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Will Democratic Government Fight

CORRUPTION?

Krassen Stanchev, Ph.D.

In trying to assess the prospects of Bulgarian Reform, emerging-market analysts fail to take into account bureaucratic factors. But these were the factors that blocked reforms under the previous administration, and which played a major role during the "Technocratic" (1993-1994) and Socialist cabinets of 1995-1997. Focusing only on macroeconomic indicators, one could grasp the results of the reintroduced reforms but lose the ability to foresee developments which may stem from the current government's role as a privileged market maker. In the past, such developments were: high formal and informal taxation, high capital and transaction costs, and non-transparent rules and decision-making procedures. The results are known: capital flight, disinvestment, virtually no foreign investment and no incentives to growth.

Prerequisites for such developments were not simply inherited from the Communist regime, but were consciously created in the period from 1993 - 1996. Bulgarian Socialists were believed to have been running a country led by a mixture of ex-Communist and populist ideologies. Their cabinet, however, was rather pragmatic, and even hypocritical and opportunistic. Most of the decision-makers had some Western education or technocratic background. This was particularly true for the cabinet's advisors, who were prompt in concentrating power in the hands of then-prime minister Zhan Videnov, remaining behind the scene as a decision-making center parallel to the central government, but more important.

The Socialists have paid tribute to the populist mood of their supporters, and thus we can explain the anti-NATO foreign policies of the last two years and that government's dubious economic rhetoric.

But the central disadvantages of Socialist rule - delayed and even stopped privatization, quasi-fiscal subsidies to idle industries, political consensus to drain banks but not force public enterprise to pay their debts, artificial electricity prices and mismanaged monopolies - had a deeper, although simple and ordinary, background.

The Socialists believed they would benefit from redistributing resources. Sticking to tradition, they replaced virtually all of the managers and boards of the public sector enterprises with their fellow-partisans, and stopped privatization to give them a chance to gain from being insiders. Electricity prices, cheap labour and fuel, as well as quasi-fiscal subsidies were believed to maintain competitive prices of Bulgarian exports. Exporters were licensed or controlled by the government, and domestic producers were protected by different tariff barriers. Whoever wanted to cut gains from the price difference between domestic and foreign markets first had to please the government. The system worked some-

how for twelve months, from February 1995 to February 1996, but was doomed to fall apart. There were clear incentives to keep gains outside the country. To keep local costs low (including that of labour), the Socialists had to reintroduce price controls or start printing money, and they did both. Then, the only way to stop the losses was to close enterprises and fire workers. The Socialists needed an excuse to do so, and this is where the IMF came in, with its program of July 1996. In the eyes of the public at large Mr. Zhan Videnov, Socialist PM, made an attempt to transfer responsibility to the IMF and the World Bank, but the administration resisted carrying out orders, and he resigned. The usual rhetoric about dangerous unregulated market forces, prices as a means of welfare policy, etc., which usually was the instrument used to disguise the Socialists' policies, did not work this time, and they lost political face.

The Heritage

Bulgaria has a working, though from time to time malfunctioning, democratic constitution. All instances and channels to block reforms have received a legal foundation. If not profoundly reshaped these foundations will again work against growth and prosperity.

To stop privatization the Socialists had to delay implementation of capital market regulations and adopt amendments to privatization rules, which prevented equity trading but created conflicts of interest and allowed the administration to collect rents from licensing. Among other things, the Socialists initiated a voucher privatization scheme mixed with conventional privatization methods, postponed registering investment intermediaries and stock exchanges, and forced the Securities and Exchange Commission to license voucher privatization funds. The funds, however, were prevented from investing and trading, and from introducing any form of corporate governance or venture capitalism.

The law contains a number of "pro-

cedural" hurdles which do not allow for moving forward sales of public assets, including:

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

...and this list may be continued.

There are conflicting procedures which have supported the so-called "selection of a strategic buyer" as a major method of privatization.

The government has obtained similar discretionary powers in virtually all segments of the market, and the administration in Bulgaria has an extraordinary opportunity to control all instances of access to capital and factors of production.

Small savings and credit institutions (like the German Sparkassen, Roscas in Mexico or town banks in other countries) are prohibited by law. After three years of unregulated operation of stock exchanges, the Socialist government introduced such barriers to entry that it took more than two years for the existing players to comply with the requirements. Commodity exchanges and wholesale markets have existed already for six-seven years. Last year, the Socialists adopted a law creating the Government Commodity Exchanges and Wholesale Markets Commission, comprised of nominees of the Council of Ministers but no merchants. The December resignation of the cabinet

has delayed implementation of the act. Commodity traders still have to apply for a licence.

Good and Evil

This is where the things stand at the moment:

The Democrats, led by Ivan Kostov, have several administrative advantages vis-a vis their predecessors. As PM, Mr. Kostov has enforced a more or less strict division of responsibilities within the Council of Ministers. It is very unlikely that there will be a parallel decision-making center. Democrats have no need to make concessions to populist moods of the voters, as they were elected on the ticket of a reform consensus and have a clear mandate to proceed as fast as possible. They have the backing of both domestic and international public opinion.

Apart from a few instances related to central banking and finance--areas closely monitored by the IMF and World Bank--the Democrats have the disadvantage of lacking bureaucratic experience: key administrative posts were a preserve for true believers and party-fellows who are not corrupted yet but might be spoiled by the system if the system is not abolished before the fall of this year. However, the prevailing mood of the new administration is, for the time being: "we are the best, we have high moral standards, we can use the system."

A major merit of the current situation is the functioning of the currency board regime. The administration is adjusting itself to hard budget constraints but seems slow in giving up rent-seeking privileges.

Systemic Sources of Corruption: Where Do We Stand at the Moment?

The macroeconomic dimensions of 1997 so far provide grounds for an optimistic outlook. Recent Bulgaria reports by Merrill Lynch and Deutsche Morgan Grenfell have already spread such moods among investors. They would prove to be correct if and only if the new administration ceases to exer-

cise "manual control" over the economy.

The key tool for "manual" (or, in other words, through direct involvement of the central government officials and/or appointees) control is the procurement of "state property rights." Rules here were established by the Council of Ministers' Decree 17 of January 1994, which replaced an older regulation (Decree 1265 of January 1992).

Articles 10 and 11 of Decree 17 stipulate that in state-owned enterprises (SOEs) sole proprietor's rights are being exercised by the line ministries and committees (those of industry, trade and tourism, agriculture, energy, posts and telecommunications, etc.), and by the Council of Ministers (in the case of military industries). In fact, the prime minister and the council are established as sole proprietors of last resort due to their control functions over the acts of the line ministers. Line ministers appoint the SOEs managers and board members at their discretion. Members of the central administration are not allowed to sit on the boards of more than two enterprises, although there is no limit for members of parliament. There is no competition requirement or any provision to contract out managerial teams or use venture capital schemes. There is no prohibition from doing so, but in reality it has never happened. Being required to exercise the public interest in SOEs, line ministers are afraid of being accused of not fulfilling this requirement. All government line-ups Bulgaria has had in the last seven years have preferred to bring in fellow-partisans, thus paying them back for political services and loyalty.

Decree 17 also requires managers and ministers to close down enterprises when liabilities exceed 50 percent of the assets. This provision has never been implemented by the Socialist administration. As a recent IME survey of decision making at SOEs has indicated, no measures to improve SOEs' performance through remuneration of managers and/or board members have been workable. For the time

being, the Democratic administration under Mr. Kostov has no intention of abolishing or amending Decree 17.

Corporate governance at state monopolies, such as the National Electric Company (NEC) and the Neftochim oil refinery, suffers from old diseases. NEC determines on its own what its conditionally fixed costs are, the costs which allow NEC enterprises to function as if there is no consumer. The oil refinery has no outsiders to measure the so-called technological losses. The new cabinet, following the provisions of Decree 17, has replaced all former board members but it is not clear yet whether the new managers will close channels of asset stripping. Recently, Mr. Kostov asked the new Neftochim board to determine the concrete amount of losses. Any concrete judgment on corporate governance issues is difficult, due to regulations which declare any information on the major monopolistic enterprises to be a state and national security secret.¹

Another important source of corruption in Bulgaria has been price controls and quasi-fiscal subsidies. The latter have practically no place already, given the fact that agreement with the IMF and consent to the currency board regime have forced the government to reduce subsidies to 0.1 percent of GDP. Price controls were abandoned thanks to high inflation in 1996 and early 1997. At the same time, the new administration re-established price controls in the form of controls over trading contracts. It issued Decree 1269 of June 1997, which requires producers and wholesale merchants to determine the final "contractual" (in fact, retail) price of a product. The intention was to eliminate wholesale intermediaries. City police in the major towns of the country, under the joint leadership of the trade and interior ministers, have flooded commodity markets asking merchants to "prove" that their contracts are "correct." This regulation deals with "contractual prices" of only fifteen consumer products, mostly foodstuffs,

and it is hardly possible to implement. But the actual damage is that it both induces populist expectations by the public at large and creates a widespread source of *petit* corruption. It also prevents farmers from bargaining in the prices of their produce, and thus hampers the adjustment of the entire agricultural sector to changing market conditions. Similarly, the Democrats have started implementation of the above-mentioned Commodity Exchanges Law; they have established the Government Commodity Exchanges and Wholesale Markets Commission and expect it to help "control" the market. The Commission was established after the annual budget was adopted, and is expected to finance its operation through fees and fines.

The case of the Commodity Exchanges Commission reveals a more general *statist philosophy* of the new administration. It has no members representing self-regulatory bodies of the commodity market itself. A similar philosophy is reflected in the draft bill on deposit guarantees, where the Deposit Guarantee Fund is managed by the government and the central bank, though being capitalized by fees collected from banks, according to their founding capital and the volume of attracted deposits.

Control over the domestic commodity markets motivates merchants to try to export goods if they can find a better price for them in neighbouring countries. "Fighting smugglers" has been the government's excuse for sticking to complicated customs procedures and delaying the abolishment of tariff barriers.

Bulgarian customs are now probably the most ridiculous in Europe. There are regulations requiring physical control on a hundred percent of the goods crossing Bulgarian borders, no matter whether they are carried by a cargo or a transit carrier or by an individual trade across the borders.

Issues related to the so-called *grand corruption* seem not to be treat-

² See the special article on the NEC in this issue of the Newsletter.

ed with the needed radicalism as well. Here we must again mention privatization procedures (as they are of particular importance), as well as special investment and concession contracts in utilities, communications and infrastructure.

Complication of the privatization procedures and of existing capital markets entry barriers are being removed slowly. Of the barriers established by the Socialist cabinet, the new cabinet has scheduled the abolishment only of the ban on voucher funds selling equity of enterprises from the mass privatization list as well as their own shares. But for the time being, capital market entry fees are so high that funds would obviously prefer over-the-counter trading. In the area of market privatization complications are still in place and are being caused by the so called "selection of a strategic buyer." With the help of the President's Economic Policy Council, the cabinet has launched the idea of speeding up privatization of the "blue chips" of the Bulgarian economy: it invited top investment banks and consultant companies to prepare the auction for those enterprises, but the selection of consultants is not complete yet and is largely lacking transparency.² There were statements in the press that the government has changed the terms of Deutsche Morgan Grenfell's contract to consult on Bulgarian telecoms privatization, but officials did not release this information.

In the field of infrastructure, there have been a number of significant policy changes attempted by the new government. It has amended the concessions' regulations (initially adopted in November 1995 but not enforced by the Socialists). A positive development is that the new regulations overcome all prohibitions related to twelve monopolistic rights of the

government established by the Constitution of 1991. According to the amendments it would be possible to: acquire a concession on all construction and road facilities built before by the government and on electric distribution networks and mineral, natural and water resources; build new facilities; and obtain a concession to investigate and explore natural resources. Absence of such provisions has been considered one of the key impediments to some major privatization deals, e.g. the Sodi Devnya deal was postponed for more than two months because of the banned concession on soda-dash mine which is a key supplier to the plant. The new regulations allow the buyer to exercise concession rights in an interim period until concession contracts are being arranged; these rights are determined by the privatization contract, and the interim period cannot be longer than three months. In addition, the act stipulates procedures omitted in the previous arrangement: 85 percent of concession revenues are being channeled to the central budget, and the rest remain in a separate off-budget account to cover the costs of concessions; the funds are being spent under the supervision of the Council of Ministers; the term of the concession (not more than 30 years but subject to prolongations automatically) enters in force as determined in the contract; and there is no possibility for newly-established (after the act was adopted) state companies to obtain a concession.

What matters, however, in terms of corruption, is the right of the government to provide a concession without an auction or any sort of competition. Three months after the act was adopted, i.e. by 1 November 1997, line ministries are required to propose to the Council of Ministries solutions to all inherited privatization

cases where a special concession arrangement is needed. The Concession Act itself leaves a lot of important details (the size and the term of investment, construction rights etc.) to be specified in the concession contract, while containing few or no guidelines for on what grounds to select concessioners. Bulgaria has been very slow in negotiating oil and gas pipe-lines and communication cables which may cross its territory and allow use of the country's absolute advantage of geographic location. Besides some progress in communication networks, pipe-lines were the most disadvantageous case of Bulgaria's reform attempts in the recent years. They have resulted in nothing but internal political tensions and raising Russian (official and private, transparent and hidden) influence on Bulgarian affairs.

A key deficiency in this respect was the inability of the Bulgarian government to negotiate with Russia and Greece. The very approach to negotiations has been based on the wrong assumption that these are governments that establish and fulfill agreements; the Bulgarian government was in fact contacting other government institutions which, in their turn, were representing huge companies and/or vested interests. Thus, the Bulgarian position has always been the weaker one, especially given the one-sided resource dependence of the Bulgarian economy on Russia.

Currently, the Democrats are fighting interest groups on the domestic scene. All of them, like Multigrup subsidiary Topenergy, have Russian counterparts or at least backing from huge companies like Gazprom, Atomenergo or the government of the Russian Federation. For the time being, the Bulgarian government is playing alone. As in the case with other huge companies and monopolies, e.g. NEC, the government has for the time being just replaced the Board members, reducing conflict of interest. For instance, Neftochim's

² The short list of investment banks advising the government on credit rating and the foreign debt issue is similar: the list (for the time being) includes CSFB, J.P. Morgan, Goldman Sachs, CBS Warburg, Merrill Lynch and some other banks but nothing is known on the selection procedures and criteria

executive director is no longer executive manager of the major supplier Rosbulneft (a joint venture with Rosneft). But again, as in other cases, newcomers are rather unknown and, presumably as a rule, possess limited professional experience. They failed to organize auctions for crude oil supply to the refinery and lost more than two months on orientation, delaying restructuring the management and accounting procedures. At the same time suppliers succeeded in fixing prices and boycotting auction proposals. The government seems to have succeeded in replacing Multigroup in Topenergy, a joint venture between the Bulgarian government and Gazprom. Multigroup is expected to strike back, which would at least mean political tensions with other parties in the Parliament. While this is relatively not a problem for the government, a regrouping of the interests is to be expected, with a still unclear outcome for either of the parties.

If the cabinet is at all seeking support for its pipe-line and infrastructure efforts, it is from International Financial Institutions and other government or multilateral organizations. The only way to avoid traps of future links behind the front stage is to invite trans-national corporations to initiate, finance and implement projects on Bulgarian territory. Simultaneously, the Bulgarian government still has to learn how to avoid or reduce geopolitical risks by relying on private corporate, but transparent interests. Such learning seems to be difficult, due to intrinsic suspicion toward foreign corporations and private institutions.

Conclusions and scenarios

It is likely that the currency board regime will help to reduce instances of *petite* corruption, such as price and trade controls, custom procedures etc. Likewise, it has virtually closed off fiscal and quasi-subsidies. Trade controls, a particularly important case, are at the cross-roads. Efforts

of the government here have two intentions. The first one is to improve tax collection and introduce accounting, labeling and packaging requirements which may lead to better reporting, quality and competitiveness standards. However, the background problem here is the level of taxation, which forces entrepreneurs to reduce costs. The second one is the ridiculous idea of eliminating wholesale trade. It would never work, unless the merchant community itself seeks more transparent transaction rules on the commodity market. For the time being, the government seems not to understand this. All regulatory bodies are being established and recruited by the cabinet and its supporters, who pay little attention to the interests already present in the marketplace. The public seems to support government rhetoric and efforts to "fight speculators." Feeling strong, the cabinet is establishing one government agency after another; just recently it founded the so-called Tobacco Commission and Energy Efficiency Commission; and seems ready with a commission to control every industrial (or trade) sector. These activities seem so far not to increase government expenditure; most of the different commission members come from the administration itself and are not remunerated for the job they are going in the commissions. But there is a danger that, when a critical mass of such bodies and/or duty requires it, administrators will start seeking opportunities to maximize their utility thus contributing to an additional and probably informal tax on entrepreneurs. Sources of *petite* corruption are being established by different multilateral aid programs. To the extent that IME has information, representatives of the donor community in Sofia are aware of the problem and are constantly trying to set as prudent procedures as possible. Newly-established government bodies are currently oriented toward obtaining support from such

programs, but they cannot last forever. Sooner or later, they would lead to additional costs imposed on the private sector.

Grand corruption, quite naturally, seems to be the major problem. It would prevent implementation of transparent and fair rules of the game, increase costs and frighten foreign investment. For the economy as a whole, this would mean less or no opportunities to make use of infrastructure projects, regardless of current favorable conditions provided by the currency board and regional constellation. Currently, the government of the Democrats resembles first six months of that of the Socialists: it has good prospects for tackling economic challenges, but it may be caught in the chains of mutually blocking interest groups. Although 1997's scheduled privatization revenue of \$350 million is likely to be exceeded, new boards of public sector enterprises may attempt to delay privatization. Combined with the increased role of bureaucrats in controlling capital and commodity markets, this could lead to slow adjustment of the Bulgarian economy to international markets and thus, to diminished prospects for growth and prosperity. For the time being, however, we are witnessing a period of administrative adjustment to hard budget constraints which would mean, at the first stage -- at least till the end 1997 and 1998 -- more organized and probably more "efficient" corruption: its impact on economic growth would come later, when it would incur additional costs of dealing with the government. A factor which may act in either direction -- to prevent such scenario or facilitate it -- is the government's awareness of its long-term political interests: it has all the prospects to remain in power for a second or even third mandate if and only if it succeeds in not giving up to the temptation to get all the benefits of being in power from the very beginning.

INSTITUTE FOR MARKET ECONOMICS
BALANCE SHEET AS OF 31 DECEMBER 1996 (in '000 BGL)

	1995	1996
Assets	4900	15643
I. Fixed Assets	2775	4385
Depreciation	(1116)	(1987)
Net fixed assets	1659	2398
II. Current assets	3241	13245
1. Work in progress	49	7
2. Future period expenses	66	273
3. Debtors	215	638
4. Finance assets	2911	12327
- cash in leva	39	359
- cash in foreign currency	2872	11968
Current liabilities	141	437
I. Taxation and social securities	141	437
Net current assets	3100	12808
Total assets less current liabilities	4759	15206
Funds	4902	13623
1. Permanent endowment fund		
2. Other restricted funds		
3. Unrestricted funds	4902	13623
Prior year income (loss)	(72)	(78)
Current year income (loss)	(71)	1661
Total funds and income	4759	15206

INSTITUTE FOR MARKET ECONOMICS
INCOME AND EXPENDITURE ACCOUNT
YEAR ENDED 31 DECEMBER 1996 (in '000 BGL)

	INCOME	
	previous year	current year
I. Ordinary income	8 034	19596
1. Economic activity income	1 127	836
2. Increase work in progress	46	165
3. Donations and grants	6 861	18595
II. Financial income	279	3262
1. Interest income	11	17
2. Gains from exchange rates fluctuation	268	3245
III. Extraordinary income		108
Total (I+II)	8 313	22966
	EXPENSES	
	previous year	current year
I. Ordinary expenses	8 290	21063
1. Expenses of materials	555	1082
2. Expenses for services	3 930	11625
3. Personal expenses		
à) salaries	1 329	2646
á) social securities	464	886
4. Depreciation	584	871
5. Other expenses	1 428	3953
II. Financial expenses	36	165
1. Bank charges	33	105
2. Losses from exchange rates fluctuation	3	60
III. Extraordinary expenses		34
III. Taxes	58	43
1. Income tax	58	43
Total (I+II+III)	8 384	21305
INCOME LESS EXPENDITURE	(71)	1661

The IME 1996 Annual Financial Report

In 1996 IME turned out to be the only independent economic institute in the country, which expanded its activities and its local and international image.

IME managed to diversify its sources of funding, which allows for:

- sustaining a good level of expertise;
- not depending on the good will of a single sponsor;
- independence when defining the research topics and recruiting associates.

The most important of IME sponsors are: ICEG, US AID, Friedrich-Naumann-Stiftung, CIPE, Open Society Fund - Sofia, Atlas Economic Research Foundation, Robert Kriebel of Kriebel Associates and John Dimi Panitza, President of Free and Democratic Bulgaria Foundation. In order to finance its general operation costs, long term assets, business trips and training personnel, i.e. costs not covered by individual projects, IME has retainers contracts with some institutional investors. Some of them are Salomon Brothers International, Trans-National Research, Merrill Lynch, Deutsche Morgan Grenfel, Sigma Bank, Daiwa Institute of Research and Banco Santander. The funds raised in this manner are used for the public good and to enhance market values.

In 1995 IME 265 co-ordination and research contracts were concluded, only one sixth of this job (except from the general co-ordination) was performed by full-time employees in the Institute, the number of the contributors from outside the Institute reached 75. In 1996 it continued to grow; since the beginning of the year 147 contracts were concluded, the decrease is mainly due to authorisa-

tion of subcontractors.

Funds received on the FNSt project amounted to DM 67,500 with accounting value of BGL 7,260,000. Expenses committed on the project - BGL 7,635,000. Detailed structure of these expenses is provided in Annex N2.

Funds received on the project Transparency of Capital Markets, financed by ICEG San Francisco, amounted to \$ 25,000 with accounting value of BGL 4,291,000. Expenses committed on the project - BGL 2,281,000 (appr. \$12,685). Detailed structure is provided in Annex N3.

Funds received on the project Strengthening of the Bulgarian Business Associations, financed by CIPE, amounted to \$ 6,815 with accounting value of BGL 486,000. Expenses committed on the project - BGL 181,000 (appr. \$ 1,023). Detailed structure is provided in Annex N4.

Funds received on the project Barriers to Economic Growth on the Balkan Peninsula, financed by US AID, amounted to \$50,000 with accounting value of BGL 8,726,000. Expenses committed on the project - BGL 4,623,000 (appr. \$ 26,006). Detailed structure is provided in Annex N5.

Funds received on the project Financial Policy in Bulgaria during Transition, financed by Open Society Fund- Sofia - BGL 422,500, all of them spent on the project. Detailed structure is provided in Annex N6.

Funds received on the project Alternative Financial Policy - \$ 7,000. The project starts in 1997.

For 1996 the IME revenues (turnover for all project related activities) are expected to be equal to \$122,000 and 74,000 DEM. In 1997 the total IME revenues according to contracts signed by November 14 1996, are up to the equivalent of \$196,000. This amount does not include the income expected from consulting contracts for IME Consult Ltd.

THE NEC CASE

The facts

On May 2, 1997, under decision #457 of The Council of Ministers, the National Electric Company (NEC) was listed among the state bodies and organizations, in which units of security and protection of the facts, records, and matters which constitute state secrets of Republic of Bulgaria (RB), are to be created. In the request for the listing are mentioned some problems with production security and the distribution of energy, as well as limitations of access to energy-producing objects, supplies of raw materials, cases of bad management were mentioned, resulting in damages against the property, thefts and misuse of materials, assurance of the secrecy of documents.

The possibility of such a request is given by Art 6 in connection with Art 2 and Art 4 (1) of the Regulation for the Function of the National

Security Service (NSS) on providing defense of strategic objects and activities and protecting the state secrets of RB, though the above Articles are not explicitly called upon in the request. This regulation is adopted with Decree of The Council of Ministers #324 of December 12, 1994, promulgated in the State Gazette, no. 5 /1995, and additionally in no. 64 /1996. The norm of Art 6 entitles the presidents of non-governmental bodies and organizations to propose, if the the NSS consents, to be declared by the CM as strategic and live-assuring objects of importance to the national security. With only some insignificant remarks of technical and legal character from the the Legal Department at the CM, and with a positive opinion from both the Service of Coordination and Analysis of Information at the Ministry of Internal Affairs (MIA)—which in the given case substituted for the consent of the NSS—and from the Structural Reform Department, the proposal was promoted by the chief-secretary of The CM and was voted through.

In order to grasp the significance of the problem, it is worthwhile to point out that NEC regulates the country's electrical power production and supply, deals with the export and import of energy, develops strategies for the future of the national energy-system, and defines the prices of energy in cooperation with the Committee of Energy.

Briefly about the List

The List (decision #457 record 58 of October 26, 1995, point 3) is formed on the basis of Art. 4, (1) of the cited regulation. It includes the so-called strategic and life-assuring objects of importance to the national security, whose special protection is entrusted to NSS in accordance with the above regulation, issued on the basis of Art. 14, (3) of the NSS law, Art. 14, point 4 of the MIA law and Art. 105 (2) of the Constitution of RB. The List was first published and became binding in 1994, as an appendix to Decree #210 of CM (State Gazette no 84/ 1994), which is an antecedent of the above Regulation. Until this time the matters of state and official secrets were treated by unpublished acts (which were themselves secret). After a very short period of publicity the cited Decree was suspended on December 28, 1994. (official gazette no. 5/ 1995). Then the List was created again, but by an unpublished decision, #457 of The CM from November 15, 1995, and was broadened by decision 93 of February 19, 1996 and by the present decision. The present list is considerably broader than the previous one. It includes objects such as: customs, duty free zones, the Bulgarian Telecommunications Company, the National Institute for Statistics, the State Savings Bank, county administrations, the Capital Municipality, as well as the Bulgarian Academy of Sciences. Among the corporations which are objects of protection are the enterprises of the Military Production Complex, the oil refineries, Kremikovtzi; of the branch of energy production are enlisted the Atomic Power Station Kozloduj and the Maritsa Iztok Complex. The list is not readily accessible: only through the system of legal information at The CM, which is presumably for internal use.

The listing of NEC as well as that of any other object is benifactoried by the following circumstances. In Bulgarian objective law the term "national security" does not have a concrete definition. The same concerns the term "strategic objects and activities." The neces-

Investor's Guide

MONEY SUPPLY AFTER THE CURRENCY BOARD

sity of the presence of a given state body or organization on the List is assessed in each concrete case. The former state-owned enterprises, reorganized into enterprises with state capital (such as NEC), which were under special protection during the near past of The Cold War, are still normatively linked to the state bodies, and in the particular case of NEC, to the Committee of Energy and Energy Resources. That is why it is not difficult to receive the consent of The CM in such cases.

Legal qualification

Based on the above, it can be concluded that:

1. NEC is listed on legal grounds, as according to Art 4 (1) of the Regulation, the competence of treating a strategic object is given entirely to CM, which decides over such a question according to expediency.

2. The purpose of the provided defense is the legal limitation of the constitutional right of citizens and corporations to look for, to acquire, and distribute information from state organs or institutions in accordance with Art 41 (1-2) of the Constitution of RB, as far as this right must not be directed against the national security and state secrets.

3. The Supreme Administrative Court is unable to review the decision of CM, because its jurisdiction according Art 125 (1), in connection with Art 120 (2) of The Constitution of RB, is to control the actions of the Government on a lawful basis. Besides, proving the legal interest would not be easy.

Real results

1. The special protection is realized in two aspects:

1. protection of objects and activities
2. licensing work with these objects and access to secret documents.

According to the Regulation, the protection of strategic objects and activities is realized through guarding and through

- administrative,
- organizational,
- technical, and
- cryptographic measures.

Evidently, only the objects are guarded, as the protection of information concerns the other measures. It is not clear what exactly these measures are (save the cryptographic), what is the procedure of their protection and which are the activities to be

cont. on p. 15

Currency in circulation increased by 59,2% on August 8, 1997 with respect to July 1, 1997 when the Currency Board was established.

Balance sheet of the Issue Department (mn. lev)	
(BGL 1000 = DEM 1)	22.8.1997
ASSETS	
Cash and nostro accounts in foreign currencies	1537502
Monetary Gold	640727
Foreign securities	1450393
Accrued interest receivable	6585
TOTAL ASSETS	3635207
LIABILITIES	
Currency in circulation	963605
Bank deposits and current accounts	633266
Government deposits and accounts	627038
State Fund for Reconstruction and Development account	590112
Other depositors	23230
Accrued interest payable	166
Banking Department deposit	797790
TOTAL LIABILITIES	3635207

Source: Bulgarian National Bank

Net foreign exchange inflow into the currency board reserve amounted to DEM 736,1 mln. within fifty one days after the establishment of the Currency Board. A better part of the money come from the households. Both tight income policy and lower foreign exchange risk motivated household sector to convert foreign exchange savings into the domestic currency.

The investment opportunities are rather poor for the time being. Commercial banks invested increased savings primarily in the government debt. The demand for government debt is much higher than the supply. This is the main factor for the strong tendency toward lower interest rate. The interest rate decreased from 74,4% at the end of April to 5,86% recently. The credit to the non-government sector is thin because banks rank the risk rather high. However, there are some positive signs in the second half of August. The credit to the non-financial enterprises increased by 11,9% with respect to the end of July. A better part of the increased credit went to the private sector.

The lower interest rate has reflected poor investment opportunities rather than some fundamental changes in the economy up to now. The increased monetary base underlined high inflation rate. The July inflation rate amounted to 3,7% on the monthly base. The inflation in August is expected to be 5%. The monthly inflation rate should not exceed one percent in order to keep inflation rate about 550%. We expect the inflation rate to be about 600% at the end of the year which is higher than the Government projected.

Prepared by *Kapital Consult Ltd*. 9 Ivan Vazov Str., 1000 Sofia, Bulgaria
tel: (+359 2) 981 61 93 fax:(+359 2) 981 41 82
E-mail addresses: capconsult@ibm.net

The Biggest 500 State Owned Enterprises

Selected Profiles!

Bulgargas SPJSCo.

66 Filipovsko Shose str.
Sofia
Bulgaria
tel:(++359 2) 259 074; 250 830; 266 405
fax:(++359 2) 266 405

Rosbulneft JSCo

NHK
Burgas
Bulgaria
tel:(++359 56) 21 172

(in thousands USD)

	1994	1995	1996
Sales	406811,3	496004,8	623103,0
Gross profit	26046,6	18331,6	6902,8
% of Sales	6,4%	3,7%	1,1%
EBITDA	22956,3	13887,8	1705,6
EBIT	19338,7	10553,5	-121,2
% of Sales	4,8%	2,1%	0,0%
Interest payments	29674,4	31071,5	1108,4
EBIT/Interest	0,7	0,3	-0,1

(in thousands USD)

	1996
Sales	503871,7691
Gross profit	117826,2514
% of Sales	23,4%
EBITDA	117437,0876
EBIT	117426,6098
% of Sales	23,3%
Interest expenditures	274,2
EBIT/INTREST	428,2637595

Bulgargas is the main natural gas supplier of companies and households in Bulgaria. The company enjoyed the low price of the gas until the mid 1997. Bulgaria financed part of the Jamburg pipeline in the past and Russia payed its liabilities with gas. The value of the gas deliveries are shown in the capital account of the BOP as disbursements.

The Jamburg agreement expired in July 1997 and Bulgargas should pay the market price of the gas. The company should be much more efficient in collecting receivables in order to improve its financial position. Long collection period for accounts receivable underlined worsening financial position of the company in 1996.

Rosbulneft JSCo. is a Bulgarian - Russian joint venture established in 1995. The Bulgarian partner is Neftohim JSCo. - the biggest refinery on the Balkans. The Russian partner is Rosneft - one of the biggest oil importers in Bulgaria. Each side hold fifty percents of the equity.

The company invested about USD 3 mln. in free trade zone near the town of Burgas. Among other investors in free trade zone are Bulgarian Investment Bank JSCo. and Burgas Industrial Holding.

Rosbulneft joint venture is an indicator of the strong interest of Rosneft in the oil business in Bulgaria.

The Banking System Under a Currency Board

by Tzvetan Mantchev

The curtailment of BNB's objectives and powers as an institution responsible for carrying out Bulgaria's monetary policy changes the mechanism of the whole monetary system. Most importantly, it places a new set of requirements for the banks. Regardless of this change, the banking system is still of vital importance for the economy as it remains the basic intermediary for the transformation of savings into investment.

1. Special features of Bulgaria's currency board

As the BNB was changing the instruments of monetary policy in the last months before the introduction of the currency board, the rules and principles of regulating the money supply converged to those under a currency board. From the beginning of 1997 the BNB started restricting its intervention on the interbank markets and thus completely freed interest rates. As early as January the central bank switched to a market basis for determining the basic interest rate. In February the BNB discontinued giving new credits to commercial banks and to the state budget. Gradually, the central bank curtailed its open market operations and stopped using them as a monetary policy instrument altogether in mid-June of 1997. By withdrawing from its function as a lender of last resort, the BNB clearly declared its neutral stance in managing bank liquidity. Given that, we can assume that from the beginning of 1997 banks operate and interact with the central bank on principles closely approximating those under a currency board.

The institutional form of Bulgaria's currency board was set by the new Law on the BNB enacted by the National Assembly on June 10, 1997. It sets the country's choice among alternative solutions to key issues such as the structure and functional principles of the currency board. The structure of BNB's balance sheet, according to the new law, implies certain peculiarities in the functioning of the currency board and in its interaction with the commercial banks.

A most significant peculiarity is that, according to Art. 28, para. 1 of the law, foreign assets provide a 100% coverage not only for the money base (the standard approach) but for all of BNB's monetary liabilities. The remainder of the foreign reserves in excess of the 100% coverage is not at the disposal of the Banking Department. Its management has been transferred to the Issue Department.

The special features of Bulgaria's currency board give rise to a different (compared to an orthodox currency board arrangement) set of relations between the BNB and the commercial banks. Even though Bulgaria opted for a currency board with a monetary agency (the Banking Department), BNB's means of providing the banks with liquidity are severely limited. The monetary agency has transferred, at least for now, its right to manage foreign reserves to the independent monetary authority (the Issue Department). The Banking Department can liquidate a part of its foreign reserves only with the approval of the Issue Department. Furthermore, the

traditional right of the monetary agency under a currency board to redistribute bank reserves has been limited. That gives a reason to conclude that the special features of Bulgaria's currency board give the BNB less room (compared to an orthodox currency board arrangement) to guarantee the normal functioning of the payments system and to intervene in order to limit the systemic risk.

The chosen set of principles for Bulgaria's currency board has both its advantages and disadvantages. The advantages lie primarily in minimizing expenditures on managing BNB's net foreign assets and in improving the control on BNB's asset portfolio. As under a central bank arrangement, only one structure, this time the Issue Department, will be managing these assets.

However, there exist important disadvantages. A basic one is that BNB's balance sheet still includes its relations with the government. Thus, the theoretical difference between a currency board and a central bank is diluted in practice. The new Law on the BNB does prohibit (Art. 45, para. 1) BNB's giving new direct credits to the government. However, the law does not prevent an increase of BNB's net domestic assets balanced by an increase of net receivables from the government. There are two alternative ways for increasing net receivables from the government. One is by decreasing the government's deposit with the Issue Department, and the other way is by purchasing IMF's SDRs with credits from the BNB, in accordance with Art. 45, para. 1, item 2. The second option arises from a loophole in the Law on the BNB which does not require explicitly BNB's forex coverage of the money base to come from non-borrowed sources. Thus, there is still the danger of a weak fiscal policy undermining the money supply. Escaping this trap was a key reason to give up the institutional choice of a payments system with a central bank that was adopted at the beginning of our transition to a market economy.

Further complications with managing BNB's budget arise from the inclusion of the government's deposit in BNB's balance sheet and from BNB's commitment

to pay interest on it. The danger comes from the fact that the interest paid on this Lev-denominated deposit will be higher than the interest earned on BNB's foreign reserves because of the risk differential between the Lev and the reserve currency interest rates. At the same time, the volume of both the government's deposit and of BNB's foreign reserves are beyond the central bank's control. The central bank has no instruments to influence domestic interest rates in order to minimize losses.

A third disadvantage is the inclusion of the net foreign assets of the Banking Department as a deposit with the Issue Department. This deprives the former of independence in managing these resources and will complicate the execution of its function of a lender of last resort imposed by Art. 20, para. 2 of the new law. This function is further limited by the legal requirements in Art. 33 of the Law regarding credit collateral.

A fourth disadvantage arising from the previous one is that the Issue Department rather than the Banking Department will be managing the bank's reserves. This burdens the former with a commitment for maintaining the normal operation of the payments system.

2. The outlook for Bulgaria's banking system under a currency board

Our analysis of the state of Bulgaria's banking system immediately before the board is based on data about the structure and quality of banks' assets. Secondly, via the banks' balance sheet indicators we will analyze the degree of the potential risk of loan non-performance.

Based on the conclusions from the analysis of the two sets of data, we will later on develop two alternative models for conditionally determining the necessary expenditures by the state to guarantee the solvency of state banks. These models could serve as a tool in determining certain exogenous parameters in fiscal policy-making.

2.1. Ownership structure and quality of banks' asset portfolios

Immediately before the introduction of the currency board, foreign-majority-owned banks and branches of foreign banks hold less than 5% of bank assets and an insignificant part of banking capital (see Table 1). During the last months before the currency board there was a gradual increase of their share in the total assets of the banking system. During 1996 the number of foreign banks has also increased (Table 2). Apparently, the state has chosen to encourage the activity of foreign banks as a possible way to secure the liquidity of the banking system.

Table 1: Bank Assets Structure

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

Table 2: Commercial Banks in Bulgaria

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

Given Table 1, the Bulgarian banking system is obviously dominated by state-owned banks. The concentration ratio ($0 < k < 1$) for bank assets is approximately 0.75 in the months immediately preceding the currency board. The value of the ratio suggests that in the short run the state will play a leading role in the banking sector. As the currency board provides foreign exchange coverage for only part of the money supply and does not cover all deposits, the state must guarantee the solvency of state-owned banks to ensure the normal functioning of the banking system. The relative shares of individual state banks in the total assets of the banking system show that potential liquidity problems of each of them can be a source of systemic risk (Table 3). The values of k based on the individual shares of the seven banks also support this conclusion.

Table 3: Asset Structure of State-owned Banks

Bank	Oct. 96	Nov. 96	Dec. 96	Jan. 97	Feb. 97	Mar. 97
A	6.8%	6.4%	6.1%	8.5%	6.8%	7.4%
B	3.6%	3.4%	3.2%	4.0%	3.5%	3.7%
C	7.5%	6.9%	6.2%	10.5%	10.1%	6.9%
D	4.8%	4.5%	3.8%	4.1%	4.3%	3.7%
E	3.9%	4.1%	3.7%	3.8%	3.0%	3.4%
F	17.0%	14.5%	13.0%	8.4%	5.4%	7.9%
G	41.1%	45.4%	50.4%	49.0%	56.0%	55.3%
Total	84.8%	85.2%	86.3%	88.3%	89.0%	88.4%
k	0.21	0.24	0.28	0.27	0.34	0.33

The quality of bank portfolios is significant in determining the outlook for Bulgaria's banking system under a currency board. It is a departing point for evaluating the possibility of future problems with bank liquidity and solvency. Credit portfolios occupy over 60% of the assets of Bulgarian banks (Table 4). Credits are heavily concentrated in domestic banks, primarily in the state-owned ones (Table 5). That is an additional illustration for the defining importance of state banks for the economy at least in the short run.

Table 4: Share of the Credit Portfolio in Total Bank Assets

	State-owned	Private	Foreign	Total
Oct. 1996	62.9%	54.0%	36.0%	61.0%
Nov. 1996	68.0%	62.8%	41.5%	66.7%
Dec. 1996	66.0%	59.3%	41.9%	64.6%
Jan. 1997	68.2%	53.3%	11.3%	65.2%
Feb. 1997	82.9%	80.7%	11.6%	80.4%
Mar. 1997	83.7%	89.9%	30.0%	82.2%

Table 5: Concentration of Bank Credit

	State-owned	Private	Foreign	Total
Oct. 1996	62.9%	54.0%	36.0%	61.0%
Nov. 1996	68.0%	62.8%	41.5%	66.7%
Dec. 1996	66.0%	59.3%	41.9%	64.6%
Jan. 1997	68.2%	53.3%	11.3%	65.2%
Feb. 1997	82.9%	80.7%	11.6%	80.4%
Mar. 1997	83.7%	89.9%	30.0%	82.2%

A big part of the credits granted by state banks have been classified as "bad loans" in accordance with BNB's Regulations No. 9 (Table 6). That means that the market value of the credits (and hence of the assets) of state banks is considerably lower than the nominal value in their balance sheets. Therefore, there remains the danger of future complications in managing the payments system, especially in cases of deposit withdrawals of a magnitude exceeding the volume of the forex-denominated deposit of the Banking Department with the Issue Department. In such cases the Banking Department will need additional resources and the opportunity to manage them flexibly. This only illustrates the fundamental necessity to restructure the banking sector and to encourage competition therein in order to decrease the value of the concentration ratio *k*. Furthermore, to prevent future problems in the payments system, the government has to develop arrangements for solving the problem with huge inherited volumes of bad loans in state banks' portfolios. Such arrangements will be discussed further on.

Table 6: Share of the Credit Portfolio of State-owned Banks in Total Credit Portfolio

	Group A	Group B	Uncollec- table	Bad Loans- total
Oct. 1996	87.6%	74.9%	63.5%	83.3%
Nov. 1996	87.1%	79.4%	60.8%	82.3%
Dec. 1996	89.2%	62.0%	73.6%	84.2%
Jan. 1997	91.0%	98.8%	71.1%	90.5%
Feb. 1997	84.3%	96.8%	87.1%	89.7%
Mar. 1997	85.9%	97.1%	83.3%	88.4%

In contrast to the initial transition to a market economy from 1991 to mid-1996, during the last months there are serious results from the measures requiring credit provision. After October 1996, the share of paid-in to required provisions has been consistently increasing; toward the end of the examined period this share is over 96% (Table 7). Bad loans granted by state, private, and foreign banks have been provided for to a considerable extent. The change in accounting rules which allowed for treating provisions as expenses was another important step toward effectively solving the problem of providing for bad loans. However, some banks have not yet updated their balance sheets in line with the new requirements. That is obvious from the value of paid-in-to-required provisions being lower than 100%.

2.2. Degree of decapitalization risk

The concentration ratios of profits (0.48) and losses (0.37) in the banking system immediately before the introduction of the currency board are quite high. In both cases the value of

the ratio is determined by the industry share occupied by domestic banks, both state-owned and private (Tables 8 and 9). State banks' share of total losses in the banking system has been falling, especially since the beginning of 1997. That is indicative of the success of short-term government measures in stabilizing the banking sector and in improving bank management before the currency board. At the same time, the increased private banks' share of total losses after the beginning of 1997 signals that some of them might face liquidity problems and a potential insolvency under the currency board.

Table 7: Ratio of Paid-in to Required Provisions for Bad Loans

	State-owned	Total
Oct. 1996	71.3%	65.8%
Nov. 1996	65.8%	58.5%
Dec. 1996	83.3%	74.9%
Jan. 1997	97.0%	91.4%
Feb. 1997	98.6%	97.1%
Mar. 1997	96.2%	96.1%

Table 8: Structure of Bank Profits

	State-owned	Private	Foreign	Total	<i>k</i>
Oct. 1996	78.5%	9.5%	12.1%	100.0%	0.64
Nov. 1996	81.2%	14.3%	4.4%	100.0%	0.68
Dec. 1996	79.9%	19.3%	0.8%	100.0%	0.68
Jan. 1997	67.2%	30.0%	2.8%	100.0%	0.54
Feb. 1997	81.5%	16.2%	2.3%	100.0%	0.69
Mar. 1997	62.1%	28.7%	9.1%	100.0%	0.48

Foreign-majority-owned banks and branches of foreign banks have serious problems in establishing themselves on Bulgarian financial markets. In a period of great uncertainty on Bulgaria's financial markets after 14 domestic banks were placed under supervision there are sharp fluctuations in the share of total profits and losses of these banks (Tables 8 and 9). Only in March of 1997 foreign banks recovered their share of total profits. Since the beginning of 1997 those banks have concentrated between 15.4% and 28.7% of the losses in the banking sector. The data shows that these banks lack flexibility and experience in working on the emerging Bulgarian financial market. Alternatively, their reported losses could be explained by their one-time initial expenses as newly established institutions and their ambition to allocate sufficient provisions for forex-denominated receivables as a cushion against unexpected exchange and interest rate fluctuations.

The relative shares of total profits and losses and the fluctuations in these indicators signal that at least in the short run the existing foreign banks and branches cannot promote confidence in the banking system. On the other hand, the losses generated by these banks do not threaten the banking system because of their relatively small share of total assets and because they can always be refinanced by their overseas headquarters.

2.3. Models of determining conditional expenditures for recapitalizing state-owned banks

The analysis so far shows that immediately before the introduction of the currency board in Bulgaria the state has kept its leading role in the banking system. The direct participation of the state in the banking industry means that at least in the short term it should assume responsibility for containing systemic risk. This is the only way for the state to prevent the banking system from a new crisis and to optimize its revenue from privatizing its share in the sector. That is why it is important to calculate at least approximately the resources needed to guarantee the solvency of the banking system and to contain systemic risk. The models offered below aim at being a reference point for the amount of state expenditure, i.e., their results could be used as exogenous variables in determining fiscal policy parameters.

Table 9: Structure of Bank Losses

	State-owned	Private	Foreign	Total	k
Oct. 1996	65.2%	29.9%	4.9%	100.0%	0.52
Nov. 1996	65.1%	31.4%	3.5%	100.0%	0.52
Dec. 1996	71.6%	24.0%	4.4%	100.0%	0.57
Jan. 1997	23.6%	47.7%	28.7%	100.0%	0.37
Feb. 1997	11.2%	73.3%	15.4%	100.0%	0.57
Mar. 1997	9.7%	72.9%	17.5%	100.0%	0.57

The two models are conditional in that they are based on certain assumptions. The first model assumes that a given bank wants to fulfill a capital adequacy (ratio of capital to assets) requirement of at least 8% (the ratio recommended by the Basle standards). We will use Reed and Gill's definition of capital adequacy: the sufficiency of banking capital to cover the bank's losses and to guarantee the payment of deposits. The use of capital adequacy as the desired indicator is justified by the fact the currency board limits the intervention of the BNB in its function as a lender of last resort to banks with enduring liquidity problems.

The minimum size of desired capital of each state-owned bank CAit can be generally designated as shown in Annex 1.

Table 10: Model 1: Conditional Expenditures for Recapitalizing State Banks (in mln. USD)

month	NNW0	NNW4	NNW8	NNW0&4	NNW0&8
Oct. 1996	0.0	10.7	27.3	10.7	27.3
Nov. 1996	0.0	0.0	0.0	0.0	0.0
Dec. 1996	0.0	0.0	0.0	0.0	0.0
Jan. 1997	0.0	52.6	143.1	52.6	143.1
Feb. 1997	0.0	88.6	215.6	88.6	215.6
Mar. 1997	26.8	77.0	187.7	103.8	214.4

At the end of March 1997, the size of necessary expenditures by the state to ensure that there are no state banks with a negative value is small--\$26.8 mln. (Table 10). However, in order to guarantee low systemic risk according to international standards we need \$214.4 mln. It is important to note that total necessary recapitalization investment increases sharply after the beginning of the year despite a considerable decrease in state banks' losses and the fact that most of them

have an operating profit during that period. The first reason for this are changing accounting rules which gradually converge to international standards. Another probable cause for the increase of necessary expenditures to recapitalize the banks lies in exchange and interest rate fluctuations, especially in February and March of 1997, which increased the significance of the currency structure of individual banks' assets in determining their total assets and, hence, their desired capital size. Given the high inflation during the examined period, BNB's requirement for banking capital to be held in Leva also contributed to increased recapitalization expenses.

Our conclusion from the foregoing analysis is that the systemic risk in the banking system remains quite high immediately before the introduction of the currency board. Thus, in constructing a budget the state should allocate adequate resources to recapitalize state banks. Alternatively, it should seek non-fiscal sources. In any event, furnishing the necessary recapitalization resources must not lead to unexpected increases of the fiscal deficit and hence to unexpected pressure on the currency board by the budget. The failed recapitalization attempts during 1991-96 illustrated persuasively the negative outcome of such approaches.

Besides state intervention is only one of the few (not mutually exclusive) options for reaching the desired parameters for state banks and for decreasing systemic risk. One alternative is to accelerate the privatization of at least some state banks which could also provide additional resources to recapitalize the rest. Another option would be to develop and apply short-term arrangements to restructure banks' portfolios without involving the state with financing those arrangements. An obvious example is provided by debt-equity swaps by which banks could restructure non-performing loans into equity shares giving them the right to manage debtor companies. This will promote investor confidence in the state banks. Increased confidence should be used to attract private and foreign investors and increase banking capital. The choice among the various policy options depends on the state's long-term strategy for the banking industry. The first option is more appropriate if the state decides to withdraw from the banking sector; the second option is preferable if the state decides upon keeping its stake in the sector at least in the short run.

By using other definitions of banking capital and reserves, we could develop different models for determining banks' net value and the conditional recapitalization expenses. For example, in Table 11 we have calculated the conditional recapitalization expenses by using the definitions of capital base and total risk component of assets stated in BNB's Regulations No. 8 on the capital adequacy of banks. This model results in considerably lower recapitalization expenses for reaching a capital-assets ratio of 8%--\$0.6 mln. at the end of September 1996 and an even more insignificant amount at the end of March 1997.

The huge difference between the size of recapitalization resources in the two models shows how important the choice of definitions really is. There is an international consensus around the Basle definition of banking capital. However, there is considerable controversy on defining assets and more

specifically on determining how to weigh individual bank assets in calculating banks' capital adequacy and net value. The controversy arises from cross-country differences with respect to determining the risk on banks' receivables from economic agents.

In Bulgaria's specific case, we should take into account the development of asset markets and the fluctuations of the market and nominal values of assets. This will improve the procedure for determining recapitalization expenses and increase confidence in the banking system.

Table 11: Model 2: Conditional Expenditures for Recapitalizing State Banks (based on BNB's Regulations No. 8)(in mln. USD)

	NW0	NW4	NW8	NW0&4	NW0&8
Sept. 96	0.2	0.3	0.4	0.5	0.6
Dec. 96	-0.1	0.0	0.0	-0.1	-0.1
Mar. 97	0.0	0.0	0.0	0.0	0.0

Note: The negative sign means that no expenditures are necessary, i.e., actual capital exceeds required capital.

3. Conclusions for economic policy under a currency board

The basic conclusion from our analysis is that the banking system still does not conform to the strict requirements posed by the new mechanism for regulating the money supply. It needs a swift, consistent, and single-minded reform strategy to turn into a functioning transmission belt between savers and investors. Otherwise, the lack of confidence in the banking system will become a brake for economic growth. On the other hand, the changed mechanism for controlling the money supply does not remove the basic weakness of the previous system--the threat a weak fiscal policy could pose for the money supply. Furthermore, the change has limited BNB's potential to cushion such effects and fiscal policy has become the only instrument for encouraging sustained economic growth. This makes swift structural reforms and the ubiquitous imposition of hard budget constraints in the economy even more imperative.

ANNEX 1

$CA_{it}=0.08(Ass_{it}-R_{prov_{it}})$, (1), or

$CA_{it}=0.08Ass_{it}$, (2),

where Ass_{it} designates the size of bank assets for bank i at a moment t ; R_{prov} stands for "required provisions," and A_{prov} stands for "actual provisions." The sum

$\sum_{i=1}^n$

SCA_{it} stands for the minimum amount of desired capital of all state-owned

$i=1$

banks at a given moment t . This capital represents the desired net value of state banks and we believe it guarantees low systemic risk.

The actual net value of each of these banks NW_{it} can be determined via (3) or (4).

$NW_{it}=(C\&R)_{it}+(P\&L)_{it}+(R_{prov}-A_{prov})_{it}$, (3), or

$NW_{it}=(C\&R)_{it}+(P\&L)_{it}$, (4),

where $(C\&R)_{it}$ is the amount of banking capital and reserves of a given bank t at a moment i , and $(P\&L)_{it}$ stands for the amount of its net profits. The sum

$\sum_{i=1}^n$

SNW_{it} represents the minimum amount of actual capital of all state banks at a

$i=1$

given moment t . This capital represents the actual net value of state banks and we believe it guarantees low systemic risk.

The absolute value of the sum of negative net values of NW_{it} at a given moment t will represent the necessary total expenditure that the state must invest to recapitalize the banks so that

$\sum_{i=1}^k$

$SNW_{it}=0$. k stands for the number of banks with a negative net value ($k < n$). The

$i=1$

additional amount of investment by the state for reaching the desired amount of banking capital CA_{it} for these banks will be determined by (1) or (2). The sum of positive differences between CA_{it} and NW_{it} for the remaining banks should also be added to

$\sum_{i=1}^k$

SNW_{it} to get the sum total necessary for recapitalizing state banks.

$i=1$

Table 10 presents the result from the model. We have used an intermediate level for desired banking capital of 4% of the value of individual bank's assets at a given moment (respectively, $CA_{it}=0.04Ass_{it}$ or $CA_{it}=0.04(Ass_{it}-R_{prov_{it}})$).

...cont. from p. 8

under protection. Given the lack of their legal definition, it remains that each protected subject decides what should they be there are clues that in the petition of NEC the spectrum of these activities is quite large.

- Guarding of objects is provided by a security unit, which is in fact an officer of the NSS, employed at the given body or organization.

II. Licenses for work and access to facts, records and matters constituting state secrets, are issued by the NSS or the regional secret services, depending on the given case.

It is interesting to note how a document becomes secret, and for what reasons. It turns out that the procedure is rather simple. The concrete bodies and organizations adopt specific lists on the secrecy of the facts, in accordance with the List of Facts, Records and Matters Constituting State Secrets, adopted by The Parliament (State Gazette, no.31 /1990, last amendment in no.99/1992), and the level of secrecy of each document is decided by the head of the organization.

The document bears a stamp, i.e. an inscription "secret," "top secret" or "top secret of particular importance," and a catalogue number; then it is attached to the secret archives. Only a licensed person is allowed to use such a document after signing.

Commentary: Possible results**General remarks**

Apparently, there is no control whatsoever over the procedure of making a document secret, due to which, consent to the List by Parliament becomes willful, not binding. When the organization is out of the system of state administration, such control cannot be executed by a superior authority. Therefore, if a citizen claims that the contents of a given document do not demand its secrecy, i.e. if he or she objects to its being made secret for some reason, there is no precedent to decide how to rule on such a complaint.

It is doubtful as to whether the legal interest required in order to bring action against somebody exists, when the violation is not a refusal to provide information, but an irregular determination of a given document as a secret one. Besides, NEC is a corporation outside the system of the state adminis-

tration, and that is why its acts cannot be the subject of applications, according to the Administrative Process Law. Besides, the above-mentioned protection of the information apparently also presupposes impeding access in the use of cryptography- access to a document. Moreover, that is a matter of documents with far less clearly defined contents, than those on the Parliament's List.

Specific remarks

To be sure, for the present we can only guess at the NEC's reason for asking for such an enforced guard, and at its consequences, when offered. Since NEC is subject to private law, having been transformed from a state-owned enterprise into a company in which the shareholder is the State, according to the Privatization and Reorganizing of the State-owned and Municipality-owned Enterprises Law, it has the right of the so-called commercial secret, which is the common law protection of its interests concerning access to information. In its new status as a strategic object, however, NEC can utilize some more inaccessibility than before.

1. Firstly, NEC is a party to numerous contracts for vending electrical power, and it should owe information in regard to the mode of price-making; especially since its competitors cannot be a natural factor for the maintaining of the real price.

2. Secondly, according to the regulation of the conditions and the order of granting information on the Privatization and Reorganizing of the State-Owned and Municipality-Owned Law, potential buyers are entitled to necessary information about the

- legal,
- financial and economic,
- organizational, and
- ecological state of the enterprise.

The potential buyer should keep this information as a service secret under the threat of punitive prosecution, but there arises the question of the extent to which NEC will offer such an information, since in the motives for the request for enlistment figure, among others, "problems related to the procedure of holding auctions".

3. It is additionally questionable whether NEC will execute its legal obligation of publishing its annual balance sheet, or the if transfer of the company's money will be secret.

4. Some obligations of NEC in connection with granting access to information also come from the Environmental Protection Law. On the basis of Chapter 2 and Chapter 4, NEC is obliged to provide access to information in the:

Active aspect:

- every act of the Company may be subjected to estimation for impact on the environment. In the hypothesis of Art. 20 this is obligatory. This is information due to the appropriate organs.

- The Company is also obliged to inform the people in cases of disasters, and if such cases are impending.

Passive aspect:

- the appropriate organs are legally bound to grant everyone the received information.

In cases of legal prohibition, the organs cannot grant such information, and it cannot be distributed. The protection of information, as described above, impedes the distribution of such information.

Making a given activity secret may particularly lead to a lawful denial of access or granting of information. Accordingly, an action on Art. 15 of the law would not be successful for the legal limitation of the right of access to information, provisioned in Art 41(2) of The Constitution of RB. It was mentioned above that the possibility to object to the very making secret of an activity is legally doubtful, due to the lack of procedures, the lack of legal interest, and the lack of definition for protected activity. informational protection of

In conclusion it has to be remarked that the right, provided by Art 6 of the Regulation is too broad in content and enables too large a circle of subjects to utilize the special protection on behalf of NSS, which is to be related to another period of the Bulgarian Law. If such protection is considered necessary in some cases, for instance for the Military Production Complex, a definition is owed of the requirements which such an object and activity must meet. Otherwise, the list would grow larger and information about objects of substantial interest for every citizen, such as NEC, would become more and more inaccessible.

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ORGANIZATION COMMITTEE
 BULGARIA INVESTMENT FORUM
 Office # 9, National Palace of Culture, 1000 Sofia,
 Bulgaria
 Phone: + (359 2) 91 66 24 07; Fax: + (359 2) 51 91
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KEYNOTE SPEAKER

Prime Minister
Ivan Kostov

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