.2	4.8
Other	2.3	1.7	2.0	3.8	4.0
Balance	-6.6	-16.6	-2.6	0.9	-2.8

1. Preliminary estimates.

2. Budget law.

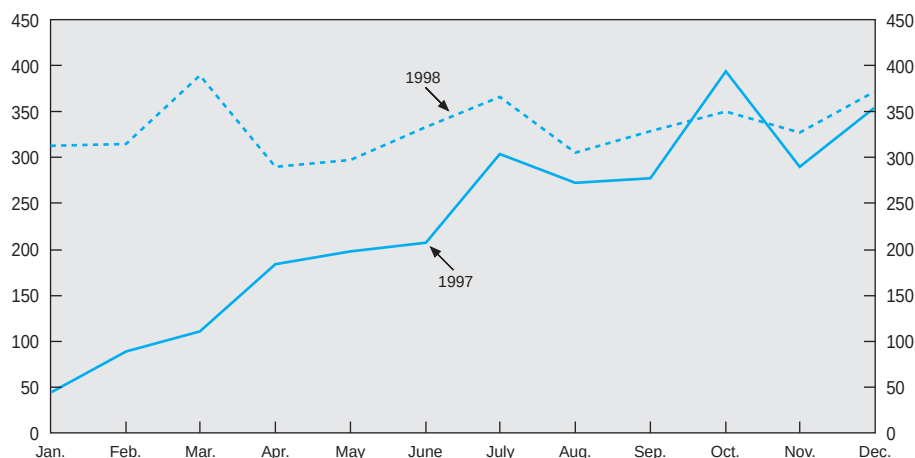
Source: Ministry of Finance.

the context of the hyperinflation, as alluded to above. High profit tax receipts reflect the fact that depreciation allowances were fixed in lev terms and not adjusted to inflation until 1998, at which time they were increased seven-fold. The programme of mid-1997 also contained measures to tighten discipline in tax administration. Evidence supports the conclusion that these measures have had some effect. The improvement in tax collection has been maintained and strengthened in 1998, despite lower enterprise profits.

Figure 10 shows (nominal) monthly tax revenue to the Central Budget in 1997 and 1998. Some of the factors that pushed up tax collection in 1998 also appear to be temporary. Even correcting for inflation, the crisis of early 1997 pushed revenues below “normal” levels. A number of large tax debts that accumulated in 1997 were collected in 1998. This particularly concerns VAT revenue. The abnormally high tax collection in March 1998 was due to a one-time payment by financial institutions of taxes due on profits from 1997, as well as to some advanced payments on corporate taxes. A number of banks that had a large share of assets denominated in dollars profited greatly from the inflation and currency depreciation of early 1997.

Figure 10. Monthly tax revenue to the central budget in 1997 and 1998

Million BGL



Source: BNB.

The fact that the basic positive momentum in tax collection was maintained even after the exceptional months in the first quarter of 1998, however, may owe partly to factors of a more permanent nature. Tax administration has been toughened, along with a crackdown on tax evasion. A higher minimum turnover requirement for registration for the VAT, introduced in early 1998, gave businesses an incentive to reveal their (higher) turnover in order to qualify for reductions. It also greatly limited eligibility for the tax. Roughly 700 firms registered for the VAT in 1998, only close to half of the number registered in 1997.²¹ Consistently higher VAT revenue was the main factor responsible for the sustained improvement in tax revenue in 1998. VAT receipts to the central budget were an estimated 75 per cent higher in nominal terms in 1998 than in 1997, and moved from 38 to 45 per cent of all tax revenue. Profit tax receipts from firms, on the other hand, have been consistently lower in 1998 than 1997, reflecting lower profits. Roughly 45 per cent of profit taxes collected in 1998 came from taxes due in 1997. The degree to which the positive trend in tax revenue can be maintained in the presence of what appear to be growing financial difficulties in the industrial sector of the economy is an important question.

Following the impressive results in 1998, the 1999 budget is considerably more ambitious than the budget law of 1998. Tax revenues are projected to remain at the high levels achieved in 1998, while expenditures will rise by 24 per

cent. A deficit is officially projected at up to 2.78 per cent of GDP, although the government has announced unofficially an intention to maintain a balanced budget if possible, or at least to keep the deficit below 2 per cent. Several new tax amendments came into effect in 1999. The VAT was reduced from 22 to 20 per cent. The highest marginal tax rate on profit (for over BGL 50 million) was also decreased from 37 to 34.3 per cent. The government intends to compensate for the reduction in revenue from these measures by the elimination of the vast majority of specific tax preferences, including those offered to foreign investors.²² An additional social security payroll tax of 6 per cent will also be levied for the creation of a National Health Insurance Fund. For businesses, a possible investment tax credit in the order of 8 to 10 per cent is under consideration. Given these changes in tax laws, the fact that receipts in 1998 were boosted by temporary factors, and the low liquidity and profits of many industrial firms, the achievement of the revenue target in the 1999 budget may be difficult.

Despite success in fiscal consolidation and debt restructuring, Bulgarian government debt remains high enough to be a potential obstacle to economic growth and stability in the medium and long-term (Table 10). After falling from over US\$10 billion to 9.59 billion during 1996, the dollar value of Bulgarian gross foreign debt increased marginally in 1997 to 9.76 billion, or 96 per cent of GDP. It further increased to US\$10.07 billion by the end of 1998, although a higher dollar value of GDP has probably caused the external debt/GDP ratio to decline to close to 85 per cent. US\$9.13 billion of this represents government debt. The external support associated with the new three-year programme implies that Bulgarian hard currency debt should remain fairly constant in the next few years, while servicing demands will gradually grow. Due to expected increases in the dollar value of GDP, however, debt/GDP ratios are projected to steadily decline.

Bulgarian domestic government debt consists of lev-denominated treasury bills, lev and dollar-denominated "ZUNK bonds", lev and dollar-denominated bonds issued for deposit insurance for failing banks in 1996 and 1997, and other miscellaneous bills. ZUNK bonds, which date from 1993, were placed in the portfolios of commercial banks as part of the government programme to assume non-performing commercial loans issued before 1991. The dramatic fall in the value of domestic debt from 65.3 to 16 per cent of GDP in 1997, shown in Figure 11, can be associated with a number of factors. The rapid inflation of early 1997, combined with the shift to predominantly fixed-rate T-bills in late 1996 and early 1997, devalued much of the lev-denominated debt. Lev-denominated domestic debt fell from 31.5 to 5.5 per cent of GDP during 1997. Second, the IMF sponsored programme of March 1997 replaced a part of domestic debt with foreign debt (IMF funds). Third, success in fiscal consolidation has been associated with a smaller supply of new treasury bills. The sharp fall in the dollar-denominated component of domestic debt in GDP shown in Figure 11 is due primarily to a higher dollar value of GDP. Separate from this effect, the value of

Table 10. **Bulgarian foreign debt**

Millions US\$ (end of period)

	1995	1996	1997	1998 ¹	% of GDP end 1998 ⁴
Gross foreign debt²	10 229	9 596	9 757	10 072	80
A. Long-term debt	8 841	8 570	8 561	9 266	73
(of which state or state guaranteed)	8 500	8 335	8 494	9 133	72
Official creditors	3 085	3 189	3 272	4 051	32
of which:					
International financial institutions	1 627	1 984	2 242	2 781	22
Bilateral credits	1 428	1 205	1 030	1 270	10
Private creditors	5 757	5 382	5 289	5 215	41
of which: Brady bonds	5 005	4 984	4 924	4 946	39
B. Short-term debt³	1 388	1 025	1 196	806	6
(of which state or state guaranteed)	916	684	684	352	3
<i>Memorandum: GDP</i>				12 638	

1. Preliminary data.

2. In convertible currencies. Data is provided by the Bulgarian National Bank, Ministry of Finance and Bulbank.

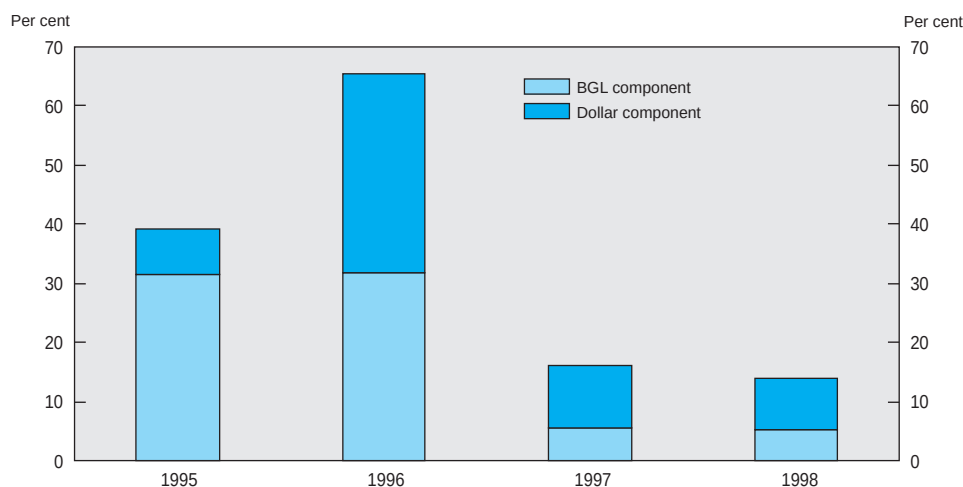
3. Including overdue principal and interest.

4. Projection.

Source: Bulgarian National Bank.

Figure 11. **Bulgarian domestic debt**

As a percentage of GDP



Source: BNB.

outstanding dollar-denominated ZUNK bonds has also declined, from US\$910 million in 1996 to US\$670 million at the end of 1998 as a consequence of debt restructuring and the use of ZUNK bonds in privatisation auctions.

Employment, income and living standards: the costs of prolonged transition

The particularly difficult experience of economic transition in Bulgaria is mirrored in low incomes and living standards compared to many other central and eastern European countries. The burden of government debt has also led to social assistance being compressed to rather low levels. The 1997 *OECD Economic Survey of Bulgaria* documented several disturbing trends in Bulgarian living standards relative to other transition countries: relatively high rates of unemployment, a longer average duration of unemployment, a social insurance system in deep crisis from increasing demands and falling resources, and growing poverty. The combination of very high inflation, tightened financial policies, and blocked access to household bank deposits in the second half of 1996 and early 1997 had a very negative effect on the welfare of many Bulgarian households, a number of which had already been living close to the subsistence margin. By December 1996, the average dollar wage in the state sector in Bulgaria had fallen to US\$56. By early 1997, food riots were even reported in some areas. General civil unrest eventually pressured the socialist-dominated parliament to agree to early elections.

Subsequently, income and wages have witnessed a partial recovery, although they are still below the pre-crisis levels at the end of 1995. Registered unemployment showed some decline in mid-1998, even above what should have been implied by seasonal factors, but apparently increased again in the last two months of 1998. Estimated real wages in the state sector remain roughly 17 per cent lower than before the crisis.²³ As indicated in Table 11, the deterioration in living standards of the Bulgarian population during the turmoil of 1996 and 1997 is visible in demographic and health, as well as economic, indicators.

As shown in Table 11, unemployment remains significant, registering at an even higher rate (16 per cent) in the November 1998 labour force survey than in November 1997 (15 per cent). This contrasts with a reported fall to close to 12 per cent, a figure lower than that recorded in June 1997. The stubbornness of high unemployment in Bulgaria is yet another indicator that the partial recovery in output has levelled off since the second half of 1997, with unfinished restructuring and liquidity constraints inducing firms to downsize.

Very high rates of official exit from the labour force continue to be a striking feature of economic transition in Bulgaria. Several explanations have been offered for this phenomenon. Low benefits and limited eligibility have reduced the incentive for the unemployed to register. The share of registered unemployed

Table 11. **Basic welfare indicators**

End of period unless otherwise indicated

	1995	1996	1997	1998
Unemployment rate (% of labour force, ILO definition) ¹	14.7	13.7	15.0	16.0
Rate of registered unemployment ²	11.0	12.5	13.7	12.2
Average wage (state sector) (US\$) ³	127.4	56.0	107.6	124.6
Share of household income spent on food	46.3	48.2	54.4	—
Real wage index (state sector) ³	100.0	70.2	76.5	82.6
Share of wages in income	55.1	52.1	53.3	—
Birth rate (per 1 000)	8.6	8.6	7.7	—
Death rate (per 1 000)	13.6	14.0	14.7	—
Infant mortality (per 1 000)	14.8	15.6	17.5	—
Registered cases of cancer (per 1 000)	21.2	22.0	22.5	—

1. November estimates 1996,1997,1998. October estimate 1995.

2. Source: National Office of Employment at Ministry of Labour and Social Affairs.

3. OECD estimates.

Source: National Statistical Institute; National Office of Employment, Ministry of Labour and Social Affairs; OECD.

with an over one-year period of registration increased from 21.5 per cent at the end of June 1997 to 38 per cent by June 1998.²⁴ Labour force surveys document an even more serious situation; over two thirds of the unemployed suffer long-term unemployment.²⁵ Given the absence of eligibility for benefits, it is natural to expect that a low percentage of these workers will register. A second, and somewhat more optimistic, explanation concerns the substantial informal economy in Bulgaria.²⁶ High social security taxes give employers a strong incentive not to register new employees. Third, a large share of workers have indeed left the labour force in recent years, including women homemakers and numerous cases of early retirement. Many believe that this is related to the nature of the current social security system that offered relatively generous options for early retirement to several categories of employees.

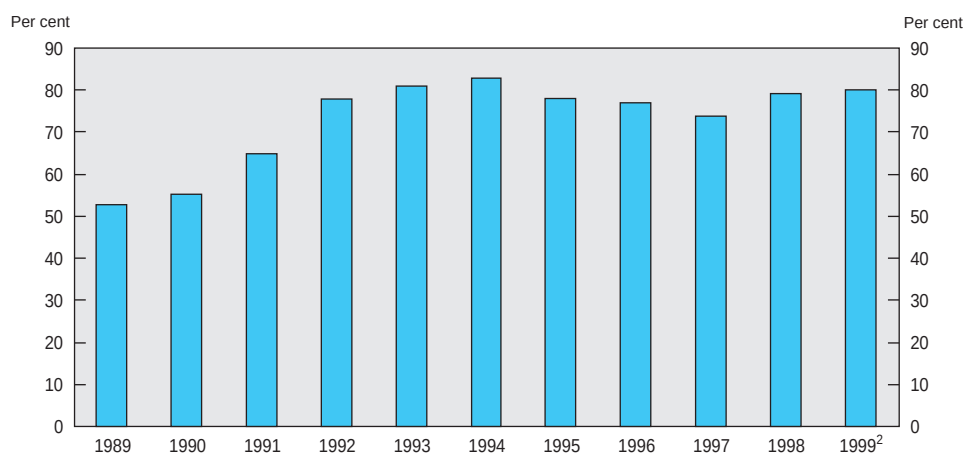
Given the substantial degree of restructuring that lies ahead for Bulgaria, unemployment promises to be a serious problem in the country for several years to come. The hardship inflicted on the population from further shake-outs in large loss-making industrial firms will depend greatly on the ability of the private sector to absorb labour. Bulgaria already possesses a wide range of programmes for supporting and retraining unemployed workers, including a special Vocational Training and Unemployment Fund. But these programmes generally suffer from rather low funding. Payments from the consolidated budget for passive and active labour policies comprised only roughly 0.5 and 0.6 per cent of GDP in 1996 and 1997, respectively. This is very low relative to eastern European transition countries other than Romania.²⁷ The World Bank is scheduled to provide some assistance in this area in the near future under the terms of a two-year Social Protection Adjustment Loan of 145.7 million DM.

Despite the partial recovery in the second half of 1997 and early 1998, the decline in wages and income during the economic crisis has re-enforced the position of Bulgaria as one of the poorest eastern European economies in transition. According to household survey data, monthly average per capita money income in 1998 remains under US\$50. On aggregate, roughly half of this income comes from wages and one quarter from pensions. As emphasised above, however, further substantial wage growth in Bulgaria that is not based on productivity gains could be a potential threat to growth and stability at this time.

On a more optimistic note, the real incomes of Bulgarian citizens may actually be higher than the above statistics would indicate. First, a large number of Bulgarian households own small plots of land and raise their own produce. It has been suggested that this was an important factor in alleviating the impact of the economic crisis on households. This factor does not show up clearly in official NSI household survey data, which shows the share of imputed income from private plots in household income increasing only from about 5 to 6 per cent during the crisis period. Those numbers would be roughly consistent with a fall in income from other sources and constant (modest) output from private plots. But a number of Bulgarian specialists contend that part of household-produced income is not captured in official statistics.²⁸ In addition, the real average monthly wage in Bulgaria is also almost certainly higher than the figure of US\$124.6 reported for June 1998 in Table 11. The presence of high social security taxes, as indicated above, gives a strong incentive to under-report wages or resort to forms of non-wage compensation. This appears to be the primary reason why official wages in the private sector are consistently lower than wages in the state sector. Paying the official minimum wage is always advantageous for a private firm, whereas wage scales in state firms are more institutionalised.

The social security and health systems in Bulgaria have recently been a source a great concern. Both of these systems are slated for difficult and comprehensive reform in the near future. The pension system has been plagued by an ageing population and rising dependency ratio at a time when resources are scarce. This ratio rose quickly from a little over 50 per cent to close to 80 per cent in recent years (Figure 12). The state budget contributed to the Social Insurance Fund, including pensions, on the order of 1.5 per cent of GDP in 1996 and 1997. At the same time, under the current pay-as-you-go system, eligibility for benefits tends to be rather liberal by international comparisons, leading to a thin spread of limited resources. While the standard retirement age for full benefits is 60 for men and 55 for women, the effective ages are lower due to exceptions made for particular categories of work. The average length of service required for eligibility is less than the officially-stated 25 years due to wide-spread access to early retirement benefits (about 15 per cent of employees).²⁹

Figure 12. **Public pension dependency ratios in Bulgaria, 1989-1999¹**



1. Number of pensioners as a per cent of the total number of pension contributors.

2. Projection.

Source: World Bank, Social Challenges of Transition database.

A draft proposal for pension reform seeks to address the sustainability of the pension system by creating three tiers. This combines pay-as-you-go, fully-funded, and voluntary components. Retirement ages will gradually be increased, while special eligibility for early retirement will be reduced. The medium-term programme estimates a transitional cost of this programme to be close to 1 per cent of GDP each year through 2001. A second new initiative seeks to revive the resource-strapped health care system, with the goal of reversing the overall deterioration in health and demographic indicators, a few of which are given in Table 11. As mentioned above, a special new payroll tax of 6 per cent is being introduced for the creation and maintenance of a National Health Insurance Fund.³⁰

II. The revival of commercial banks

Following the virtual collapse of the financial sector in 1996 and early 1997, important progress has been made toward rebuilding commercial banking on the basis of new principles. By the beginning of 1998, the situation in the commercial banking sector had essentially stabilised, with operating banks, on aggregate, appearing solvent and well capitalised. Since 1997, commercial banks have invested primarily in relatively safe and liquid assets such as government securities, while very cautious attitudes toward commercial lending reflect a new concern of banks for their own solvency. A recent trend toward a narrowing of profit margins, however, suggests that Bulgarian banks may be increasingly compelled to assume more risk in their portfolios to remain profitable. While this process should have the positive effect of inducing banks to develop skills for effective financial intermediation, the low level of institutional development of credit markets in Bulgaria also raises concern about possible future difficulties. In this context, particularly given the absence of an active refinance policy, the future regulation and supervision of commercial banks by the BNB, promises to remain a challenge. The government is committed to the rapid privatisation of remaining state banks as a means of promoting the efficiency, capitalisation, and solvency of the banking system. But a number of important institutional and regulatory problems still need to be addressed for the successful revival of commercial banking in Bulgaria.

Background: commercial banks and the economic crisis of 1996-97

The activities of commercial banks were central to the economic crisis of 1996-1997. First, the Bulgarian government used commercial banks for the administration of implicit subsidies as soft credits to loss-making state-owned enterprises. Second, with access to soft refinancing, the managers of (under-capitalised) commercial banks themselves actively expanded credit, primarily to the new private sector and often in the context of corruption.³¹ Until 1996, commercial credit was expanded to the non-financial sector in Bulgaria to a degree that was unprecedented relative to any other European transition economy.³² The

modest economic recovery and progress in stabilisation from mid-1994 to 1996 contrasted sharply with the growing decapitalisation of the banking sector and the accumulation of bad debt. In this context, banks continued to expand new credit, not fearing for their own insolvency.³³ As documented in the 1997 *OECD Economic Survey of Bulgaria*, banking incentives became highly distorted for various reasons, including low capitalisation, problems in regulations, little power of the Central Bank to enforce regulations, lax refinance policies, state interference in loan policies, and corruption.³⁴

In addition to active refinance policies of the National Bank (BNB), numerous special state bond issues partially recapitalised distressed banks between 1991 and 1996. Under the largest such operation, the state assumed all non-performing bank loans issued before 1991, placing bonds of equivalent value in the portfolios of affected banks (so-called “ZUNK bonds”), a large share of which were denominated in dollars. The burden of servicing these bonds was a primary cause of the severe budgetary imbalances and debt spiral during the crisis, as discussed in Chapter I. Dollar-denominated ZUNKs remain important assets in some of the larger commercial banks, accounting for roughly 14 per cent of assets in the consolidated balance sheet as of mid-1998.

The growing decapitalisation of commercial banks, together with a number of failed financial pyramid schemes, affected the confidence of the population in late 1995. This mushroomed into mass bank runs after the eruption of the exchange rate crisis in the spring of 1996. An attempt to restore confidence at this time through a commitment to 100 per cent state insurance for household deposits was compromised by the budgetary crisis and the lack of foreign reserves to back up hard currency deposits. By mid-1996, the Bulgarian banking system was devastated, with highly negative net worth and extremely low liquidity, and the government no longer had any resources to keep it afloat.

Changes in laws and regulations for commercial banks: 1996-1998

In mid-1996, the government and National Bank (BNB) introduced radical shifts in economic laws and policies toward commercial banks. Even before this time, the Bulgarian government and BNB made some important progress in developing basic banking laws and prudential regulations based on international experience. A primary problem was that many of these regulations were simply not enforced. First, some regulations were overly ambitious and could not feasibly be satisfied by the vast majority of banks. Second, the very low capitalisation of many private banks implied an insufficient fear of failure on the part of bank management. Finally, and perhaps most important, neither the BNB nor any other government body had sufficient power to discipline or punish banks in violation of regulations. Until mid-1996, the BNB was essentially unable to initiate the

bankruptcy or liquidation of a distressed bank. In two cases, the BNB explicitly took over the ownership and management of failing banks. At the time, however, this was only tantamount to the bailout of the enormous liabilities of the banks in question. In addition, until 1997, no government body actively pursued charges against bank managers for corrupt or illegal activities.

Changes in banking laws and regulations since 1996 have addressed these problems. The basic Law on Banks was amended in 1996, and then replaced by a new law in July 1997. These changes greatly expanded the regulatory power of the BNB.³⁵ A clause of mid-1996 first granted the BNB the right to close a bank, even obliging the BNB to revoke a banking licence and petition the courts for bankruptcy in the event that a bank is found to be insolvent. Further adjustments in 1997 strengthened and simplified this clause, essentially reducing the role of the court to that of checking the legality of the documentation of the BNB.³⁶ Neither the court nor the bank in question can actively contest the decision of the BNB any longer. If the documentation is properly prepared, the court must simply declare the bank insolvent (or liquidated) and appoint a receiver to carry out the bankruptcy and liquidation procedures. The BNB may also place a bank “near insolvency” in “conservatorship”, under which its activities are temporarily suspended and subject to BNB-appointed management. The new law shortens the maximum length of time during which a distressed bank may be “saved” in this way from 6 to 3 months. Finally, the new law makes banks, as well as borrowers, clearly liable and subject to legal prosecution for various types of inappropriate lending.³⁷ From mid-1996 to early 1997, the BNB immediately exploited the new opportunity by placing 17 banks in receivership and petitioning the courts for their bankruptcy. By early 1998, the court had declared 15 of these banks bankrupt, while the other two were sold to outside investors. As discussed below, however, the actual liquidation of these banks has been a prolonged and difficult process.

Prudential regulations and supervision were also strengthened and made more severe in 1996 and 1997. This addressed not only deficiencies in past bank regulations but reflected a general concern about the potential vulnerability of banks under a currency board regime. One set of conditions makes accounting more transparent and subject to regular external auditing. A manager of a commercial bank must obtain special certification from the BNB, which can be granted only to candidates with a higher degree in economics or law, qualifications in banking, and the absence of past ties to a failing bank.³⁸ The minimum capital requirement for the operation of a commercial bank was increased from BGL 2.2 billion to BGL 10 billion (DM 10 million) as of June 1998.³⁹ New regulations for capital adequacy establish accounting procedures that parallel those of the EU, and require the establishment of even higher ratios (less risky asset portfolios) than the EU norm. Minimum total capital adequacy is to be increased from 8 per cent at the end of 1997 to 10 and 12 per cent in 1998 and 1999,

respectively.⁴⁰ Regulations for liquidity and the provisioning for risk were also tightened. A special “liquidity management body” in each commercial bank must submit regular detailed reports to the BNB, while a clause in the new Law on Banks obliges the BNB to withdraw the license of any bank in default on payments for more than 7 days.⁴¹ Past regulations on big and internal loans are maintained as of 1995, while additional conditions tighten restrictions on insider lending. A particularly restrictive clause in the new banking law essentially required all commercial loans to be collateralised, although a change in late 1998 makes this requirement apply only to “big loans”.⁴² The most important qualitative break with the past, however, is probably the enhanced monitoring and commitment to the enforcement of these regulations, supported by the threat of licence revocation and liquidation.⁴³

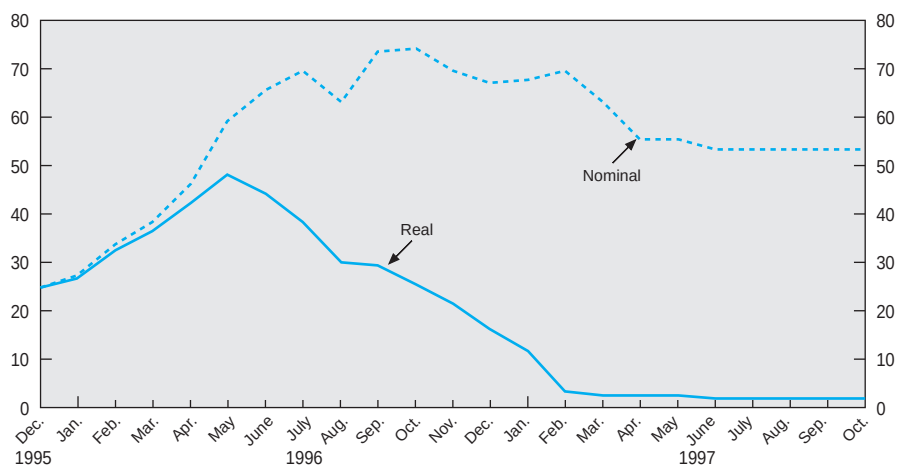
A substantial reserve requirement of 11 per cent of all deposits has remained throughout the period of the currency board. But changes in the specific reserve requirement regulations in April 1998 have decreased some of the burden of this requirement on commercial banks. Before this time, banks were obliged to transfer 11 per cent of all deposits to the BNB on a daily basis. The new conditions give banks the right to satisfy the reserve requirement only on the basis of average monthly deposits, thereby allowing them the flexibility to determine the exact schedule of flows. Under the new conditions, commercial banks have succeeded in reducing somewhat the amount of their reserve deposits with the BNB in 1998 relative to 1997.

Since the introduction of the currency board, commercial banks have not been required to satisfy any regulations on open foreign exchange positions for assets denominated in the reserve currency. Thus, commercial banks can move assets between lev and DM denominations without restrictions. Regulations for other foreign currencies were liberalised somewhat in early 1998. The restriction on the holding of any one currency was increased from 10 to 25 per cent of capital, while the regulation on the overall foreign currency position of the bank was relaxed from 30 to 60 per cent. Nevertheless, several of the banks that hold large portfolios of dollar-denominated ZUNKs are currently in violation even of these higher limits, and have been given a timetable for compliance.

Outside of the State Savings Bank, no explicit deposit insurance existed in Bulgaria until the end of 1995. A limited deposit insurance law of late 1995 may have actually added to the panic and bank runs, as a large part of the population probably believed in implicit 100 per cent state insurance in state banks until that time. The government proved able to honour its final 1996 commitment of 100 per cent insurance for households (50 per cent for juridical persons (firms and organisations)) only in the first half of 1997. In 1998, the government passed a new, more limited deposit insurance law that protects the majority of individual and other deposits only up to BGL 5 million (5 000 DM).⁴⁴ Banks are now also required to contribute 0.5 per cent of deposits annually to a centralised deposit insurance fund.

As explained in Box 1 of Chapter I, the conditions of the currency board regime essentially eliminate the possibility of refinance by the BNB. This represents a dramatic change from the past for most banks. In fact, the BNB ceased its former active refinance policies well before the actual introduction of the currency board. As illustrated in Figure 13, the sharp qualitative break in the refinance policies of the BNB actually followed the adoption of the Action Plan in mid-1996. This plan contained a number of clauses to restrict flows of BNB resources into the banking system, including an explicit commitment not to refinance several large banks and the isolation of a number of loss-making enterprises from bank credit (See Chapter III). While refinancing continued to increase at a brisk pace both in nominal and real terms in the first half of 1996, nominal values subsequently levelled off and did not increase with inflation. By early 1997, the real value of outstanding credit from the BNB to commercial banks reached very low levels. As of April 1997, the BNB ceased new refinancing altogether. Remaining claims of the BNB on commercial banks are all delinquent loans issued before mid-1997.

Figure 13. **Bulgarian National Bank refinancing of commercial banks**
Billion BGL



Source: BNB and OECD.

The state and behaviour of Bulgarian banks since mid-1997

While 35 commercial banks were active in Bulgaria as of February 1998, 74 per cent of all assets remained concentrated in seven large banks, five of which were in state hands. The other two have been privatised. The government has stated a resolve to privatise the other five large banks, preferably in deals involving foreign investors, within the next 2 to 3 years. The United Bulgarian Bank was privatised in mid-1997 in a deal involving a one-third participation of the EBRD and one-third of another foreign investor. Post Bank was successfully privatised in 1998 to an American and Greek consortium. Express Bank, Hebros Bank, and Bulbank are slated for privatisation in 1999. A sixth bank, the Biochim Commercial Bank, is recognised as the most problematic of the remaining large state banks. The government therefore appointed external (foreign) management to this bank in February 1999 under the intention of preparing it for privatisation within two years. The State Savings bank (SSB) is currently being converted into an ordinary commercial bank that will no longer enjoy special additional government guarantees for deposits. After this two-year transformation, the government plans to privatise the SSB as well. Eighteen small and medium-sized, and nine foreign banks account for the remaining 19 and 7 per cent of assets, respectively.

Within the big seven, Bulbank is significantly larger than any other single bank, accounting for over 30 per cent of all assets. Bulbank also has the distinction of being the one large Bulgarian bank that weathered the storm of 1996 to 1997 in relatively good shape. Bulbank received a large share of the dollar-denominated ZUNK bonds discussed above. In stark contrast to other banks, Bulbank did not pursue active loan policies during the years of rapid credit expansion from 1993 to 1996, investing instead in the securities market.

The hyperinflation and massive devaluation of early 1997 actually had a beneficial side effect for Bulbank and the other large Bulgarian banks that were holding large portfolios of dollar-denominated ZUNKs. Inflation greatly eroded the value of liabilities (deposits) relative to the value of these bonds. This significantly reduced Bulgaria's needs for recapitalising the banks before the establishment of the currency board. The privatisation deal involving United Bulgarian Bank was the only major infusion of capital into the banking system in 1997. The dramatic improvement in 1997 of indicators relating to solvency, profitability and capitalisation, discussed below, owes much to this effect.

The financial crisis and mass bank runs, together with the end of accommodation by the BNB, essentially paralysed commercial bank operations in Bulgaria between mid-1996 and the introduction of the currency board in mid-1997. Since this time, surviving commercial banks have been gradually expanding their activities, although under entirely different incentives and constraints than in the past. The population (depositors) has gradually regained some confidence in commercial banks, but remains very cautious. Lending to the non-financial sector

has become a relatively insignificant part of banking activities, although credit to the non-financial sector did apparently rise marginally (6.3 per cent in real terms) during 1998. Bulgarian banks have been holding most of their assets in domestic and foreign securities, and most have been maintaining high cash balances as well. Much of the change in the orientation of Bulgarian banks can be seen in Table 12.

Table 12. **Commercial bank indicators**

	Dec. 1995	Dec. 1996	Jun. 1997	Dec. 1997	Jun. 1998	Dec. 1998
Number of active commercial banks	46	34		36		35
Assets (billion lev)	1 087	3 631	7 634	7 410	7 815	7 685
Assets (billion US\$)	15.4	7.5	4.4	4.2	4.0	4.6
All assets	100	100	100	100	100	100
<i>of which:</i>						
Cash reserves	9.3	8.2	15.0	18.3	16.1	13.4
Government securities	23.2	18.9	20.1	24.1	25.2	19.9
Claims on non-financial sector	42.3	45.8	35.2	22.1	23.3	26.5
Claims on financial institutions	12.1	19.3	23.1	28.4	27.8	31.7
In leva	4.9	3.2	0.7	1.3	0.7	1.4
In foreign currency	7.2	16.1	22.3	27.1	27.1	30.3
All liabilities	100	100	100	100	100.0	100
<i>of which:</i>						
Capital	6.6	5.1	4.5	4.7	7.7	8.2
Profits	0.5	5.0	-4.2	4.9	1.9	1.5
Attracted resources from non-fin. sector	52.8	39.1	56.6	67.1	64.0	78.5
Attracted resources from banks and fin. inst.	26.8	31.9	36.7	14.4	12.0	11.3
Total capital adequacy	4.6	10.8	11.3	23.4	35.5	36.7
Percentage of classified loans in commercial credit	48	58		21.2		13.4
Share of "uncollectable" loans in commercial credit	7	11		12.9		9.5

Source: Bulgarian National Bank; OECD calculations.

From the currency depreciation and write-offs of some bad debts, the dollar value of Bulgarian bank assets fell from US\$15.4 billion to 4.4 billion by mid-1997. Commercial credit to the non-financial sector declined even faster, falling from 42.3 per cent to 26.5 per cent of bank assets between 1995 and the end of-1998.⁴⁵ (This dramatic reduction in credit is also illustrated in Figure 7 of the previous chapter.) The real value of lev-denominated credit fell dramatically with inflation, while credits denominated in foreign currency have decreased only marginally. Remaining credits in foreign currency correspond primarily to loans issued before mid-1996. Roughly 65 per cent of outstanding Bulgarian bank claims

on the non-financial sector were denominated in foreign currency as of in mid-1998, although many of these loans have actually been written off of the banks' balance sheets that are summarised in Table 12.

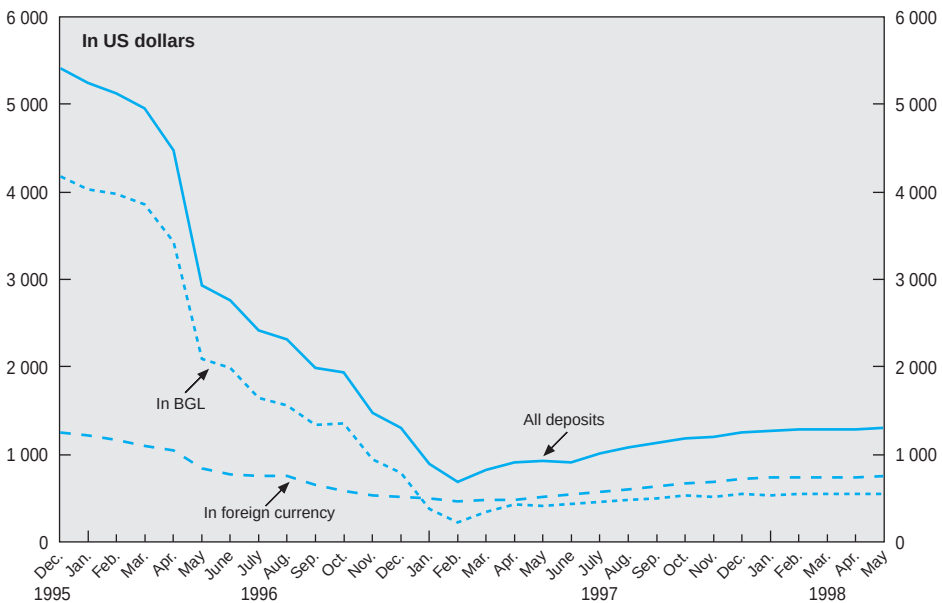
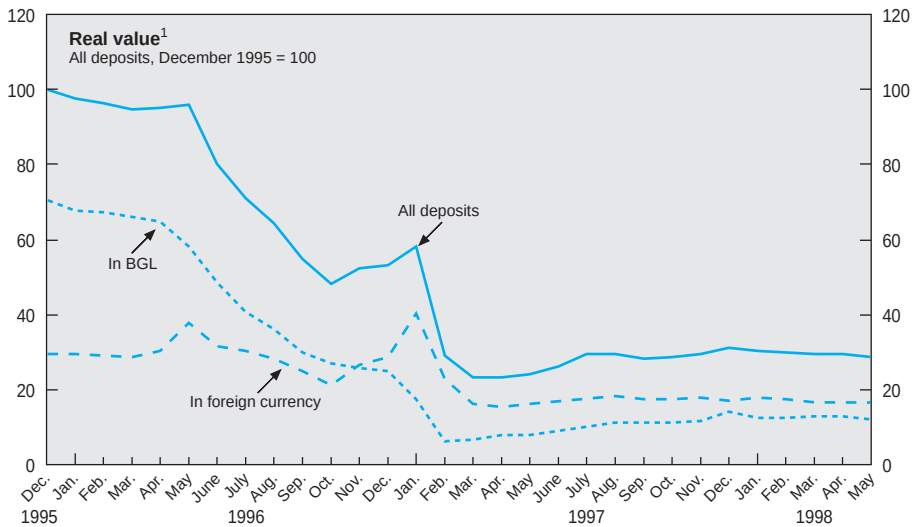
A large share of the modest new lending since mid-1997 can be associated with either government guarantees or a number of highly-collateralised loans to households beginning in late 1997. New loans with state guarantees included over BGL 200 billion in agricultural credits in 1997 and a loan of US\$10 million to a shipyard. Bulgarian banks other than the SSB have reduced new loans to the non-financial sector to an insignificant part of their activities. Commercial lending did show some a slight upward trend toward the end of 1998, however, as visible in Figure 7 of Chapter I.

The share of Bulgarian government securities in commercial bank assets has remained mostly in the range of 20 to 25 per cent since 1995. Over half of these securities consist of dollar-denominated ZUNK bonds. Most other government securities are T-bills. As mentioned in Chapter I, the bidding by highly liquid Bulgarian banks for the small supply of new T-bill issues has been the major factor responsible for bringing interest rates on these securities down to very low levels for a transition economy like Bulgaria (see Figure 4 in Chapter I). Real (lev) interest rates turned negative in the second half of 1997, although the implied DM interest rate always remained somewhat higher than that on German T-bills. As Bulgarian banks are free to hold foreign (low risk) DM-denominated assets without restriction, such an interest rate differential is likely to remain. In the context of the unexpectedly low inflation in 1998, real interest rates on T-bills, as well as deposits, have become positive.

The substantial holdings of foreign assets by Bulgarian banks show up in Table 12 primarily as "claims on financial institutions in foreign currency". These holdings reached 32 per cent of Bulgarian commercial bank assets at the end of 1998. Finally, liquid cash reserves have increased from 9.3 to 13.4 per cent of assets. 53 per cent of these cash reserves were also reported as being in foreign currency as of December 1998. The high liquidity and low level of risk at which banks are working is evident in much more than sufficient (by prudential standards) capital adequacy. Total capital adequacy of the banking sector reached 36.7 per cent by the end of 1998, in comparison with the 10 per cent minimum prescribed by regulations.

Changes in the real value of bank deposits of the non-financial sector are depicted in Figure 14. As can be seen, real deposits have shown only very marginal growth since the low point in March 1997, which may reflect a still cautious attitude of the population toward commercial banks. Low interest rates paid on deposits (see below) may be another reason for their sluggish recovery. Despite the decline in aggregate deposits, the liability side of the aggregate balance sheet in Table 12 indicates an even greater and growing dependence of

Figure 14. Deposits of the non-financial sector in commercial banks



1. Deflated by monthly CPI.

Source: BNB and OECD.

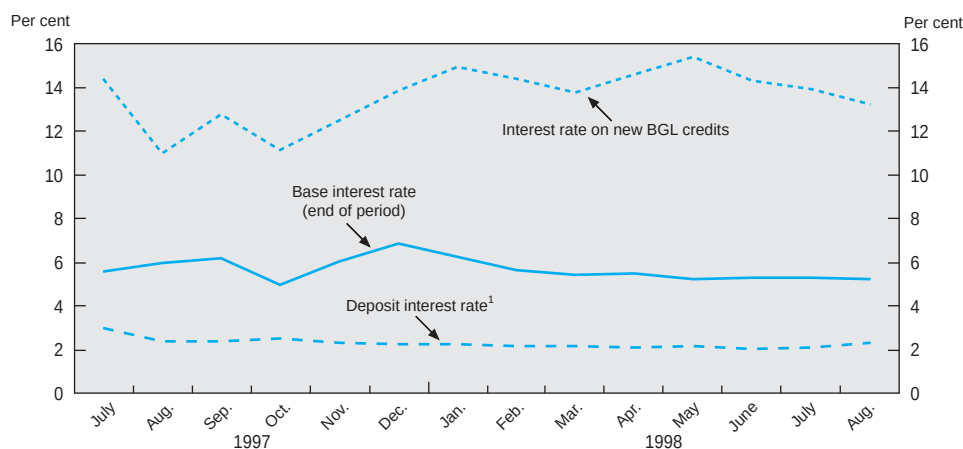
banks on attracted resources (deposits) from the non-financial sector. These resources reached almost 80 per cent of liabilities by the end of 1998. This trend owes much to a decline in the ability of Bulgarian banks to attract resources from financial institutions, most importantly the BNB. The majority (almost 60 per cent) of deposits of the non-financial sector are in foreign currency.

Exceptionally high aggregate profits in 1997 derived primarily from the effect of inflation and currency depreciation on the balances of banks holding dollar-denominated ZUNKs, as discussed above. For this reason, profits in 1997 were concentrated in the seven largest operating banks listed above. Every one of these banks reported net profits in 1997, while the aggregate gross profits of this group of banks increased 17.5 times. By contrast, remaining small and medium size Bulgarian banks reported net losses for 1997.⁴⁶ Thus, few conclusions on the financial prospects for the near future can be drawn from the results for 1997.

A more encouraging sign is the fact that the banking sector as a whole apparently managed to operate at a profit in 1998, although profit margins have been much lower. The primary source of profits for Bulgarian banks appears to be a remaining significant interest rate differential between that paid on deposits and that received from Bulgarian or foreign (low risk) securities. Figure 15 shows the evolution of three annualised interest rates since mid-1997. The lowest interest rate represents something close to the average interest that Bulgarian banks have paid on deposits. Different interest rates on different types of deposits are weighted accordingly. The highest curve shows the average interest rate on new loans, which is of limited relevance since Bulgarian banks are not engaging in much new lending. The middle curve shows the base interest rate of the National Bank, which is set on the basis of average returns on Bulgarian T-bills. Judging from the fact that new Bulgarian T-bill issues are oversubscribed, and the fact that Bulgarian banks hold significant amounts of lower-yield German securities, this interest rate is probably close to, or even a bit higher, than the average return that most banks receive on their assets.

The squeeze on the profits of Bulgarian banks has increased in the second half of 1998. Required provisions for losses after the sharp decline in Bulgarian asset prices that followed the Russian crisis in August may have even temporarily pushed aggregate profits to negative levels. Again, this particularly concerns the larger banks that have substantial holdings of ZUNK bonds. As illustrated in Figure 16, the value of ZUNK bonds fell by close to 40 per cent between June and September 1998. The successful negotiation of the 3-year arrangement with the IMF appeared to have restored at least some confidence and value to Bulgarian bonds toward the end of 1998, however, with positive implications for the profits of the larger banks.

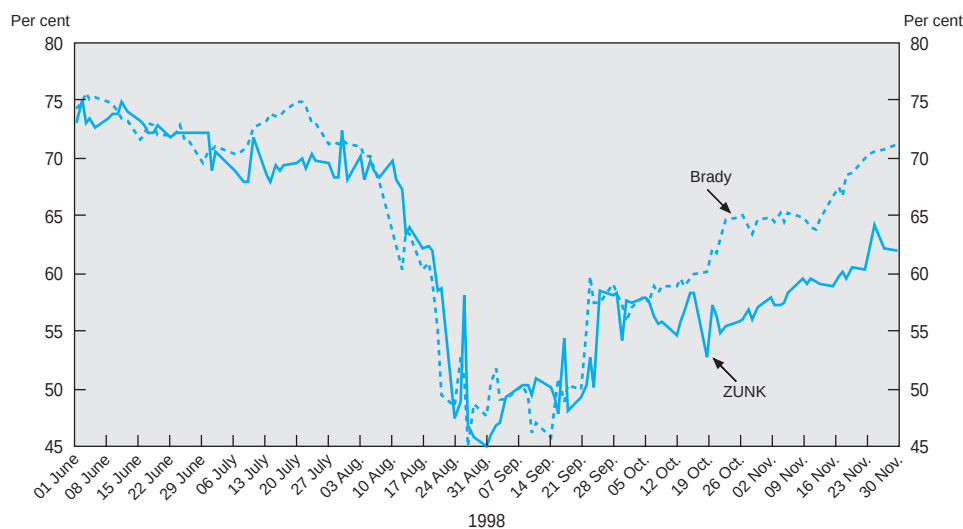
Figure 15. **Interest rates**
Average annualised



1. This rate was calculated as an average weighted interest rate paid by Bulgarian commercial banks on deposits, where the weights correspond to the share of particular types of deposits in the consolidated balance sheet.

Source: BNB and OECD.

Figure 16. **Offer prices on Brady¹ and ZUNK bonds**



1. Average offer price of FLIRBs, IABs and DISCs.

Source: BNB.

The rebuilding of commercial banking in Bulgaria: the challenges for the future

While commercial banks in Bulgaria have not yet regained their function as financial intermediaries between domestic savings and investment, the Bulgarian government appears to have successfully created the first foundations for the reconstruction of commercial banking and the financial sector. The new policies and enhanced regulatory framework of the BNB has greatly improved incentives in commercial banks. The employees of commercial banks now bear much more of the responsibility for their own risks and policies, and have adjusted their behaviour accordingly. So far, most banks have managed to achieve solvency and profitability under rather high liquidity and low risk. The Bulgarian government appears strongly committed to selling remaining banks to foreign investors with the capital and skills to accelerate the resurrection of commercial banking and credit markets under sound principles.

A number of important problems and policy challenges remain, however. Selling the remaining state banks to reputable foreign investors according to the ambitious announced schedule may be difficult, particularly given the current cautious attitudes among investors toward emerging markets. Some banks still reportedly suffer from a low level of managerial competence and high inefficiency. Institutions that could support the profitability of “normal” intermediary activities for banks are still largely absent in Bulgaria. Although the bankruptcy procedure for insolvent banks has been streamlined remarkably, the liquidation procedures themselves still suffer from uncertainty and ambiguity. The new tough BNB policies may still also require time to become completely credible in the eyes of some banks.

While the BNB has indeed improved the credibility of bank supervision and discipline since mid-1997, the resolve of the BNB may still be tested in the near future. When three banks failed to meet the new minimum capital requirement of BGL 10 billion on 30 June 1998, the BNB extended the deadline until the end of August, although also pledging that no further extensions would be offered. The three banks in question succeeded in meeting the requirement in the next two months. In January 1999, however, the BNB acted quickly to withdraw the license from, and initiate insolvency proceedings against, a struggling bank for the first time since the establishment of the new regime. With the future profitability of many banks being questionable, it is possible that the BNB will soon be put in a position where strong measures will be required to prevent an erosion of newly-gained credibility and maintain the overall healthy development of the banking system.

Given the current liquidity problems in the real sector of the economy, many analysts and government officials have raised concern over what they believe may be an excessive decline in commercial lending. How bank

regulations might be changed to alleviate this problem is currently a subject of active debate within Bulgaria. Although a positive effect from some marginal changes in bank regulations cannot be ruled out, the very cautious nature of current bank policies derives primarily from the high risk and uncertainty associated with crediting Bulgarian firms, and the absence of developed institutions to alleviate these problems. The presence of a currency board offers another important reason why Bulgarian banks might need to maintain higher liquidity and lower risk than would otherwise be the case. The extreme scarcity of commercial credit in Bulgaria today is not very surprising in the light of the severity of the recent crisis, the remaining low confidence of the population in financial institutions, and the experience of other countries. In those transition and developing countries that refrain from administering state subsidies through commercial banks, the vast majority of investment capital is financed out of retained earnings, while commercial banks typically provide only limited short-term working capital.

Several important areas of institutional development and reform in Bulgaria could help to promote a greater activity of banks in the real sector, particularly in the financing of short-term working capital. This includes measures to strengthen the ability of banks to collect their claims and discipline the management of firms in default on commercial loans. Commercial banks currently suffer from very weak leverage over firms in the event of default, including their ability to collect collateral, discipline or remove firm management, or pursue bankruptcy and liquidation through the courts. The new medium-term programme of the government, announced in mid-1998, contains general clauses on the subject of strengthening the rights of commercial creditors, although no specific measures are spelled out. Unless managers of firms genuinely fear that they can be held responsible or removed in the event of delinquency on commercial debts, Bulgarian banks will encounter extraordinary difficulties in their attempts to distinguish potentially responsible from irresponsible borrowers. Strengthening the rights of commercial creditors is indeed the most effective means of promoting a greater and healthier involvement of banks in financing the real economy. Firms in need of finance, as well as banks, stand to profit from such measures.

Institutions for bankruptcy and liquidation remain poorly developed in Bulgaria, despite a new and potentially effective bankruptcy law. Until such basic problems in liquidation and bankruptcy can be resolved, Bulgarian commercial banks will most likely be quite limited in their abilities to expand their loan portfolios in a profitable way. Other than the firms that were included in the explicit Liquidation and Isolation Programmes of mid-1996 (see Chapter III), very few large enterprises in Bulgaria have yet been declared bankrupt or liquidated. Ironically, the cases of the 15 banks that have actually been declared bankrupt are highly indicative of problems remaining in this area. None of these banks has yet been liquidated. The state has long assumed responsibility for most liabilities

(deposits) of these banks, while the banks themselves still have assets estimated at roughly BGL 240 billion. But the creditors to these banks have apparently still received close to nothing.⁴⁷ The liquidation process appears to suffer from serious incentive problems, as appointed liquidators can profit from prolonging the process and continuing to “work” at the expense of the state and outside creditors. Banks in liquidation are also not required to make regular balance sheet reports to the BNB as do other banks, which has led to much speculation and uncertainty surrounding the activities of receivers.

In the light of the highly distorted banking practices of the first half of the 1990s, Bulgarian banks may have lagged behind a number of other countries in developing requisite skills for effective credit policies. This includes the gathering and processing of information on creditworthiness, project appraisal, project monitoring, and the effective pursuit of creditors’ rights in the event of default. These skills can only be developed over time. The degree to which banks will invest in acquiring these skills depends on the process of institutional development discussed above, *i.e.* the perceived expected net return to the acquisition of such skills must be greater than alternative profits that can be made through passive investments in safe securities. This is one primary advantage of sales to reputable foreign investors that already have developed management and banking skills. But even foreign companies can be expected to have difficulty in applying these skills to support active loan policies to Bulgarian firms in the current difficult context.

The rather small size of most Bulgarian banks is also an obstacle to the expansion of credit policies. Prudential regulations on large loans alone prevent many banks from extending significant commercial credit to industry. The consolidation of smaller banks into larger institutions may therefore be an important part of the re-activation of commercial banks as financial intermediaries. Inherently risky credit portfolios need to be balanced with substantial holdings of “safe” assets such as government securities. In an economy such as Bulgaria, there are severe limits to possible advantages from diversification in credit policy. In fact, the poor information and uncertainty surrounding Bulgarian firms makes the profitability of a highly-diversified credit portfolio unlikely. It would therefore be natural for Bulgarian banks to begin their involvement in the real sector through a type of “relational contracting” with a very small number of firms.⁴⁸ Under such arrangements, resources for information gathering and monitoring can be concentrated effectively, while long-term mutually-beneficial relationships would help to maintain trust. While corrupt relationships between Bulgarian banks and firms were quite common in the past, the primary basis for this corruption was access to state resources. If special access to state resources or guarantees can be eliminated, however, close relationships between banks and enterprises can also be productive.

The development of credit market institutions can also help to alleviate the difficult problems in corporate governance and predominant employee control in Bulgarian enterprises, which are discussed in Chapter III. The ability of commercial banks to petition through the courts for a turnover of managerial personnel in firms that default on commercial debt provides a natural market mechanism for the replacement of ineffective management. This mechanism can be of particular value at a time when the market for corporate control in Bulgaria is still virtually non-existent.⁴⁹ As already alluded to above, such an institutional arrangement also serves to heighten the ability of banks to identify potentially profitable loan policies. If enterprise management that seeks finance is aware that failure to service this debt would likely result in its removal, the quality of the initial pool of applicants for commercial loans will be higher.

The current trend toward declining profits may pressure banks to change their investment strategies in the near future. It is not clear how much room the remaining interest rate spread leaves for the continued profitability of low risk asset portfolios, particularly considering the conclusion of a recent international study that Bulgarian commercial banks generally suffer from “high cost structures and inefficient operations”.⁵⁰ This is one reason why Bulgarian commercial banks may be compelled to develop more active loan policies in the near future, operate more efficiently, and invest in the skills necessary to become effective financial intermediaries.

While this possible change in banking behaviour has positive implications, the riskiness of bank portfolios will need to be monitored very closely in the light of the severe institutional and human capital problems discussed above. Some banks could conceivably increase the riskiness of their portfolios beyond their abilities to manage this risk, thereby threatening the banking system with numerous failures. This could particularly be the case if competition for deposits through interest rate adjustments was to become more fierce.⁵¹ Thus, ironically, a potential important concern for Bulgarian banking in coming years could be exactly the opposite of that discussed above regarding excessive risk aversion.

The problems discussed in this section underline the potential value of the planned privatisation of the remaining large state banks to foreign investors. Such a strategy offers partial solutions to the problems of low capital, inefficient operations, and poor banking skills. But the proposed highly-ambitious schedule for privatisation may be difficult to realise in practice. International investors are understandably cautious about expanding banking and credit activities into Bulgaria at the present time. The conclusion of the new three-year deal with the IMF, together with a perceived strong resolve of the Bulgarian government, are important positive counteracting factors. Bulgaria is also undertaking measures to make the privatisation process itself more attractive and transparent. A current proposal to disseminate regularly detailed balance sheet information on a

voluntary basis for banks that are searching for foreign capital could have an important impact on the privatisation process. Given that these banks belong to the state, and are monitored on a regular basis by the BNB, the open and effective dissemination and verification of information for foreign investors and international analysts is clearly possible.

III. Privatisation and restructuring in the corporate sector

The medium-term prospects for stability and economic growth in Bulgaria depend greatly on the pace of restructuring and privatisation. In recognition of this fact, recent government programmes have placed strong emphasis on targets in these areas. Bulgaria had lagged behind most transition economies in restructuring, privatisation, and the attraction of foreign investment for a number of reasons, including relatively adverse initial conditions, soft budget constraints, and a high degree of political instability. Before the eruption of the financial crisis in the spring of 1996, bankruptcies or liquidations of large industrial enterprises were virtually unknown, no more than 4 per cent of state assets had been transferred to private hands, and per capita (cumulative) foreign direct investment was less than US\$70, well below other countries in the region. The disruptive process of land restitution had stalled with less than 20 per cent of land having been returned to former owners. In recent years, the government has succeeded in making important progress in all of these areas, although many problems and challenges remain for the future. The chapter summarises recent accomplishments and seeks to identify some of the important remaining challenges.

Industrial enterprises: measures to cut losses and promote restructuring

Before 1996, Bulgarian industrial enterprises enjoyed access to commercial credit to a degree that was unprecedented among European transition countries (see Chapter II). The availability of soft credit not only weakened incentives for restructuring, but supported various types of rent-seeking behaviour that siphoned state resources into private hands. As described in previous chapters of this survey, a part of the accumulation of bad debt and decapitalisation of commercial banks, which led into the economic crisis of 1996 to 1997, mirrored implicit subsidies for keeping afloat loss-making industrial enterprises. The collapse in commercial credit to the non-financial sector, discussed in Chapter I, had an immediate dramatic effect on the operation of many Bulgarian enterprises. It is one of the primary factors that can be associated with the fall in industrial output and rise in unemployment in 1996 and 1997.

A key element of the “Action Plan” of mid-1996 to address the financial crisis was the creation of two lists of enterprises, a Liquidation List and an Isolation List. The Liquidation List consisted of 64 firms, which accounted for an estimated 29 per cent of the losses among state enterprises in 1995. These enterprises were slated for immediate closure and liquidation. The Isolation List included 70 companies (later increased to 72) that accounted for an estimated 50 per cent of losses in the state sector in 1995. These enterprises were isolated from new bank credit and temporarily excused from servicing outstanding debts. They were to face future liquidation unless they could operate under a profit and avoid new payment arrears under those conditions. The liquidation and isolation programmes represented the first major step by the Bulgarian government towards confronting the problem of loss-making industrial enterprises. Part of the assistance of the World Bank was oriented toward alleviating the social costs of the implied liquidations.

The actual process of closure and liquidation of the firms on the first list has taken longer than initially anticipated. By mid-1998, however, all but eight of the firms on the Liquidation List had been either closed or sold. The other eight were moved to the Isolation List. The enterprises on the Isolation List are either producers or suppliers of goods and services with controlled prices and tariffs (Group A, including mines, heating companies and the electricity concern NEK, as well as the national railway and Sofia municipal transport companies), or manufacturing and transport companies facing particularly difficult conditions (Group B, including Kremikovtzi, Balkan Airlines, and Agropolichim) (Table 13). A special department in the Ministry of Finance, which co-operates directly with the IMF and World Bank, is responsible for monitoring the financial rehabilitation of these

Table 13. **Financial results of enterprises on the isolation list**

In BGL million, except for number of employees

	Total income		Total expenses		Profits	
	1996	1997	1996	1997	1996	1997
Group A – total	251.1	2 611.8	259.2	2 156.6	–2.3	170.5
<i>NEK</i>	144.4	1 528.1	115.4	944.1	16.2	332.3
<i>State railways</i>	35.4	346.1	43.8	337.8	–8.4	3.1
<i>Maritza East mine</i>	27.4	238.0	24.3	176.0	1.4	35.4
Group B – total	227.0	1 990.6	242.6	2 003.7	–18.8	–34.2
<i>Kremikovtzi</i>	92.9	945.7	91.0	940.2	0.5	2.8
<i>Balkan Airlines</i>	38.2	347.6	53.4	385.5	–15.2	–37.9
<i>Agropolichim</i>	18.5	149.3	18.1	151.0	0.2	–1.7

Source: Ministry of Finance, Monitoring Unit.

companies. Since mid-1996, the only source of external finance for these firms has been a special Rehabilitation Fund, managed by the Ministry of Finance as part of the state budget. Twenty-two firms in Group B had been either privatised or liquidated by the end of 1998.⁵²

A large share of firms on the Isolation List succeeded in showing a profit in 1997 (Table 13). At least part of the explanation for this relates to special temporary factors that inflated the profitability of most Bulgarian enterprises in 1997. The hyperinflation in the early part of the year generated windfall profits for many firms, as many costs were paid in past prices. Perhaps even more important, depreciation allowances were not adjusted until 1998. The generally high profitability of industrial firms in 1997 can be seen in Table 14, which shows a substantial rise in recorded profitability of all state-owned enterprises.

Table 14. **Profitability of state-owned enterprises**

As per cent of balance sheet assets

	Net profitability				
	Industry	Construction	Transport	Trade	Other
1992	-7.87	0.26	0.08	-1.62	0.00
1993	-12.74	-2.17	-6.99	-1.14	-4.96
1994	-4.89	-2.14	-3.28	0.43	5.37
1995	-4.24	-1.14	-5.23	-1.31	1.10
1996	-5.54	-1.18	-5.85	-1.78	-6.71
1997	2.89	0.99	3.43	2.30	2.50

Source: Agency for Economic Analysis and Forecasting.

As discussed below, the vast majority of state-owned industrial enterprises have either been privatised during 1997 and 1998, or are slated for rapid privatisation in the future. Nevertheless, the process of restructuring in Bulgarian industry is still only at its initial stages. It is doubtful that the profitability of a large share of existing industrial enterprises can be maintained even in the near future. Indeed, in 1998, roughly half of state-owned industrial firms have again reported net losses, while industrial sales fell by 6.7 per cent in the first three quarters of the year relative to the same period in 1997.⁵³ Given the low development of credit and equity markets in Bulgaria, external finance other than foreign investment for restructuring should remain quite scarce. Under such conditions, a large share of closures and liquidations should still be expected, which speaks for the importance of establishing the appropriate legal, economic, and social institutions to facilitate this process and reduce the social costs.

While Bulgaria now possesses bankruptcy and commercial laws that are consistent with international practice, the implementation of these laws has proved complicated.⁵⁴ This is witnessed by the fact that, despite serious problems of solvency and payment arrears, very few large industrial enterprises have been forced into bankruptcy or liquidation by any institution other than the government.⁵⁵ The previous chapter emphasised the absence of institutions by which commercial creditors can pursue their claims in the event of default as a major factor hindering the development of credit markets and corporate governance. The ability of suppliers to pursue claims on non-paying firms through the courts, under the threat of bankruptcy, is also crucial to the development of contract law and the restructuring process in general.

Related problems in corporate governance are also central to the restructuring process in Bulgaria. Given the underdeveloped state of credit and equity markets, there still exists no market mechanism for the disciplining and removal of ineffective management. Far from all current managers possess the requisite entrepreneurial talent and initiative for successful restructuring. The large number of recent privatisations through management and employee buyouts may have even further cemented existing management to enterprises. It is true that, in Bulgaria, ministries have been very active in replacing management over the last few years, a process that has typically followed changes in government. But the government is far from an effective institution to carry out the process of managerial selection.⁵⁶ In addition, following privatisation, the disciplining of management in this way is no longer feasible. The development of effective corporate governance in Bulgaria hinges on the development of institutions to support credit and equity markets, including market-based institutions of bankruptcy and liquidation discussed above and in Chapter II.

The official Bulgarian stock exchange started operations in October 1997. While institutional and information problems will likely prevent the stock exchange from playing an important role in corporate finance in the near future, the development of the exchange has important potential value for the medium-term. This particularly concerns possibilities for the concentration of outside ownership through secondary markets in the aftermath of mass privatisation.⁵⁷ Despite the fact that trading on the stock exchange is temporarily limited to only shares of employees of the respective firms, a transfer of shares from privatisation (voucher) funds to direct and portfolio investors may already be occurring, to some degree, by means of forward contracts. Only a handful of large firms have shown any liquidity, however. The effectiveness of the stock market in creating a market for corporate control will depend on strong measures to protect the rights of shareholders and expedite the process of bankruptcy and liquidation, as discussed above.

An unfortunate consequence of the poor state of financial markets in Bulgaria is very tight liquidity constraints for most Bulgarian industrial firms at a time when successful restructuring might require substantial investments. The particular institutional barriers to the functioning of financial markets in Bulgaria today imply the probable failure of a number of enterprises that may have even succeeded under more favourable conditions. While this problem cannot be eliminated, several areas of policy could have an important impact here. Chapter II outlines policy directions that could help to re-activate gradually the role of commercial banks in the economy. The current tax reform initiative could also be of prime importance here. This initiative seeks to reduce the explicit tax burden, eliminate numerous exemptions, and promote the stability and transparency of exiting rules (see Chapter I).

Privatisation

The privatisation process in Bulgaria has included a large array of different programmes. Two of these programmes are concerned with the restitution of urban and rural property to former owners and relatives. Explicit sales of state assets are handled by the state Privatisation Agency and line ministries. These sales can combine cash deals, debt-equity swaps, investment and other side commitments, and transfers to employees. Finally, a large share of state assets are being transferred to the population through a voucher privatisation programme, the first round of which was concluded in 1996. After years of delay, late 1996 and 1997 witnessed a significant acceleration in almost all forms of privatisation. While the results of 1998 have been somewhat more modest, the goals for the near future remain ambitious.

The 1997 Stand-by Agreement with the IMF set a target for the privatisation of all commercial enterprises and one half of utilities by mid-1999. A "Strategy for Accelerating Privatisation", adopted by the new government in May 1997, expressed the goal of privatising 38 per cent of all state assets by 1998 and a further 15 per cent in 1999.⁵⁸ These targets were quite ambitious, considering the fact that only an estimated 20 per cent of state assets had been privatised in the entire period from 1991 to 1997. The programme excludes from mandatory privatisation the largest power generating stations, the gas and electricity distribution network, and a number of other utilities. Although the government has subsequently fallen behind these targets somewhat, the new medium-term programme of the government reiterates a strong commitment to the acceleration of the privatisation process, proposing to complete the transfer of half of all state assets subject to privatisation by the first quarter of 1999, and reach 70 per cent by the end of the year.⁵⁹

Restitution

The restitution of urban property, mostly in the form of shops, proceeded relatively quickly in the early years of transition, and provided an important foundation for the emergence of small private retail businesses in Bulgarian cities. By contrast, the programme for the restitution of agricultural land, which was also launched in 1991, has suffered from major complications and delays. As late as September 1996, only an estimated 18 per cent of arable land subject to restitution had been restituted, while actual legal titles had been issued for only about 6 per cent of the land. Policies in the mid-1990s added to confusion by encouraging the voluntary formation of agricultural co-operatives as a substitute for claiming individual property rights. Uncertainty over property rights, the small size of most restituted parcels, and the virtual absence of a land market have contributed to the particularly poor performance of Bulgarian agriculture throughout the transition period.

The change in government in 1997 has proved critical for the revival of the land restitution process. With the help of important amendments to the Land Act of 1991, which have both strengthened ownership rights and extended the terms for claiming property, land restitution is again moving ahead. By the end of 1998, 79.6 per cent of arable land subject to restitution had reportedly been restituted, although still only 24 per cent of landowners have apparently received deeds.⁶⁰ Beginning in 1999, the Bulgarian government hopes to give the leasing market a lift by removing a current 6 000 hectare ceiling on the amount of land that can be leased to one individual. Important issues for the development of a genuine land market, including possibilities for foreigners to buy and sell land, remain under discussion.

Cash and voucher privatisation: recent programmes and laws

The privatisation process is governed by the basic 1992 Law on the Transformation and Privatisation of State-Owned and Municipal Enterprises (Privatisation Law), although this law has been amended many times.⁶¹ Article 3 assigns the responsibility for privatising the largest companies with the Privatisation Agency (PA), delegating smaller firms to the line ministries. The multiplicity of possible privatisation approaches foreseen by the Privatisation Law and “Strategy”, including the possibility of debt/equity swaps using either Brady (external) or ZUNK (domestic) bonds, implicitly delegates certain responsibilities to other state bodies, causing potential problems in co-ordination.⁶² For this reason, the recent “Strategy” has upgraded the status of the PA, making it responsible for the co-ordination of the whole privatisation process. The PA is to manage its greater role partly through an extensive use of foreign consultants for the sales of large enterprises. This can involve both the sales of single enterprises or “pools”, which attempt to bundle together more and less attractive firms. In light

of the limited institutional capacity of the line ministries, the management of a number of smaller privatisations has also been contracted out to Bulgarian consultants. Table 15 summarises the approaches (methods) to privatisation that are currently followed.

Table 15. **Methods of privatisations**

Responsible institution	Characteristics
Privatisation Agency¹	
<i>Direct sales and tenders</i>	Tenders, which accounted for most of the PA's sales until 1997, are expected to markedly lose importance.
<i>Privatisation advisors and transaction agents (PATAs)</i>	In 1997, the Privatisation Agency hired international consultants, with funding from foreign donors (EU-PHARE, USAid) and institutional creditors (World Bank), to manage and speed up the sale of "pools" of enterprises within a single industry. A second round of pool privatisation was launched in 1998-99, remunerating consultants on a success-fee basis and extending participation to domestic advisors. In both rounds, some pools included one firm only.
<i>Public offerings</i>	Floating of minority stakes on the stock exchange.
Line ministries¹	
<i>Direct sales and tenders</i>	The share of sales through tenders is expected to rise in 1999.
Centre for Mass Privatisation	Following a first wave, launched in 1996, vouchers were issued again to all Bulgarian adults in late 1998, upon payment of a small registration fee.

1. The Privatisation Agency is responsible for companies with fixed assets exceeding BGL 1 000 million; the privatisation of smaller companies is managed by line ministries.

The government has recently launched an innovative method of large-scale "pool" privatisation that contracts out the responsibility for structuring and negotiating sales to foreign consultants. These consultants then present their proposals on the final buyer to the PA. Some pools include one large firm only. This programme is being funded with the help of the World Bank and a number of foreign donors. The first round of contracts (Table 16) offer both a retainer and a success fee to the foreign consultants, while some more recent deals operate primarily on a success-fee basis. The hope is that the experience and financial expertise of foreign consultants will increase the speed and transparency of privatisation deals, and help to attract foreign investors. Pool privatisations that have been contracted out to foreign consultants include 81 manufacturing enterprises and 22 hydropower stations associated with the National Electricity

Table 16. **Privatisation deals contracted to advisors and transaction agents**

Sector	Date (time frame to conclude the deals)	Financing	Long-term assets (per cent of total)	Agent
First round				
Agrochemicals and petrochemicals	Feb. 98 (20 months) ¹	EU-Phare	3.60	Arthur Andersen
Air transport	Sept. 97 (12 months)		0.28	TOB Speedwing
Chemical and petrochemical	July 97 (12 months) ²	USAid	0.79	KPMG Barents
Electronics and metalwork	Nov. 97 (20 months)	EU-Phare	0.71	Ronald Berger
Miscellaneous (light industries, mining)	Nov. 97 (20 months)	EU-Phare	1.64	Raiffeisen
Plastics, rubbers and fibres	Nov. 97 (20 months)	EU-Phare	0.89	RES
Shipbuilding	Nov. 97 (20 months)	EU-Phare	0.35	DFC
Steelworks	Nov. 97 (20 months) ³	EU-Phare	5.07	WS Atkins
Telecommunications	Sept. 98 (12 months)	World Bank	2.32	Morgan Grenfell
Second round				
Balkankar	Sept. 98 (12 months)	Government	1.76	Price Water
Bulgartabak (tobacco)	Sept. 98 (12 months)	Government	0.44	pending
Chemical	May 98 (11 months)	Government	0.23	SPA
Inkoms (electronics)	June 98 (12 months)	Government	0.27	Nord Impuls
Machine building I ⁴	—	Government	0.57	pending
Machine building II	Sept. 98 (12 months)	Government	1.27	BRIB
Metallurgy	May 98 (10 months)	Government	0.56	Expandia
NEK (electricity)	July 98 (12 months)	Government	0.20	Credit Suisse
Tourism	May 98 (8 months)	Government	0.27	KPMG

1. A bid associating management, employees and a US financial investor was selected for the Sviloza chemical plant.
2. In the first and only pool deal concluded at end-1998, a management-employee bid bought majority ownership in the detergent-maker Verila. No offer for Chimco, the chemical firm, was submitted by the 19 November 1998 deadline.
3. A potential Turkish buyer is performing in-site inspections at the Kremikovtzi steel mill.
4. In November 1998, five enterprises were dropped from the initial list of enterprises subject to pool privatisation because of lack of interest from potential agents.

Source: Privatisation Agency.

Company (NEK). Success fees for foreign consultants are negotiated on an individual basis. Enterprises in a pool privatisation that are not sold within a given deadline are subject to liquidation, under which foreign agents still receive a negotiated nominal fee.

In addition to cash privatisation, a mass voucher-based privatisation scheme was launched in 1996, based largely on the Czech model. For a small fee, each citizen could receive vouchers with a “nominal” value of BGL 25 000. Only 3.2 million individuals, roughly half of the eligible population, collected their vouchers. The rather low interest was probably due in part to the effect of the financial crisis on the confidence of the population in 1996. Vouchers were not

transferable except to close relatives and (voucher) investment funds. Citizens could decide to invest their vouchers either directly or through one of 81 new private investment funds. Stakes in 1 050 state enterprises were made available in a first round that included three separate bidding sessions. While a special government body, the Centre for Mass Privatisation, was responsible for issuing vouchers and organising the centralised auctions, the PA or the line ministries retained power for the selection of enterprises and the preparation of prospectuses. Vouchers that were not used in the first round could be carried over to future rounds.

Major amendments to the Privatisation Law were made in October 1997, April 1998, and August 1998. First, the threshold book value that determines which companies are to be sold by the PA was increased, initially from BGL 70 million to BGL 350 million, and later to BGL 1 billion.⁶³ Second, the rule requiring mandatory prior evaluation of companies to be privatised has been eliminated. This could, in principle, speed up the average time for sales. The requirement of mandatory prior evaluation has been maintained, however, for enterprises sold through direct negotiations or for small-scale deals. An important amendment allows employees of enterprises the right to use vouchers for up to 10 per cent of payment in MEBOs. They can also make payments in instalments under special conditions: 10 per cent down and future payments in nine equal instalments during the next nine years.⁶⁴ Employees also received free of charge 10 per cent of the shares of firms slated for mass privatisation. More recently, the evaluation of bids by employees in the case of MEBOs has changed to encourage competition from outside investors. The minimum reservation price has been abolished for cases of more than one bidder in secret auctions, and the bids from MEBOs are now discounted by 10 per cent to account for deferred payments. The government has also created a list of special enterprises for which MEBOs privatisation is excluded. Additional amendments include an increase of the portion of proceeds retained by the PA and ministries from 7 to 10 per cent.

In order to accelerate privatisation in the future, the government intends to make greater use of tendering, using price as the main criterion. This method will be applied to 2 000 small and medium-sized enterprises from the portfolio of line ministries, representing 11 per cent of state assets. Another part of assets are to be sold at public auctions, where an allowed means of payment will be investment bonds associated with the new voucher privatisation scheme. This second wave of voucher privatisation is to involve the residual shares of firms for which demand on the part of foreign and domestic strategic investors has been insufficient.⁶⁵ A final programme focuses on restructuring and breaking apart several “infrastructurally important” enterprises as a preparatory measure for privatisation. This includes the national power company, district heating companies, coal mines, and water and sewage systems.

The results of privatisation: 1997-1998

The recent results of privatisation have been encouraging relative to the past, even though the target of selling 38 per cent of state assets by the end of 1998 included in the ambitious "Strategy for Accelerating Privatisation" has not been reached. A reported 30 per cent of state assets have nevertheless been privatised. Relative to the past, 1997 marked a particularly successful year for both privatisation and foreign direct investment. The PA and the line ministries contracted for payments, corporate liabilities assumed by buyers, and investment commitments for a total of US\$1.5 billion, an amount roughly equal to the cumulative sum of such contracts for 1993-96 (Table 17). Cash payments contracted in 1997 reached US\$608 million, as compared to 442 million in 1996. A large part of the acceleration in cash privatisation in 1997 came from sales to foreign investors (Table 18). The sale of the MDK Pirdop copper mine to Belgium's Union Minière alone brought payments and contracted investments totalling US\$300 million. Bulgarska Roza Svetopolis, which produces the famous rose oil, was sold to an Irish company, while a consortium led by the Banque Nationale de Paris acquired a 33 per cent stake in the Albena Black Sea tourist complex, the first resort to be privatised.

In 1998, the reported results of privatisation remain significant. A total of 1 495 state-owned enterprises were reportedly involved in either complete or partial privatisations. Contracted payments, liabilities and investment commitments amounted to US\$1 029 million, of which US\$638 million represent cash payments. A large part of this sum, however, has yet to be paid. For large scale privatisations handled by the PA, 49 per cent of reported contracted cash payments in 1998 had been received by February 1999. Part of the reason for this is that a high share of privatisation deals in 1998, 494 out of a total of 1 114 concluded by the PA and line ministries, represent MEBOs, under which payments are typically made over time under preferential treatment, as described above.

Despite various legal complications and operational delays, the bidding sessions associated with the first wave of mass privatisation appear to have been successful. Shares representing 14.6 per cent of fixed state assets were transferred to the population through vouchers (Table 19). This includes controlling blocks of 67 per cent stakes in 666 of the 1 050 enterprises included in mass privatisation.⁶⁶ The residual shares of enterprises sold in the first round of mass privatisation are now being offered for cash, and may also be included in subsequent rounds of voucher bidding.

Problems and policy challenges in privatisation

For political as well as economic reasons, large-scale privatisation has presented major policy challenges to virtually all of the transition countries. The

Table 17. **The results of cash privatisation**

Type of privatisation	Total number of firms in public ownership in 1993	Partial and complete privatisation ¹ 1993-1995	1996	1997	1998
Municipally-owned enterprises					
Number of small-scale sales	7 500	1 650	2 575	1 014 ⁴	381 ⁴
<i>Proceeds contracted (in US\$ mn)²</i>		78	25	<i>n.a.</i>	<i>n.a.</i>
State-owned enterprises privatised by:					
Branch ministries					
Number of sales ¹		420	369	506	935
<i>Proceeds contracted (US\$ mn)²</i>		131	41	182	398
<i>Investments contracted (US\$ mn)³</i>		112	13	225	207
The Privatisation Agency					
Number of sales ¹		116	146	84	179
<i>Proceeds contracted (US\$ mn)²</i>		356	376	426	240
<i>Investments contracted (US\$ mn)³</i>		301	158	666	184
Subtotal					
Number of sales	3 500	536	515	590	1 144
<i>of which: To foreign investors</i>		17	14	38	39
<i>Proceeds contracted (US\$ mn)²</i>		487	417	608	638
<i>of which: To foreign investors</i>		196	47	424 ⁶	122
<i>Investments contracted (US\$ mn)³</i>		413	171	891	391
<i>of which: To foreign investors</i>		195	33	629 ⁶	120
Corporate liabilities assumed (US\$ mn)		185	232	36	50
Total number of firms	11 000	2 186	3 090	1 604	1 495
Total proceeds contracted (US\$ mn)²		565	442	608	638
Total investments contracted (US\$ mn)³		413	171	891	391

1. Including privatisation of whole enterprises and parts of enterprises (defined as privatised if more than 50 per cent of assets have been transferred to private ownership); US\$ values are given at the exchange rate prevailing at the time of the deal; figures correspond to contracted deals and not actual payments.
2. Apart from cash payments contracted, these amounts also include Brady bonds and bonds from internal debt rescheduling programmes ("Zunk bonds"), which were exchanged for shares, as well as debts of privatised enterprises assumed by buyers.
3. Future investment commitments that are part of privatisation contracts.
4. Data for the municipal privatisation deals for 1997 and 1998 record only deals reported to the Privatisation Agency.
5. Proceeds and investment for foreign investment transactions in 1997 include those of the Privatisation Agency and the largest transactions of branch ministries.

Source: Privatisation Agency.

slowdown in the pace of large scale cash privatisation, falling under the competency of the PA, in 1998 can be associated with a number of factors, not all of which are related to changes in policy. The special "emergency privatisation programme" of late 1996 provided a context for the conclusion of a number of important deals for some of the most valuable Bulgarian firms in the first half of 1997 under the new government. A number of the deals expected from privatisation consultancy contracts in 1998 failed to materialise. The financial

Table 18. **Largest privatisation deals since 1997**

Foreign investor	Enterprise (activity)	Share (per cent)	Cash revenue (million US\$)	Investment commitment (million US\$)
Solvay	Devnya (soda ash plant)	60	160.0	67.0
Union Minière	MDK Pirdop (copper plant)	56	80.0	220.0
Marvex	Devnya (cement)	70	44.5	209.5
Daewoo	Sofia WTC (services)	70	20.0	5.0
Barek	Drouzba (glass)	51	20.0	30.0
Sudi Ozkan	Novotel Sofia (tourism)	100	12.0	4.0
BNP	Albena (tourism)	33	10.1	0
White Beam	Orgahim (chemical)	51	8.9	5.0
Thrace	Belovo (paper)	58	6.4	10.7
Helian Commodities	Kambana (food processing)	68	5.5	23.0
Electron fund	Bulgarska Rosa (perfumes)	68	5.2	25.0
Knaut	Gipsfazer (building mat.)	60	4.6	5.4
Glasinvest	Stind (glass)	70	4.1	27.3
Kaindl/Cronospan	Bules (wood processing)	51	3.2	7.0
Sudi Ozkan	Trimontsium (tourism)	58	3.2	3.5

Source: Privatisation Agency.

Table 19. **The results of mass privatisation**

Enterprises in which all shares offered for vouchers were sold	623
Enterprises where less than 5 per cent of the total shares offered for vouchers were not sold ¹	199
Enterprises where 67 per cent or more of shares offered for vouchers were sold	666
Enterprises where 50-67 per cent or more of shares offered for vouchers were sold	81
Enterprises where less than 50 per cent or more of shares offered for vouchers were sold	293
Enterprises in which privatisation funds acquired 34 per cent of shares ²	369

1. According to the existing legislation, these shares will be distributed to the shareholders of the respective enterprise, in proportion to the shares they have acquired for vouchers.

2. This was defined as the ceiling which can be reached by funds in bidding for the shares of a single company. This stake is sufficient to block decisions (such as capital increase/decrease or transformation of the company) which require a qualified majority of 67 per cent.

Source: Centre for Mass Privatisation.

crises in emerging markets have been associated with more cautious attitudes among foreign investors toward transition countries since the second half of 1997. But problems in privatisation procedures and co-ordination between institutions have also remained important obstacles to successful privatisation in a number of cases.

Bulgaria is currently trying to make up lost time in privatisation relative to other transition economies of the region. From this point of view, a policy of divestiture that offers flexibility in the range of employed methods is understandable. But the multiplicity and complexity of privatisation methods can also be

associated with problems. The complexity of the privatisation programmes strains the capacity of the public administration to cope with implied difficulties in co-ordination and implementation.⁶⁷ This is particularly true for the case of Bulgaria, where public administration currently suffers from a shortage of competent personnel and an over-centralisation in decision-making. These factors are often cited as a cause of delays and misunderstandings in privatisation deals.⁶⁸

A related problem concerns the continuing role of line ministries in the privatisation process. As emphasised in the 1997 *OECD Economic Survey of Bulgaria*, ministries have operated under generally weak incentives to privatise assets under their jurisdiction. A large share of privatisations at the ministerial level reportedly still involve direct bilateral negotiations, as opposed to tenders or auctions that could potentially speed up the process. Due to its limited administrative capacity, the PA has often provided the line ministries with exceptional authority to complete privatisation deals with larger enterprises that should properly be the task of the PA itself. The ministries have also managed to increase the share of enterprises under their jurisdiction through the creation of holding companies. While the line ministries have to relinquish to the PA their shares in firms valued at more than US\$200 000, this rule does not apply to holding companies. At the same time, the results from 1998 indicate that ministries, particularly the Ministry of Industry, have recently come to play a more active role in the privatisation process than in the past (see Table 17).

The special conditions offered for MEBOs have been a target for complaints by outside investors, particularly foreigners. It has been suggested that, in some cases, financial investors may hide behind managers and employees in order to exploit the special benefits offered to MEBOs. A number of foreign investors consider the potential threat of such a competing bid as hindering the general transparency and attractiveness of cash privatisation in the country. Given the potential advantages in corporate governance and future investment from sales to genuine outside entrepreneurs, current efforts to limit special benefits for employees in privatisation, discussed above, could be of importance.

The very high level of debt in many Bulgarian firms also raises questions for privatisation. Some firms on the Isolation List (see above), for example, were transferred to private investors at a very low or zero “price”, under the obligation that the latter would assume outstanding debts. But incentive problems can arise here due to limited liability. Investors who have not had to spend any of their own capital could conceivably profit by accepting ownership of these firms, stripping their assets, and then filing for bankruptcy. Some concern in this regard has been raised for the case of Plama. Ownership of this large refinery, which had been scheduled for liquidation in 1996 amidst much controversy, was finally granted to a group of investors who agreed to assume the plant’s enormous debts. Since this time, the plant has been virtually idle and wages have not been

paid since early 1998.⁶⁹ The problem of high enterprise debt may have been one motivation for including a clause in the new “Strategy” to the effect that the government may opt to assume the debt of some enterprises before sale, thereby increasing the net value of the firms and requiring the purchaser to put up more of its own capital.

While the use of foreign consultants may offer promise for increasing the effectiveness of privatisation, the initial experience with such contracts has raised a number of questions. So far, the number of deals that have been concluded under such contracts is quite low.⁷⁰ Government officials have repeatedly argued that this is due to an insufficient zeal on the part of the foreign consultants.⁷¹ There have been numerous complaints, however, pointing to political pressures on the independent judgement of the latter.⁷² In a highly-publicised case, Slovan-ske Lodenice, a Slovak shipbuilder, has appealed to the Bulgarian supreme court against the Privatisation Agency’s decision to sell the Rousse shipyard to a rival bid. In August 1998, in the first decision taken under the EU’s PATA programme, the consultant had expressed its preference for the Slovak offer, a decision that the PA then revoked.⁷³ In the current second round of contracts with foreign consultants, the incentive and fee structures being proposed are a cause for concern. The government has proposed to reward them solely on the basis of success fees. While this could possibly be effective for the clearly blue-chip items, the advisers responsible for pools would have an incentive to concentrate only on the few clearly sellable items and let the rest wait. As for less attractive individual firms, the scheme may fail to attract any reputable advisory service.

Foreign direct investment

As emphasised in Chapter I, foreign investment is of critical importance to Bulgaria, not only because of the direct impact of foreign capital and business practices on restructuring and institutional change, but for the alleviation of balance of payments constraints to ensure medium-term economic stability and growth. As privatisation is a primary channel by which foreign direct investment is attracted to the country, the discussion of the previous section has already covered a number of important developments and problems in this area. The attraction of foreign direct investment continues to be a challenge. Although progress in stabilisation and the strong commitment of current government has made Bulgaria more attractive to foreign investors, the recent turmoil on international financial markets has worked in the other direction. With regard to the legal environment for foreign investors, the Bulgarian government has recently changed its strategy, moving away from preferential tax and other treatment for foreigners in favour of creating an equal, stable and fair environment for both domestic and foreign investors.⁷⁴ Possible clauses that would allow some exemptions for large imports of capital equipment remain under discussion in the government.⁷⁵

According to figures of the Foreign Investment Agency, cumulative foreign direct investment, defined as both inflows and re-investment by firms with dominant foreign participation, amounted to US\$1 881 million for the period of 1992-1998 (Table 20). Slightly more than US\$50 million of this figure represent portfolio investments, which are counted as FDI in the event that over 10 per cent of a company's shares are acquired. One third of all foreign investment came from Germany, followed by Belgium (US\$315 million and US\$282 million, respectively). Solvay, the Belgian company, tops the list of foreign investors, with the purchase of the Sodi soda ash plant in North Eastern Bulgaria (the second largest in Europe).⁷⁶ Industry attracted roughly half of total FDI, followed by trade (17 per cent), finance and tourism. Foreign investment in agriculture is only equal to US\$6 million. Although Bulgaria's human capital endowment is often considered a possible source of comparative advantage for the country, there have so far been quite few greenfield ventures. Within the CMEA, Bulgaria specialised in disk-recording devices, microelectronics and electronic devices related to military industry, but the high-tech sector has failed so far to attract much interest.⁷⁷

Table 20. **Foreign direct investment in Bulgaria¹**

	To end- 1992	1993	1994	1995	1996	1997	1998 ²
Number of contracts	69	604	2 276	1 932	3 308	1 889	332
Cumulative	69	673	2 949	4 881	8 189	10 078	10 410
Annual volume (US\$ mn)	34.4	102.4	210.9	162.6	256.4	636.2	477.9
Change over previous year (%)	..	198	106	-33	57	148	..
Annual volume <i>via</i> privatisation (US\$ mn)	34.4	22	134.2	26	76.4	421.4	167.7
Percentage of total volume	100	22	64	16	30	66	35
Change over previous year (%)	..	-78	190	-75	88	120	..
Cumulative volume (US\$ mn)	34.4	136.8	347.6	510.2	766.6	1 402.8	1 880.7
Index, 1992 = 100	100	398	1 010	1 483	2 228	4 078	5 467
Average size per project (US\$ 000)							
Per annum	498.6	169.5	92.7	84.2	77.5	336.8	1 439.4
Cumulative	498.6	203.3	117.9	104.5	93.6	139.2	180.6

1. These figures correspond to the value of capital actually transferred and registered in the courts, plus investments from retained earnings of foreign-owned companies, plus (for 1997 and 1998) foreign direct (over 10 per cent of a company shares) and portfolio investment inflows *via* the capital market. The latter amounted to US\$22.7 million in 1997 and to US\$13.5 million in the first half of 1998. Due to revisions of foreign investment figures, this table and Table 34 of the 1997 *OECD Economic Survey of Bulgaria* are not comparable.
2. Preliminary.

Source: Foreign Investment Agency.

The European Bank for Reconstruction and Development (EBRD) has been an important investor, and has established several funds to invest in the country. The Black Sea Fund (BSF) was set up in August 1998 jointly with the International Finance Corporation (IFC, part of the World Bank group) to provide equity and equity-based financing to ventures in the Black Sea region over the next 10 years.⁷⁸ It plans to invest at least a half of its committed capital of US\$62 million in projects in Bulgaria. The BSF sees food industry, textiles, clothing, new technologies, construction materials and packaging materials as the most promising sectors for its future investment in Bulgaria. It plans to take part in management buyouts or share the risks with reliable foreign investors in privatisation deals. Euromerchant Balkan Fund, another fund set up by the EBRD and IFC in 1994 to provide investment to the Balkan region, has so far fully invested in six projects in Bulgaria, including sewing and textiles, Goody's restaurant chain, glassware packaging, aluminium window frames and Chipita packaged snacks.

Table 21. **Foreign direct investment in transition economies**
(US\$ per capita)

	1992 ¹	1997 ²	Cumulative 1989-97 ²
Visegrad countries			
Czech Republic	151	124	823
Hungary	497	207	1 667
Poland	37	79	321
Slovak Republic	44	9	227
South-Eastern Europe			
Albania	51	13	148
Bulgaria	18	60	147
Croatia	128	41	297
Romania	24	54	149
Slovenia	522	161	639
Baltic States			
Estonia	156	88	695
Latvia	78	139	543
Lithuania	20	59	344
Commonwealth of Independent States			
Russia	19	25	63
Ukraine	3	12	53

1. OECD (1997), *Economic Survey of Bulgaria*, p. 126, based on data of the Austrian Federal Ministry of Economic Affairs (foreign investment) and World Bank Development Report (population).

2. Estimates.

Source: OECD, EBRD (1998), *Transition Report*.

The government expected to attract US\$1.2 billion in 1998, approximately as much as total accumulated flows in 1992-1997. Such an optimistic projection was conditional on the expected sale of a number of large state-owned enterprises, most notably the Bulgarian Telecommunications Company (BTC). FDI (inflows and re-investment) recorded by the Foreign Investment Agency for 1998 amounted to US\$478 million, as opposed to US\$636 in 1997. The difference in actual inflows of FDI recorded in the balance of payments is even more striking, however: US\$161 million for the first 10 months of 1998 as opposed to US\$473 million for the corresponding period in 1997.⁷⁹ In terms of cumulative per capita foreign investment, Bulgaria still trails behind most other transition economies, although it now compares favourably with Russia, and is at roughly the same level as Albania and Romania (Table 21). Clumsy administration and bureaucracy, political uncertainties related to frequent changes of governments, the lack of transparency in business-state relationships, “incessant” changes of the legal and regulatory framework, the customs regime, and unfair competition from contraband, are often cited as impediments to foreign investment.⁸⁰

The international competitiveness of the corporate sector

It is difficult to evaluate aggregate enterprise performance in a transition economy. Progress in restructuring can imply temporary declines in output and even lower efficiency, while new investments and technology usually require time to yield improvements. Moreover, trade specialisation patterns show a high degree of path-dependence. It is very difficult for any country to change its position in the international division of trade flows within a few years from the start of reforms. Nevertheless, in the case of Bulgaria, it is clear that the slow process of creating a set of incentives favouring corporate restructuring and economic efficiency has taken a heavy toll. The low share of manufactured goods in Bulgarian exports is but one indicator of the slow pace of restructuring.

The legacy of planning is still visible in the structure of Bulgarian foreign trade. While Bulgarian trade patterns did change sharply with the collapse of the CMEA market, moving away from exports of electronics and other manufactured goods, these specialisation patterns have not changed very much in subsequent years. Traditional and resource-intensive industries continue to dominate exports.

Table 22 shows Bulgarian revealed comparative advantages and disadvantages at the two-digit level of the SITC Classification. This indicator is based on the observation of net export flows (exports minus imports) for each product, normalised by their weight in total trade. Bulgaria remains specialised in some labour-intensive products (apparel and clothing, footwear), a natural outcome of the abundance of cheap labour, and capital-intensive industries (non-ferrous

Table 22. **Bulgaria's revealed comparative advantage and disadvantage**

code	Main comparative advantages	1992	¹ 1995	1997	Export share ²	Cumulative share of exports ²	SITC code	Main comparative disadvantages	1992	¹ 1995	1997	Import share ²	Cumulative share of imports ²
68	Non ferrous metals	4.6	4.7	7.5	9.1	9.1	33	Petroleum, petroleum products and related materials	-19.6	-11.2	-11.4	16.8	16.8
67	Iron and steel	4.0	7.8	7.4	10.3	19.4	34	Gas, natural and manufactured	-6.3	-8.4	-9.9	9.9	26.7
84	Articles of apparel and clothing	3.4	3.3	5.1	7.0	26.4	32	Coal, coke and briquettes	-2.7	-1.5	-3.8	3.8	30.5
56	Fertilisers manufactured	3.1	4.5	3.4	3.5	29.9	65	Textile yam, fabrics, made-up art., related products	-0.8	-2.1	-3.6	7.1	37.6
11	Beverages	1.9	3.2	2.7	2.9	32.8	72	Machinery specialised for particular industries	-2.3	-1.8	-3.0	3.7	41.3
12	Tobacco and tobacco manufacturers	6.3	5.2	2.7	3.3	36.2	28	Metalliferous ores and metal scrap	0.4	-1.4	-1.9	3.4	44.7
51	Organic chemicals	0.0	0.7	1.7	3.6	39.7	78	Road vehicles	-5.9	-3.7	-1.8	2.3	47.0
66	Non metallic mineral manufacturers n.e.c.	1.2	1.2	1.6	2.8	42.5	04	Cereals and cereal preparations	2.2	2.8	-1.5	2.0	49.0
85	Footwear	0.7	1.0	1.4	2.5	45.0	06	Sugar, sugar preparations and honey	-1.8	-1.4	-1.5	2.1	51.1
05	Vegetables and fruit	2.4	1.4	1.4	2.2	47.2	59	Chemical materials and products n.e.s.	-1.0	-1.2	-1.2	1.6	52.6
79	Other transport equipment	0.4	1.2	1.3	1.7	48.9	64	Paper, paperboard and manufactures	-1.0	-1.9	-1.1	2.0	54.6
55	Essential oils and perfume materials; toilet, polishing and cleansing prep.	-0.2	0.6	1.1	2.0	50.9	26	Textile fibres (excl. wool tops) and combed wool and their wastes	-1.1	-1.4	-1.1	2.0	56.6
54	Medical and pharmaceutical products	0.5	0.3	0.9	2.8	53.7	75	Office machines and automatic data processing machines	-1.0	-1.6	-1.0	1.4	58.0
57	Plastic in primary form	0.1	0.6	0.8	1.8	55.6	87	Professional, scientific and controlling instruments and apparatus n.e.c.	-0.8	-1.0	-0.9	1.2	59.2
24	Cork and wood	0.7	0.5	0.7	0.9	56.4	76	Telecommunications, sound recording and reproducing apparatus and equipment	-1.4	-1.5	-0.9	1.2	60.4
52	Inorganic chemicals	1.7	-0.3	0.6	2.4	58.8	61	Leather, leather manuf. n.e.s. and dressed furskins	-0.1	-0.3	-0.8	1.2	61.6
63	Wood and cork manufactures	0.4	0.5	0.5	0.8	59.7	53	Dyeing, tanning and colouring materials	-0.7	-0.7	-0.4	0.7	62.3
82	Furniture and parts thereof	0.5	0.3	0.5	0.7	60.4	08	Feeding stuff for animals (excl. unmilled cereals)	-0.3	-0.1	-0.4	0.5	62.8
01	Meat and meat preparations	1.9	0.4	0.4	1.3	61.6	62	Rubber manufactures n.e.c.	0.4	-0.2	-0.4	0.8	63.6
73	Metalworking machinery	1.1	0.5	0.4	0.9	62.5	89	Miscellaneous manufactured articles n.e.c.	0.8	-0.2	-0.3	1.6	65.2

1. RCA: revealed comparative advantage indicator ($X_i/X - M_i/M$), see text.

2. As percentage of total exports or imports in 1996.

Source: OECD Secretariat elaboration on data provided by the National Statistical Institute.

metals, iron and steel, fertilisers), which were given priority under the plan.⁸¹ In 1997, two sectors – non-ferrous metals and iron and steel – had the highest revealed comparative advantage and alone accounted for roughly a fifth of the country's sales abroad. On the import side, energy goods (petroleum, gas, and coal) dominate. Changes since the early 1990s also indicate a possible deterioration of the competitiveness of Bulgarian agriculture. Among sectors showing a positive revealed comparative advantage, tobacco has had to cope with the reorientation of consumers' preferences in the former CMEA markets.

These trade patterns do not seem *per se* atypical for a small open economy. For example, while the export concentration of Bulgaria is slightly higher than that of Denmark, it is lower than that of Portugal, among low-income OECD countries, and Romania and the Slovak Republic among transition economies.⁸² In the dynamics of technology-intensity, however, Bulgaria seems to be falling behind other transition countries. Based on analyses of both the factor mix and the technology used, the revealed comparative disadvantages in the most sophisticated industry clusters have increased. Furthermore, while Bulgaria had a low comparative disadvantage in specialised supplies (industrial machinery) and science-based goods in 1998, in both cases it has been the only country to record a deterioration during the 1990s.⁸³

Bulgaria has also had limited success in attracting EU-based firms seeking to relocate part of their operations abroad in search of lower labour costs. Outward processing traffic (OPT) refers to the arrangement whereby EU firms supply subcontractors with materials, parts and components to be processed or assembled, and then re-imported into the EU. In the early 1990s, this kind of arrangement accounted for an important share of exports from transition economies, especially in industries such as textiles and clothing where EU preferential tariff quotas exist. While no aggregate data are available on OPT, the case of Italy provides a good proxy of overall EU OPT, and can therefore be taken as representative of more general trends.⁸⁴ In OPT arrangements with Italian firms, Bulgaria not only lags well behind Romania, a transition country with a similar level of economic and institutional development, but also behind OECD Central European countries where labour costs are much higher. Additional evidence of particular difficulties in Bulgaria transition is provided by the very low diffusion of standardisation among Bulgarian firms (Table 23). Obtaining a so-called ISO licence is becoming increasingly important for enterprises from emerging markets, as it signals to foreign customers (and potential investors) that the goods and services supplied match strict quality requirements of industrialised countries. Not meeting this test can put Bulgarian firms at a disadvantage, as it increases the low-quality stigma often attached to products from transition countries.

Table 23. **The diffusion of standardisation in transition economies (end-1996)**

	Number of ISO 9000 licence holders ¹
Hungary	423
Poland	260
Czech Republic	366
Slovenia	152
Slovakia	135
Romania	61
Russia	56
Croatia	38
Bulgaria	14
Ukraine	14
Estonia	4

1. ISO 9000 consists of standards and guidelines relating to “quality management” systems, and related supporting standards on terminology and specific tools, such as auditing (the process of checking that the management system conforms to the standard). The standardised definition of “quality” in ISO 9000 refers to all those features of a product (or service) which are required by the customer. “Quality management” means what the organisation does to ensure that its products conform to the customer’s requirements, although ISO 9000 is not a product standard.

Source: ISO (International Organisation for Standardisation).

Opening the economy to competitive pressures

In the socialist planned economies, the centralised co-ordination of production typically resulted in a high concentration of industries. In Bulgaria, this anti-competitive inheritance from planning was especially strong. The average size of industrial enterprises in Bulgaria was larger than in all socialist countries other than the Soviet Union.⁸⁵ During the first years of transition, problems in high industrial concentration were compounded by delays in privatisation. Collusion, transfer pricing, and tax evasion, sometimes involving relationships between state firms, private firms, banks, and government organs have often impeded competition, efficiency, and equity. A large amount of economic activity has been concentrated in a small number of business groups.

The Bulgarian competition authority, the Commission for the Protection of Competition (CPC), was founded in 1991 by the Law on the Protection of Competition. In spite of the difficult environment of macroeconomic instability and slow privatisation, the CPC has been surprisingly active during transition. The number of petitions filed has been substantial relative to the average in transition economies, and so has the percentage of petitions accepted for investigation. The activity of the CPC, however, has been heavily skewed towards “unfair” trade practices and contract enforcement problems, issues that are normally settled through the judicial system, while hard-core anti-competitive behaviour has

received much less attention.⁸⁶ With eleven members, the CPC board is also rather large by international standards.

The current reform of competition policy aims at making Bulgarian laws and regulations fully compatible with the framework of the European Union (EU). The Law on the Protection of Competition of May 1998 increases the powers of the CPC, defines its prerogatives in merger cases, and states that its decisions can only be appealed before the Supreme Administrative Court. An important exception is made, however, as regards the CPC's decision to approve or block mergers and to grant or refuse exemptions for anti-competitive agreements. Here, the CPC is severely limited in its ability to appeal such decisions to the Supreme Court. This effectively gives the CPC a high profile role in privatisation as many purchases will constitute mergers subject to review. Clearly, the effective co-ordination between the CPC and other government bodies, particularly the Ministry of Industry, is of critical importance here. Finally, the new law contains very restrictive clauses on advertising, with the justification of promoting fair competition. But these clauses may need to be reviewed, with consideration given to the potentially valuable information that advertising can give consumers about marketed products.⁸⁷

Privatisation and liberalisation in network industries

Competition in public utilities – energy, telephony, transport, and sanitation – raises specific issues. International experience demonstrates how a combination of ownership change, liberalisation, and better regulatory design can generate large efficiency and welfare gains.⁸⁸ The experience of developed economies in this area suggests a number of policy lessons: *a)* thought should be given to the separation of monopoly elements from potentially competitive sectors before privatisation; *b)* the nature of regulations and the span of intervention should be specified in advance in order to maximise certainty; *c)* decision criteria must be consistent across sectors and time in order to minimise the risk of regulatory arbitrage; and *d)* a clear arbitration system must be in place to solve disputes between utilities and agencies. These issues, in particular the relevance of market structure, are quite relevant to transition countries, where weak institutional development suggests a need to reduce the burden put on regulatory agencies. The law-maker's task is further complicated by the presence of important distributional issues. This concerns both the price structure and the definition of core universal services. A delicate balance must be realised between these concerns and the need for increasing efficiency.

Energy

Average electricity prices for 1998 were below 4 US\$ cents/kWh, that is less than half the average in the OECD area. In line with the commitments of the

funding programme with the IMF, a three-year programme for the energy sector was approved in August 1998. Its objective is greater efficiency through restructuring and privatisation of electricity production. Electricity tariffs will rise by an average 3.57 per cent from 1 January 1999, and then by 7.9 per cent from 1 July 1999, 1.7 per cent from 1 January 2000, and 7.8 per cent from 1 April 2001. Average price hikes are calculated on the basis of electricity prices for both households and industrial consumers. Also in accordance with a recommendation from the IMF, coal and heating prices were raised by 30 per cent from 1 September 1998. All state subsidies are to be removed by the end of the three-year term.

In mid-1998, the PA appointed a sale agency for the pool National Electricity Company (NEK), which includes 22 hydroelectric power plants and three thermal power plants. NEK's restructuring is aimed at separating design activities, engineering operations, consulting, and equipment repair services into separate companies. From the viewpoint of market competition, the key policy issue concerns the unbundling of generation, transmission, and distribution. NEK is to privatise on its own at least one big thermal power station by the end of 1999, all coal mining enterprises by 1999-2000, and other state assets in electricity production and distribution by 2001. The high-voltage network and the Kozlodui nuclear plant will remain under state ownership. With respect to coal mining, the strategy for development is based on the extensive use of those mines with the lowest production costs. It also foresees gradual price increases until 2001, the time at which all coal prices will be completely liberalised. Finally, in accordance with EU norms concerning the liberalisation of energy markets, the Bulgarian government and the parliament are preparing a new law to establish an energy regulation body.

Telecommunications

The Bulgarian Telecommunications Company (BTC) is to be sold by early-1999.⁸⁹ BTC was established in 1993, when the postal service was separated from telephone services. In 1997, an external advisor was named, and BTC's accounts were audited. The advisor recommended offering 66 per cent of BTC's shares to a strategic buyer and permitting 50 per cent of the price to be paid using debt instruments (Brady and ZUNK bonds). The government approved the strategy for the privatisation of the company in July 1998, setting the percentage of shares to be sold at 51 per cent. Some investment has already taken place, but BTC's network is still largely based on outdated analogue equipment, with only 13 per cent of digitalised switching, despite quite extensive penetration (32 lines per 100 inhabitants). The government is offering potential investors a monopoly on local, long-distance, and international fixed-line telephone operators until end-2002. In order to increase the allure of BTC, the buyers will be granted the

license for a second mobile phone operator, competing with the existing one. The buyer(s) will not have the right to sell its stake in BTC until 2002 without approval of the PA.

The promotion of competition can help to facilitate increases in efficiency, reductions in tariffs, and quality improvements. The adoption of a telecommunications law and the creation of an independent regulatory authority remain essential to the liberalisation process. If Bulgaria wishes to attract substantial new investments, it should provide international investors with strict guarantees that only an independent and competent body could make credible. International experience indicates the key role that independent regulators can play in assuring equal access. The final draft of the telecommunication bill was approved by the National Assembly in August 1998, only a few months before the sell-off. While the law establishes a transparent set of rules, the new State Telecommunications Commission (STC), which will govern the sector, is not at all independent from government. The members of the Commission will be appointed by the Prime Minister, whereas similar bodies in other countries respond to Parliament. Competencies of the commission are also shared with the Council of Ministers and its newly-created National Radio Spectrum Board. Another key issue that remains to be addressed is the division of responsibilities between the STC and the CPC.⁹⁰

The EU accession process

Bulgaria submitted its application for membership to the European Union in December 1995 as part of the historic process of ending the division of Europe and consolidating the establishment of democracy across the continent. In July 1997, the Commission presented an *Opinion* on Bulgaria's request for membership,⁹¹ applying the criteria established at the Copenhagen European Council of June 1993.⁹² The Commission acknowledged that Bulgaria is on the way to satisfying the political criteria, as it has democratic institutions whose stability now seems secure. But it was also concluded that these institutions still need to be reinforced by greater respect for the rule of law at all levels of public administration.⁹³ The Commission also stressed that considerable efforts are needed to defend basic rights, combat corruption, and improve the operation of the judicial system. For the present, the Commission concluded that Bulgaria would be likely to have trouble coping with competitive pressure and market forces within the Union.⁹⁴

In December 1997, the European Council decided that the Accession Partnership would be a key feature of an enhanced pre-accession strategy, mobilising all forms of assistance to the applicant countries within a single framework.⁹⁵ The purpose of the Accession Partnership, launched in 1998, is to set

Table 24. **Priorities and objectives included in the Accession Partnership**

Policy area	<i>Short-term (1998)</i>
Economic reform	Establishment of medium-term economic policy priorities and joint assessment within the framework of the Europe agreement; pursuit of the programme launched by the government, including transparent privatisation of state enterprises and banks and restructuring measures in industry, financial sector and agriculture and measures to encourage increased foreign direct investment.
Institutional strengthening	Adoption of the draft civil service law and progress in public administration reform; advance in the areas of internal financial control capacity, environment, customs policy, reinforcement of phytosanitary and veterinary administrations, particularly as regards facilities at external borders; begin to set up structures needed for regional and structural policy.
Internal market	Further alignment in the areas of intellectual and industrial property rights, financial services, taxation; adoption of the necessary legislative framework for state aid monitoring; adoption of a new competition law.
Justice and home affairs	Concrete steps to combat corruption and organised crime and improve border management.
Environment	Continue transposition of framework and horizontal legislation.
Energy	Establishing a comprehensive, long term, energy strategy and respect of nuclear safety standards and realistic closure commitments for certain units as entered into in the Nuclear Safety Account Agreement.
<i>Medium-term</i>	
Political criteria	Further efforts to consolidate the protection of individual liberties and integrate the Roma (Gypsy population).
Economic reform	Complete the privatisation process. Strengthen market economy institutions.
Economic policy	Regular review of the joint assessment of economic policy priorities, focusing on satisfying the Copenhagen criteria.
Institutional strengthening	Completion of reform at all levels; improved operation of the judicial system; further development of the National Audit Office and internal financial control structures; establishment of anti-trust and state aid monitoring bodies; improvements in accounting, auditing and statistics and strengthening nuclear regulatory authority.
Internal market	Alignment of competition policy, state aids, customs, taxation, audio-visual policies, public procurement legislation; upgrading of standardisation, conformity assessment structures and establishment of a market surveillance system; harmonisation of technical legislation on industrial standards.

Table 24. **Priorities and objectives included in the Accession Partnership** (*cont.*)

Policy area	<i>Medium-term</i>
Justice and home affairs	Development of effective border management and frontier control systems; implementation of migration policy and asylum procedures as well as the fight against organised crime and corruption; alignment of visa policy.
Agriculture and fisheries	Concluding the land restitution process and establishment of a land register and functioning land market; development of the capacity to implement and enforce the CAP and the common fisheries policy.
Energy	Implementation of a comprehensive policy based on efficiency and diversification.
Transport	Further efforts on alignment to <i>acquis</i> and to provide necessary investment for transport infrastructure.
Employment and social affairs	Development of appropriate labour market structures and joint review of employment policies as preparation for participation in EU co-ordination; alignment of labour and occupational health and safety legislation and development of enforcement structures, in particular early adoption of the framework directive on health and safety at work; enforcement of equal opportunities between women and men; further development of active, autonomous social dialogue; development of social protection, undertake steps to bring public health standards into line with EU norms.
Environment	Development of monitoring and implementation control structures and capacities.
Regional policy	Introduction of legal basis and development of administrative structures and budgetary procedures.

Source: European Commission.

out in a single framework the priority areas for further work identified in the *Opinion*, the conditions applying to assistance, and the financial means available. Table 24 lists the short and medium term priorities and intermediate objectives which have been identified on the basis of the analysis of the *Opinion* and the Council's examination. In particular, Bulgaria will need to make substantial efforts in order to apply the *acquis* in the fields of telecommunications (particularly price structures), audio-visual, taxation, statistics, consumer protection and customs, as well as to align its procedures in environment, employment and social affairs (in particular labour law and the structure of the labour inspectorate) with EU standards. Bulgaria must also provide the investment necessary for extending the European transportation network, which is an essential element for the effective operation of the single market, and put in place fundamental reforms of its agricultural sector. Around 40 per cent of Bulgaria's electricity is produced by the Kozlodui nuclear power station, which has to be modernised in the medium term to meet internationally accepted standards. Moreover, in 1993 Bulgaria agreed to close those units which cannot be modernised, and must also make a number of modifications to its legislation to comply with Community rules in the nuclear sector and to respect international regimes.

A more recent Regular Report submitted to the European Council in December 1998 on Bulgaria's progress toward accession acknowledges that Bulgaria now fulfils the Copenhagen political criteria. The Commission also concluded that Bulgaria has made considerable progress in macroeconomic stabilisation and recent reforms, although at an early stage, are helping to improve international competitiveness. The report stresses the importance of building on achievements to date, giving priority to completing trade and price liberalisation and accelerating privatisation in the financial and enterprise sectors. It is noted that increased foreign involvement in the banking sector will help improve the efficiency of financial intermediation. In addition to these reforms, the report stresses that public administration must adapt to its role in a market economy.

Notes

1. The share of so-called “administered prices” in the consumer (CPI) basket increased from an estimated 16 per cent in 1992 to 48 per cent in 1996. Such prices were closely monitored, often subject to various discounts or mark-ups, and, in some cases, actively controlled.
2. Bulgaria has greatly reduced the number of goods subject to administrative pricing since 1997. Now such controls are generally confined to cases of natural monopolies or very limited competition: utilities, natural gas, postal services, tobacco products, and pharmaceuticals.
3. These and other numbers cited in this paragraph refer to balance of payments statistics, which are reported on an FOB-FOB basis.
4. See below for an explanation of these instruments.
5. Decree 68 of 27 February 1997, as cited by AEAF (1998a), p. 11.
6. One study showed that most industrial enterprises, the majority of which did not meet the stated conditions, increased wages in 1997 between 1.5 and 3 times. Furthermore, there was apparently no noticeable correlation between wage increases and profitability. (AEAF 1998a, p. 12.) In November 1998, Ivan Neikov, the Minister of Labour and Social Policy, announced that many state enterprises had been still violating the wage growth restrictions in 1998 [“One Hundred State Firms...” (1998)].
7. From NSI national accounts data.
8. As mentioned in the previous section, despite the moderate recovery in output in 1998, exports for the first half of the year were below levels achieved in 1997. Although some of this could be attributed to the restoration of domestic demand, the real appreciation of the lev, and lower prices on a few key commodities, the export numbers during the crisis months of 1997 still appear to be abnormally high.
9. See Chapter 2.
10. The National Statistical Institute estimates that roughly 214 000 employees moved from the state to the private sector as a result of privatisation between March and December 1997.
11. See 1997 *OECD Economic Survey of Bulgaria*, Chapter III. While private firms received a large share of commercial credit before the 1996 crisis, this credit was concentrated in a rather small number of firms. See Footnote 33.
12. Hristov (1998), “Grain Growers...” (1998).
13. Simple average MFN rate. In 1999, average rates for non-agricultural and agricultural goods are 12.58 and 25.55 per cent, respectively, bringing the overall average rate to 16.18 per cent. (Ministry of Trade and Tourism.)

14. Memorandum... (1998), par. 27 Bulgaria has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the IMF Articles of Agreement as of 24 September 1998.
15. See, for example, Aghion and Bolton (1997), Hunya (1997).
16. OECD (1997), p. 107.
17. Austrian Institute of Economic Research (1997).
18. GDP growth was 19 per cent higher in the first quarter of 1998 relative to the same period of 1997, which mostly explains why GDP was 12 per cent higher for the first half of the year.
19. "Industrial Business Climate..." (1998), "Sales in Industry..." (1998).
20. In official data, this is listed as "credit" from the BNB to the Ministry of Finance. In reality, however, the BNB can be viewed as only intermediating IMF funding in this case. Indeed, under the currency board arrangement, the BNB is forbidden from crediting any domestic institution.
21. Ministry of Finance.
22. Under former law, foreign businesses undertaking "priority investments" could be exempted from 50 per cent of the profit tax for a 10-year period. Imports of equipment could be exempted from all duties if they added to the capital of a foreign company.
23. For reasons highlighted below, the wage rate in the state sector is arguably a more reliable overall measure of movements in wages than combined reported state and private wages.
24. AEAf (1998b), p. 34.
25. OECD (1998c).
26. On the basis of a limited opinion poll taken by the National Statistical Institute of a number of "experts", the share of the shadow economy in GDP increased in 1997, and may have accounted for over 30 per cent of GDP that year. Another opinion supported in the study is that at least 40 per cent of Bulgarian businesses evade taxes to some degree. ["Black Economy Generates..." (1998)].
27. Ministry of Labour and Social Affairs, OECD (1998c).
28. Institute of Economics (1998) p. 11, also AEAf (1998a).
29. OECD (1998c) p. 47, Ministry of Labour and Social Affairs.
30. Memorandum... (1998).
31. The 1997 *OECD Economic Survey of Bulgaria* contains a detailed analysis of the behaviour of commercial banks. Among other conclusions, it was found that a very large share of bad commercial credit was concentrated in a handful of large loans, each over US\$1.4 million dollars, to private firms. The aggregate volume of these large loans, the majority of which were delinquent, was in the range of 10 per cent of GDP, a figure comparable to the entire volume of commercial credit in GDP in Russia at the same time. Bulgarians have a common expression for insiders that struck it rich from corrupt loans: "credit millionaires".
32. The share of commercial credit to the non-financial sector in Bulgaria stood at over 40 per cent on the eve of the crisis of 1996. While this is not a high level for a developed OECD country, it is much higher than that of any of the CEFTA transition countries other than the Czech Republic and Slovakia. These latter countries, however, have maintained high ratios due to a large amount of bad debts inherited from

the pre-transition period. The state assumed these debts in Bulgaria and rapid inflation devalued much of the other debt from the past. Thus, Bulgaria was unique in maintaining a relatively high ratio of credit to the non-financial sector in GDP that was comprised of new (post-transition) loans. The volume of this credit reflects the highly distorted incentives under which banks operated [OECD (1997), Chapter II].

33. Indeed, even most of the larger banks were already insolvent by the end of 1995. But the National Bank did not even have the power to impose bankruptcies or liquidations on banks until mid-1996.
34. OECD (1997).
35. "Law on Banks" in Bulgarian National Bank (1998b).
36. This clause addressed a major problem that existed from mid-1996 to mid-1997. During this time, courts typically attempted to carry out their own investigations of the alleged insolvency of the bank. Not only did this require much time, but in several cases the courts refused to declare bankrupt clearly insolvent banks on the basis of various technicalities.
37. Chapter V in Bulgarian National Bank (1998b).
38. Chapter II, Article 9 in Bulgarian National Bank (1998b).
39. Three banks did not meet this requirement by the end of June 1998. The deadline was extended to the end of August, after which time all banks officially met the requirement.
40. Regulations.
41. Article 21(2)1 in Bulgarian National Bank (1998b).
42. Article 41(1) in Bulgarian National Bank (1998b).
43. The nature of monitoring and banking supervision has been changed fundamentally since 1997. Specific USAID and EU-PHARE projects have targeted the improvement of banking regulation, and Barents Group has been giving technical and consultancy support in this endeavour. The number of on and off-sight inspections has been increased, while inspection rules and strategies to deal with problem banks are being elevated to world standards. A CAMELS system for rating banks is being implemented; 12 banks had already been rated as of early 1998.
44. This insurance covers 95 per cent of deposits up to BGL 2 million and 80 per cent between BGL 2 and 5 million.
45. In fact, except for the large Bulbank, commercial credits accounted for the vast majority of assets of most banks at the end of 1995.
46. Bulgarian National Bank (1998a).
47. Todorova and Dimitrova (1998).
48. For analyses of the costs and benefits to relational financial contracting, see, for example, Aoki and Dinc (1997), Williamson (1995), and Rajan (1996).
49. On the potential benefits of the development of credit market institutions for corporate governance in transition economies, see Aoki (1995).
50. Michael Borish and Company (1998).
51. On this subject, Bulgarian authorities should be aware of recent research that suggests a possible role for regulating interest rates on deposits should such a difficult situation arise. This is discussed in two recent studies by Hellman, Murdock, and Stiglitz (1996 and 1997). The rationale is as follows: often the elasticity of savings with

- respect to small changes in interest rates on deposits is not very high. Yet the effect on bank profitability can still be substantial, and even essential in the presence of underdeveloped credit markets. Banks can still compete for deposits using means other than interest rates. This is very much a “second best” measure, and the resulting distortions and welfare reductions for depositors must be weighed against the extent of the perceived threat to the banking sector.
52. Ministry of Finance.
 53. *Bulgarian Economic Outlook*, No. 38, 25 September 1998.
 54. Despite this fact, legislation is continuing to be adjusted with the goal of expediting the bankruptcy process. In 1998, amendments were passed to the commercial code that tightens the definition of “insolvency” to include default on payments of over 30 days. Courts are also now obliged to begin insolvency proceedings on the same day that a claim is filed and take no longer than 3 months to deliver a judgement.
 55. As of January 1998, there existed 2 reported cases where creditors both initiated insolvency proceedings against large enterprises (more than 250 employees) and had their claims met as a result of liquidation (data provided by the Ministry of Industry).
 56. For example, the performance of a sample of 123 Bulgarian industrial enterprises in 1995 and 1996, which had directors replaced since mid-1997, indicated higher profitability, export orientation, and investment than the averages in their respective industries (OECD sources).
 57. The first securities market in a transition economy was established (or re-opened) in Budapest in 1990. In Central and Eastern Europe and the Baltic states, the total market capitalisation of the securities markets has increased dramatically and reached around \$50-60 billion at the end of 1997, which is around 15-20 per cent of the GDP. Most of the listed shares are privatised enterprises, though in several advanced transition economies the initial public offerings of “pure” private companies have started.
 58. This strategy was agreed with the World Bank in association with a Financial and Enterprise Structural Adjustment Loan (FESAL).
 59. These targets are not formal requirements of the recent Stand-by Agreement, however.
 60. Ministry of Agriculture, Forestry, and Agrarian Reform.
 61. Up to August 1998, the Privatisation Law has been amended 15 times.
 62. The conditions surrounding debt/equity swaps in privatisation have been altered on several occasions. According to the most recent ordinance issued in December 1997, Brady bonds may be used for paying up to 50 per cent of a privatisation deal (for state-owned assets only), and they are accepted at par value.
 63. Following the revaluation of state-owned assets carried out at the end of 1997, the book value of some state-owned enterprises has risen by as much as 10 times, leading to a dramatic increase in the number of enterprises falling under the responsibility of the PA. Prior to the August 1998 amendment to the Privatisation Law, the PA had issued authorisations to line ministries, on a case-by-case basis, to proceed with transactions for state-owned enterprises with book value of over BGL 350 million.
 64. In practice, however, the PA has been pressuring employees to make a large percentage of such down payments in cash.

65. More than half a million persons have received voucher books amounting to BLG 250 000 each as part of the second wave of mass privatisation. Subscription for the first auction of shares started in January 1999, when shares of 31 enterprises, with a combined par value of BLG 196 million were put up for sale.
66. According to the commercial code, a 67 per cent stake is required in order to control decisions concerning an expansion or contraction of the capital, or for company transformations such as mergers.
67. Similar concerns have been expressed for the Romania's privatisation programme. See OECD (1998a), p. 98.
68. See the discussion of this in the next section on foreign investment and Footnote 80.
69. After selling a 75 per cent stake to Euroenergy Holding in 1996, the government, which now holds less than one per cent in the plant, has been trying to conclude a deal that will allow International Equities Inc., part of Stellar Global of Canada, to buy Euroenergy and its Plasma share. The deal failed. In early June 1998, eleven creditor banks, the government and Plasma representatives agreed that insolvency proceedings should begin (Reuters, 17 June 1998). The District Court of Pleven declared the company insolvent and opened a procedure for winding it up. In November, the PA signed an agreement with a Swiss-Norwegian consortium on the settlement of Plasma's rights and obligations and the transfer of shares ("Pleven Oil Refinery Goes to Plasma Consortium Ltd.", *Bulgarian Economic Outlook*, 20 November 1998).
70. Up to November 1998, the only deal concluded through an intermediary has been the MEBO of Verila, a manufacturer of detergents. By the end of the year, however, 2 more deals have reportedly been concluded.
71. "Instead of Complaining Intermediaries Should Make Proposals", *Bulgaria Economic Outlook*, 13 November 1998.
72. "With New Rules, Privatisation Agency Doubles Work of Foreign Consultants", *Bulgaria Economic Outlook*, 13 November 1998.
73. "Shipyard dispute raises doubts over Bulgarian sell-off process", *Financial Times*, 16 October 1998. The supreme court has recently ruled in favour of the Privatisation Agency on this issue.
74. Such privileges date from amendments to the Foreign Investment Law of October 1997. These Privileges included exemption from the VAT and customs duties for imports of equipment. A new category was also created for "priority investment projects", which are either over US\$5 million, create 100 jobs, or are located in high unemployment (priority) areas. These projects became eligible for a 50 per cent rebate on state profit tax for ten years, as well as liberal profit and capital repatriation provisions. Other than the repatriation conditions, these privileges were repealed in 1998.
75. "FIA Proposes Tax Exemption for Imported Equipment", *Bulgarian Economic Outlook*, 4 December 1998, No. 48, p. 8.
76. EU-wide competition policy issues delayed the clearing of the Sodi deal. The Bulgarian supplier was the only competitor of Solvay on the Italian market, partly because US producers, which are subject to EU anti-dumping duties, were finding it uneconomical to export to Italy. The Italian Anti-trust Authority therefore decided to condition its approval of the take-over to the removal of the discrimination against US producers, which was decided by the Commission following a request in this sense by Solvay and other smaller European soda-makers. See Amato (1998), pp. 126-31.

77. One of the first such investment was made by George Soros, the international financier, who founded a software company together with the Bulgarian telecommunication company (*Central European Economic Review*, July-August 1998, p. 6).
78. The EBRD has contributed some 30 per cent of the fund's capital, the IFC some 16 per cent and the remainder was distributed among several Greek and US private companies and pension funds. Since 1992, the EBRD has approved 28 projects for Bulgaria (of which 22 are in the private sector), totalling ECU 341 million.
79. BNB preliminary data.
80. The Bulgarian International Business Association (BIBA), grouping the largest foreign investors in the country, publicly released a document highlighting such obstacles. See "Make Business in Bulgaria Forum Attracts about 250 Companies", *Bulgarian Business News*, 8 June 1998 and "Investors' Problems", *Bulgarian Economic Outlook*, 16 October 1998. See also Houbenova-Delissivkova (1997) and Konings and Janssens (1996).
81. The extraction sector, indeed, appears to be characterised by the highest average efficiency level of the whole Bulgarian economy. See Konings and Repkin (1998).
82. OECD (1996), Tables 17-1, pp. 80-3 and OECD (1998), Table 16, p. 106.
83. See Guerrieri (1997), and Kubiela (1998).
84. See Graziani (1997).
85. See Hoekman and Djankov (1997).
86. It appears that the new Law on the Protection of Competition may be having an important effect in re-orienting the activities of the CPC. Since the new law came into effect on 12 May 1998, 60 per cent of the CPC's case studies toward the abuse of dominant position and concentration of economic activities, as opposed to unfair trade practices.
87. The European Union has also observed that a credible control system for state aid should be established. In particular, in accordance with EU practice, the establishment and updating of a comprehensive state aid inventory, and the drafting of supporting legislation, would improve transparency. The state agency in charge of monitoring aid should receive sufficient powers to review existing aid, monitor new aid, and be sufficiently staffed with qualified personnel. See European Commission (1997).
88. See Helm (1994) and Bitran and Sàez (1994). On the complication of introducing these reforms in the context of the more advanced transition economies, see Canning and Hare (1996).
89. The term for submitting bids for a 51 per cent stake of the Bulgarian Telecommunications Company (BTC) was extended by two months in mid-November, until 28 January 1999, in order to give enough time to foreign investors who had shown interest in the planned sale to visit and study the company.
90. On the general issue of the split-up of responsibilities and duties, see OECD (1998b).
91. European Commission (1997).
92. The Conclusions of this Council stated that those candidate countries of Central and Eastern Europe who wish to do so shall become members of the Union if they meet the following conditions: i) stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; ii) the existence of a functioning market economy, as well as the ability to cope with competitive pressures

and market forces within the Union; *iii*) the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

93. Bulgaria is a signatory of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, concluded on 21 November 1997. The convention requires that adhering countries define what constitutes bribery of a foreign official in terms similar to those used in the US Foreign Corrupt Practices Act. Those found guilty of bribing foreign officials must face the same punishments as those found guilty of bribing public officials in their own countries, and the profits from any bribe-induced transactions must be seized and confiscated.
94. Meeting the Maastricht convergence criteria is not a condition for membership, although countries are expected to pursue policies which aim to achieve real convergence in accordance with the Union's objectives of economic and social cohesion, and nominal convergence compatible with the ultimate goal of adoption of the euro. In March 1998, the government indicated that its macroeconomic programme is consistent with attainment of the criteria, although, according to the Commission, Bulgarian participation in the third stage of economic and monetary union would pose serious problems, given the substantial structural reforms which still need to be achieved. More generally, substantial administrative reform will be indispensable if Bulgaria is to have the structures to apply and enforce the *acquis* effectively.
95. European Commission (1998).

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