

Conditions for Long-term Growth and Prosperity in the Balkans

**In Search of Growth:
Bulgaria's Lessons and Policy Options**

A Report by the Institute for Market Economics

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INTRODUCTION

1999 is a year displaying the end of a decade of economic transition experienced in former communist countries in Central and Eastern Europe.

In a broad sense, the first phase of transition implies liberalization of economic activities, macroeconomic stabilization, structural reform, privatization, improvement of enterprise management and efficiency, establishment of new institutional and legal framework, imposition of clear and transparent market-entry regulations, etc. The economic performance of Bulgaria during last decade of transition, similar to the other post-communist countries in the Balkans, has been worse than in Central European countries. The major factors contributing to such a performance were lack of political consensus and weak (or undermined) institutions.

Bulgarian economic reforms started in February 1991, a delay of 15 months after the communist regime fell. A political consensus was achieved on the following main economic reform targets:

- monetary and fiscal policies: financial stabilization, inflation curbing, money aggregates and budget deficit regulation;
- structural reform: changing patterns of economic behavior through prompt privatization;
- effective economic governance: exercising pressure on enterprises to adjust to the changing economic environment, and setting up fundamental market economy institutions in the country; and
- effective general economic policies: attempting to follow coherent economic policy.

The philosophy of this agenda, and even the wording, have been very similar to that of that of Poland, expressed in the “Government Program of Economic Stabilization” of October 1989.¹

The difference between the two programs has nothing to do with their content. It lies in the political setting. Bulgaria’s reform goals have never been publicly announced as a part of any of the political parties agenda. Moreover, they have never been included in a written government statement. The initial consensus was based on the effects of the unilaterally announced moratorium on the country’s foreign debt payments in March 1990. The implementation of market reforms proceeded successfully until October 1991 elections. The democratic minority cabinet of 1991-1992 attempted to follow the same philosophy, without daring to scrap price controls and promptly privatize. The emerging private sector grew on decapitalization of the state-owned enterprises (SOEs), and especially of large and constitutionally protected² monopolies. With parliamentary support eroded, the democratic cabinet resigned. The cabinet of experts succeeded in signing, in mid-1994, a Brady plan for Bulgaria, restructuring its foreign debt by 47%. In order to fulfill foreign debt payment schedules, the government had to achieve growth rates of 45% of GDP in 1995 and 1996. Technocrats, backed by *ad hoc* majorities in the legislature, failed to promote the private sector and an investment-friendly environment. Their successors, the socialists, not only gave up 1991’s reform ideas, but introduced opposite economic policies. Zhan Videnov’s administration, backed by an absolute majority in the Parliament, attempted a sort of second edition of the central planning,³ supported loss-making public

¹It included: “a) return to a monetary economy with stable money understood as the criterion, rather than narrowly as an instrument, and with money recognized as a measure of value, convertible, universally accepted and balancing the market; b) return to the market mechanism as the main mode of functioning of the economy, ensuring equilibrium of supply and demand, abandonment of economic function, genuine prices and a hard mechanism of verification of production influencing allocation decision; c) return to private ownership as the condition of microeconomic rationality and the basis of work on one’s own account and responsibility” *Waclaw Wilczynski, Five Years of the Polish Transformation: 1989-1994. In Five Years After June: the Polish Transformation, 1989-1994, Ed. by Jan Winięcki, London, The Center for Research into Communist Economies, 1996, p. 24. In Poland, the initial reform stage was interrupted by general elections as well, however, the reform philosophy was consciously and publicly pursued even after ex-Communists’ turnover in 1994, and managed to produce its main results.*

² Article 18 of the Bulgarian Constitution establishes 12 exclusive government monopolies: on energy, communications, mineral, natural and water resources, coastal area and transport; the constitution, however, stipulates that execution of these exclusive rights should be regulated by a specific law; such a law was adopted in November 1995, the Concessions Law, which is still not implemented.

³ In 1991, price liberalization left only 10% of prices (those on fuel, communications, electricity and public

sector, at the price of draining the banking sector and causing severe macroeconomic disequilibrium, and brought the country back to the brink of defaulting in mid-1996, this time with a Brady deal in place.

As a result of delayed structural reforms, several failed attempts to implement a coherent stabilization policy and a chronic lack of financial discipline, Bulgaria experienced the most severe financial crisis since the start of reforms: a paralyzed banking system, undermined credibility of key institutions, substantial depreciation of the Bulgarian currency and several months (December 1996 - February 1997) of record hyperinflation. A consensus was reached again, this time concerning a combination of policy measures to overcome the crisis. Among policy measures was adoption of a Currency Board Arrangement (CBA) in 1997. The CBA had an enormous stabilizing effect in the span of relatively short period of time. Since 1997, Bulgaria has managed to achieve sound macroeconomic stabilization. The main challenge in the next phase of Bulgaria's transition is to attain sustainable growth.

The objective of this paper is to examine some aspects of Bulgaria's economic development during last decade of transition and to determine possible pro-growth policies.

transport) under government control; by 1994 price controls grew slowly to 16% of the consumer basket to reach 49% in 1996.

PART ONE

TRANSITION AND RECESSION

Preliminary Remarks

When starting to examine the aggregate output dynamics in a post-socialist transition country, one must be extremely cautious in the use of indicators, such as the gross domestic product, for any comparisons. If an analyst makes cross-country or time-series based comparisons of different GDPs, it is his or her duty to specify the reliability level of the provisional conclusions. In the case of Bulgaria (and probably also in other European transition countries), the following clarifications should be outlined before we embark on our analysis of GDP dynamics and other comparisons in this report.

1. The official statistics provide only aggregate figures. They do not always reflect real economic processes in the economy, as they are based on formal reporting. The methodology is changed often, making temporal comparisons quite problematic.
2. Although there are no precise estimates of the scale of the informal economy (they vary from 30% to 50% of GDP), it is reasonable to assume that the fall in output registered by the official statistics is to some extent compensated for by “shadow” output.
3. It is difficult to use real GDP growth as an indicator of welfare improvement and prosperity as accurately as for developed countries. This is especially true in the case of comparisons of the pre-1989 period with the post-1989 period. The imports used to come from other socialist countries, which had similar structures of output in terms of utility. The price system did not reflect consumer preferences and official statistics registered GDP increases, which did not necessarily mean an increase in the overall utility from consumption. After 1989, the market itself eradicated production in the face of no demand, which resulted in a registered decrease in aggregate output. At the same time, however, it brought a greater variety of products (either domestically produced or imported), which could not compensate in the money-measured GDP indicators, but marked additional utility.

Below, paying necessary attention to growth dynamics, we concentrate on developments in GDP structure with regard to:

- demand side (final consumption, investments, government expenditures and net exports)
- supply side (shares of the main sectors in the production of domestic output); and
- ownership structure (shares of the private and public sectors).

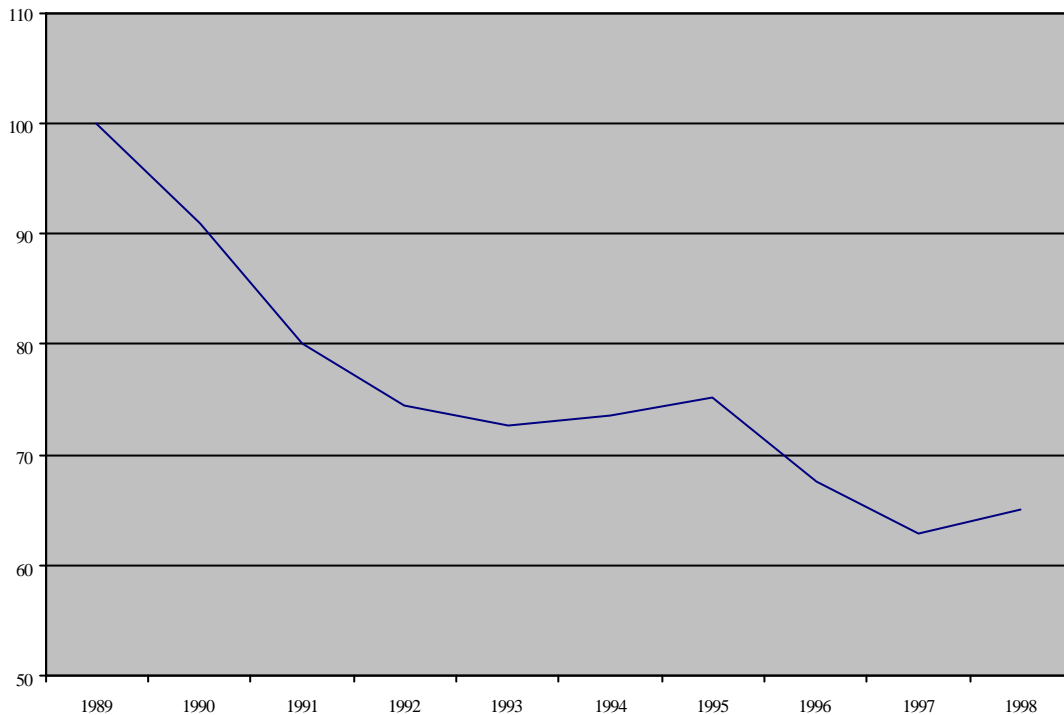
Structural changes in aggregate output, along with changes in productivity, represent a core economic process of transition. We assume that structural reforms differ in at least in three ways from the continuous structural changes seen in developed countries:

1. the changes were prompt;
2. there was a high level of dependency of the reforms on political developments in transition countries (e.g. for privatizing the state sector and further liberalizing the economy); and
3. reallocation of resources is turning out to require much more time than originally expected, due to inappropriate institutional frameworks and underdeveloped financial markets.

Real GDP Dynamics

After 1989, Bulgaria faced a post-socialist recession. In the ensuing nine-year period, only three years registered growth in real GDP (1994, 1995 and 1998). Since 1989, real GDP has lost more than one-third of its initial volume.

Real GDP Index (1989=100)



Source: National Statistics Institute(NSI), IME's own calculations

It is generally accepted that the reasons for the decline were the loss of the former COMECON markets and the official foreign debt (plus 1990 default), restricting the overall investment capacity of the economy.

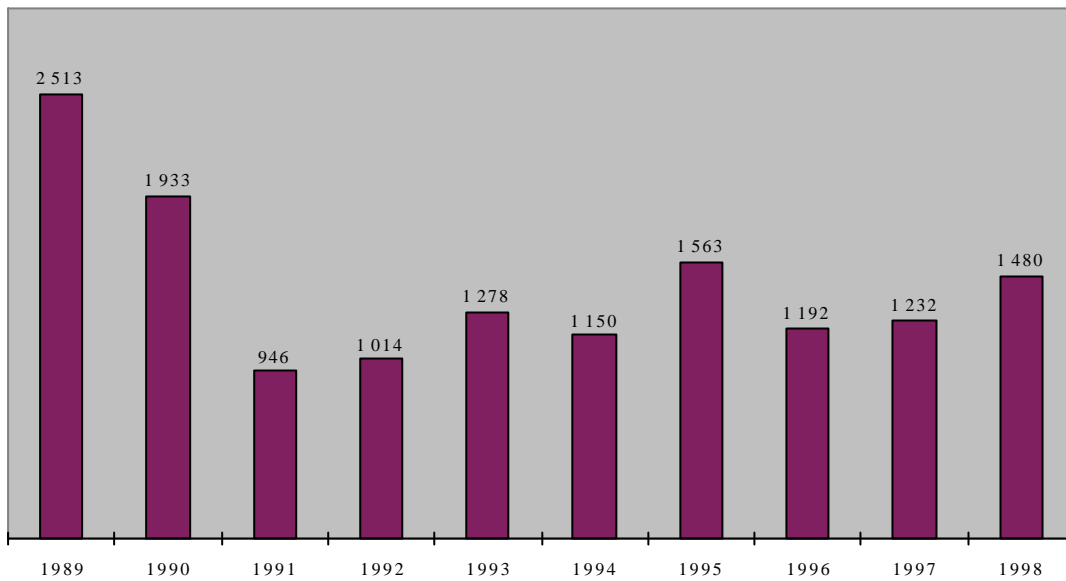
However, these causes are relevant only to the period before 1994, when the economy registered its first positive real growth since the beginning of the transition. The costs for this upward move were:

- a significant delay in needed restructuring of the real sector and
- a sharp decline in the central bank's foreign reserves.

Structural reforms had barely started, when in 1996 the economy turned downward once again. In early 1997, the country faced a hyperinflation shock, combined with a steady decline in real GDP. The medicine for this ailment was found in the introduction of the currency board arrangement (CBA). This brought monetary and financial stability and in 1998, the economy recovered to a growth rate of 3.5%. In fact, the limiting of government discretion via the CBA coincided with the recovery.

GDP per capita (in current year USD) showed an even more dramatic drop than real GDP, from US \$2,513 in 1989 to US \$946 in 1991. It should be noted, however, that it was not until 1991 that the exchange rate used by for official statistics caught up with the market rate.

GDP per capita (current year US dollars)



Source: NSI, IME's own calculations

Structure of GDP

In the post-socialist years the *demand-side* GDP structure changed in the direction of an increased share of households' consumption, and decreased shares of the government's final consumption and investments. The share of net exports has varied from -7.4% to 5.5%. Although the share of the government's expenditures for final consumption has shrunk to 15.1%, the state has retained a dominant share in the economy, as more than 40% of GDP goes through the budget. Moreover, a huge part of the economy's assets are still owned by state companies.⁴

Demand-side Structure of GDP (shares)

	1991	1998
Private consumption	55.9%	71.3%
Government consumption	17.2%	15.1%
Investments	22.6%	14.7%
Net exports	4.3%	-1.1%

Source: NSI

The sector structure of aggregate output is most correctly represented by gross value added (GVA). This showed a significant decline for the industry share, and an equivalent increase of the shares of services and agriculture. Several factors led to this change in the structure of GVA:

- the industrial sector's restructuring, through privatization and liquidation of state-owned enterprise;
- the restitution of lands, increasing the share of agriculture; and
- the emergence of the private service sector.

Structure of GVA* (shares)

	1991	1998
Industry	42.8	28.7
Agriculture	14.2	21.1
Services	43.0	50.2

⁴ Even after completion of the largest privatization deals (expected in the first half of 2000), about 35% of the assets will remain state property.

Source: NSI

*GVA represents GDP minus adjustments, which are the financial intermediation services indirectly measured, non-deductible value-added tax, excises and import duties.

Privatization and liquidation of the state-owned companies contributed to the change in the ownership structure of GVA, as the share of the private sector reached 63.7%, starting from almost zero in 1989, and almost tripling its share between 1992 and 1998. The private sector produces 75% more than the government-owned enterprises, while employing only 40% more. This also indicates a higher productivity level in the private sector.

Lessons of the Post-socialist Recession

Despite the Kosovo war, which placed additional obstacles before Bulgarian exporters, in 1999 the country seems to be heading for a second consecutive year of moderate growth,⁵ after the sharp decline in 1996-1997. There is a general belief that restructuring (meaning also a reduction in output) of state-owned industry is coming to an end. On this basis, there are, among economists and IMF mission personnel, hopes for more robust growth next year. In terms of the search for growth, 1999 and 2000 mark a turning point. For this reason it is more than appropriate to assess past experience and derive conclusions for the future.

There are several major reasons for the long-lasting transitional recession in Bulgaria. They may be summarized as follows:

1. The transition period relatively quickly removed the institutional framework of the centrally-planned economy, while the establishment of the free-market institutional framework (in terms of regulations, institutions and relations) turned out to be a long trial-and-error process. The first years after 1989 brought about a gap in the *coordination of the economy*.⁶ The result was a delay in the reallocation of resources previously employed by the socialist industry. Unclear property rights, the non-functioning legal system and the underdeveloped financial system may be viewed as major characteristics of this framework.
2. The restructuring of the real sector required a political will to privatize and liquidate loss-making enterprises. In turn, there was a need for administrative backing to implement, follow and sustain the will to lift that responsibility off the government's shoulders. Either a lack of political will or misconceptions about privatization and liquidation let the economy lose seven years.
3. Government-retained control over state-owned assets slowed the liberalization of economic life (in terms of domestic and foreign trade controls and permissions, procedural and tariff barriers, combined with unstable tax regulations) and has kept the business environment rather unfriendly.

The following policy lessons seem to be relevant:

- the transition could have been much less costly (in terms of lost wealth and economic opportunities) if the state had concentrated on the establishment of the free-market institutional framework, rather than over-regulating the newborn private sector. For a period of nine years it is obvious that the private sector has often compensated for the decline in the government sector,⁷ it has been constantly increasing its role in different segments of GDP creation, and in the first half of 1999 it compensated for the sharp decline of the government-owned former export leaders;
- monetary stability was empirically proven to be a crucial factor for development, and the best — in Bulgaria's circumstances — way to achieve it was CBA; i.e., the restriction of the government monopoly on the money supply and tying the monetary "policies" of the central bank to its foreign reserves; thus, envisioning of competitiveness and the flexibility of economic entities seem to have become a key precondition for prosperity.

⁵ The National Statistics Institute (NSI) estimated 0.5% real GDP growth for the first half of 1999.

⁶ The term is used by Janos Kornai, in his "Transformation after Socialism."

⁷ An exception is represented by the period from mid-1996 to early 1997, during which private sector output was declining as well, though at a slower pace.

PART TWO

FOREIGN TRADE LIBERALIZATION

Prosperity and Foreign Trade

An element of the globalization process is obvious in the recent development of Bulgaria's foreign trade. But there are no signs of regional integration accompanying increased globalization.

The tables below show a positive trade balance with Balkan countries, and an increasing share of non-Balkan partners in Bulgaria's foreign trade.

Relative share of exports to some groups of countries

	1996		1997		1998		6 months 1999	
	US \$mln	share	US \$mln	share	US \$mln	share	US \$mln	share
EU	1,912.5	39.1%	2,128.7	43.3%	1,083.8	49.7%	971.7	55.6%
Other OECD	554.0	11.3%	661.7	13.5%	249.0	12.0%	219.9	12.5%
EFTA	49.5	1.0%	44.3	0.9%	15.5	0.8%	31.6	1.8%
CEFTA	94.8	1.9%	137.1	2.8%	119.9	4.8%	72.6	4.1%
Balkan countries	514.2	10.5%	291.9	5.9%	397.6	5.4%	80.2	4.5%

Relative share of imports from some groups of countries

	1996		1997		1998		6 months 1999	
	US \$mln	share	US \$mln	share	US \$mln	share	US \$mln	share
EU	1,780.3	35.1%	1,823.1	37.3%	1,044.9	45.2%	1,243.4	54.3%
Other OECD	275.4	5.4%	343.8	7.0%	227.1	8.1%	203.0	8.8%
EFTA	86.4	1.7%	86.8	1.8%	34.0	1.5%	45.6	1.9%
CEFTA	159.9	3.2%	231.7	4.7%	120.0	6.0%	150.9	6.5%
Balkan countries	163.3	3.2%	95.2	1.9%	68.4	1.6%	23.2	1.0%

The Balkans have no market identity per se. The trade picture of the region as viewed from other Balkan countries is similar to that as viewed from Bulgaria. According to the UN ESE,⁸ the respective Southeastern European share for different countries in 1997 was as follows: for Albania: 7.13% of exports and 5.6% of imports; for Bosnia and Herzegovina: 60.2% of exports (Croatia's share is 57%) and 20.1% of imports; for Croatia: 18.6% of exports and 2.6% of imports; and for Macedonia: 16.3% of exports and 22.4% of imports (half of this trade being with Yugoslavia). These figures suggest that geographic and background factors still play a key role in commercial exchange within the southeastern corner of Europe.

For Bulgaria, regional trade could not be worse.

Recent theoretical ideas focus on the channels through which free trade links foster growth (Grossman and Helpman 1989, also Krugman 1990).⁹ According to their assumptions, free trade stimulates innovation of production because international trade provides access to international markets, and hence to advanced technology. Therefore, it leads to economies of scale and faster growth. Vamvakadis'¹⁰ assumption focuses on the evidence that the size of the domestic market is important to a closed economy, whereas trading with developed countries fosters economic growth for small open economies.

⁸ Economic Survey of Europe, 1999, No. 2, p. 15.

⁹ See: Krugman, Paul, *Geography and Trade*, Cambridge, Mass., MIT Press, 1991, pp. 90-130.

¹⁰ See: Vamvakidis, Athanasios, "Regional Trade Agreements or Broad Liberalization: Which Path Leads to Faster Growth?", IMF Staff Paper Vol. 46, 1999.

For the time being, there is little evidence that Bulgaria has benefited from openness and regional integration. Recent theories of international economics assume that a country that is open to free trade will perform better. Willingly or unwillingly, such was the assumption behind Bulgarian foreign trade regulation in recent years, as is the commitment to liberalize further in the years to come as agreed between IMF and the Bulgarian government.

Openness of the Economy

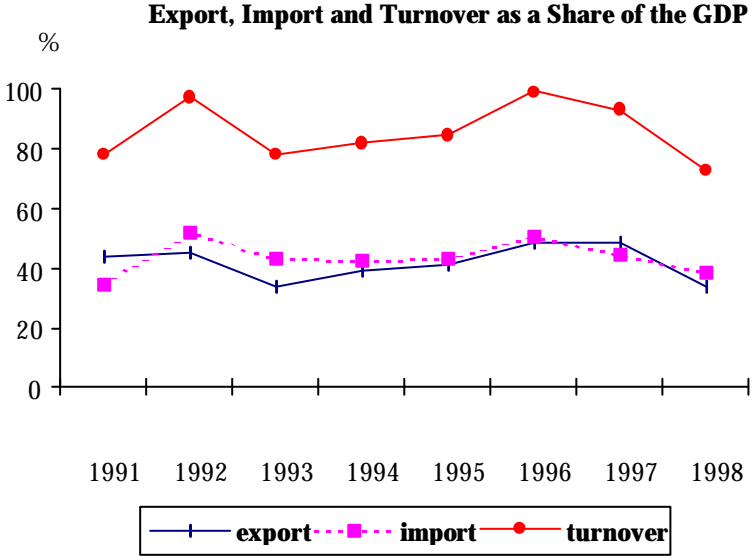
The guiding principles of free trade are: liberalism (no or minimal restrictions on international transactions) and openness of the economy to international markets. Opening the economy and the liberalization of foreign trade are interdependent. Gains in and degree of liberalization are difficult to quantify and estimate. However, some general indicators are in use for measuring openness. The traditional measurement of openness is $(exports + imports) / GDP$ – trade share of import and export in total turnover, growth of exports and imports.

Level of openness in Bulgaria¹¹

	1992	1993	1994	1995	1996	1997	1998
Bulgaria %	39.1	33.0	40.6	40.4	48.8	45.4	36.5

Source: IMF Direction of Trade Statistics, EBRD and IME calculations.

The table above depicts the dynamics of trade openness in Bulgaria. It has a high value of the trade index, it is basically higher than Switzerland’s. Foreign trade is an important factor in the formation of GDP. In 1998, the index reflects losses in market shares in Russia and lower export volumes to other markets.



The decrease of the share of turnover in GDP is due to ongoing structural reform and low domestic demand. Jeffrey Sachs and A. Warner¹² construct in their work variables of openness, based on four

¹¹ Trade openness is measured by the ratio of total trade(exports + imports)/2 over GDP. For more details, see: Liargovos, Panagiotas, "Post Communist Transition and European Integration Process". Economic Reconstruction of the Balkans Summer School.

¹² Based on empirical analysis of industrialized and developing countries with different degrees of openness, Sachs and Warner find that open economies grow on average 1.5% faster than closed economies. The Sachs-Warner openness indicator is a zero dummy, which takes the value 0 if the economy is closed according to any one of the criteria mentioned. See further: "Economic Reform and the Process of Global Integration," NBER Working Paper Series, 1995.

dimensions of protection: average tariffs at rates higher than 40%, non-tariff barriers that cover on average more than 40% of total imports, black/informal market premium, and the role of the state in the economy. According to their criteria the Bulgarian economy may be characterized in the following way:

1. With regard to the criterion "average tariffs at rates higher than 40%": the average tariff rate in Bulgaria is less than 40%. Since 1991, customs tariffs have been changed several times (1991, 1992, 1993, 1997) and were basically adjusted to the requirements of the Harmonized Customs Tariffs. The average tariff was 11.4% in 1991, 15.4% in 1992, 17.5% in 1993 and 17.2% in 1995. According to the Customs Tariffs Act adopted in 1997, the average tariff rate is 17.8% (for the Ist column), and 16.2% (for the IInd column), and the average tariff of General Customs Tariffs amounts to 57.7%. The average weighted tariff for agricultural products is 21.23%, while that for industrial products is 9.29% (this evaluation is only for ad-volume tariffs). In 1998, the average tariff for industrial products was 16.7%, and 25.9% for agriculture products. Since January 1999, a new Customs Code has been introduced, based on the EU Customs Code. According to the new Customs Code, duties on a significant number of industrial products have been reduced. The average rate for these goods is 12.58%, with respect to Most Favored Nation Treatment agreements. It is expected that up to January 1, 2000, the average tariff on industrial products will reach 12%, and 24% for agriculture products, while starting from 2002 they will decrease further, and the average tariff on industrial products will be 10% and that for agriculture products 22%.
2. With regard to the criterion "non-tariff barriers cover on average more than 40% of total imports": most non-tariff barriers have already been eliminated, except those under bilateral agreements with EU countries for numerous products.
3. With regard to the criterion "black/informal market premium exceeds 20%": in Bulgaria, the exchange rate is fixed. There has been no parallel currency market since 1991.
4. With regard to "the role of the state in the economy": in Bulgaria, the privatization of major exporters began in 1997. Some progress has been achieved in terms of restructuring and privatization of the large, state-owned foreign-trade enterprises. On the whole, the structural reform in foreign trade has been delayed. At present, privatization of these enterprises is ongoing. In 1998, of a total of 37 foreign trade enterprises 14 were sold, four will remain state owned and the others are still under privatization or liquidation procedures.

One of the key developments was *de facto* demonopolization of the foreign trade at a very early stage. This has been an institutional incentive to lobby for indirect control over the foreign trade through government export quotas, privilege contracts with government industries, etc. Under the pressure of international financial institutions (IFIs), such efforts seem to have been thwarted.

Towards Foreign Trade Liberalization in Bulgaria

There is a positive relationship between the liberalization of foreign trade and achieving sustainable economic growth, as trade balance and external debt are basic macroeconomic indicators for output recovery. Important factors for growth are the opening of the economy and introduction of export-stimulating measures. A common feature of countries in transition is a U-shaped response to output dynamic (a sharp decline in output, followed by recovery). Therefore, foreign trade liberalization is used as a tool for the improvement of aggregate demand when market-oriented reforms start. All countries in transition follow a similar model of transformation; what is different is the speed of progress in market reforms. Bulgaria undertook measures toward price liberalization and reduction of tariff and non-tariff barriers, simultaneously with implementing a variety of other policy reforms – fiscal, monetary, financial regulations, and reduction of government intervention.

A major disadvantage of the Bulgarian transformation was a constant macroeconomic imbalance, from start of reforms in 1991 until 1997, and the dependence of Bulgarian production on imported inputs from traditional partners, such as Russia. A typical feature of the Bulgarian economy is a low rate of GDP growth. Positive GDP growth has been achieved in the short term, not the long term.

Bulgarian foreign trade turnover suffered from the international embargo against Serbia and Montenegro. The Kosovo conflict disrupted the regular transport link with Western countries and was a cause of the balance of trade deficit registered for the first six months of 1999.

Despite this unfavorable external environment, Bulgaria made progress in foreign trade price liberalization, the foreign exchange regime and reduction of tariffs on imports and exports. A specific feature for Bulgaria is that economic growth is driven mainly by domestic demand, imports rising faster than exports, especially during the last year.

Foreign trade liberalization has been a case of market reform success in Bulgaria. The liberalization process took place gradually. The foreign trade regime was changed several times, towards decreasing tariff barriers.

The foreign trade liberalization process may be divided into the following periods, according to the extent of trade liberalization and EU integration progress:

First period: 1991-1995. In 1991, trade liberalization started with price liberalization and the introduction of internal currency convertibility. As a result of this internal convertibility, the gap between domestic and international prices decreased. Non-tariff barriers and export subsidies were eliminated. Despite the liberalization measures, protection on import goods remained to enforcement of the new Customs Tariffs. The Customs Code (1992) did not influence trade liberalization, because import duties remained very high: 3-30% (first column) and 5-40% (second column). Customs Tariffs were changed in 1993 and some duties on imports of raw material decreased. Foreign trade regulations and restrictions changed very often, aiming at decreasing licensing procedures (import licenses, export permissions, etc.).

Second period: 1995-1998. The main feature of this period was the signing of the EU Association Agreement (EAA) and Bulgaria becoming a member of the WTO. In 1995, new Customs Tariffs were introduced. Macroeconomic instability and an inefficient export structure impeded the effects of foreign trade liberalization on output. Frequent changes to foreign trade regulations created uncertainty for economic agents. The foreign trade regime was changed several times. (Council of Ministers Decree N307/1994; Decree N 82/ 1995, amendments to decree N180 from 1993, Decree 226). All of the changes to the foreign trade regime reflected the measures included in the EU Association Agreement.

Third period: 1998-present. The progress of EU integration has been outlined in the pre-accession to the EU strategy and a National Program for Adoption of the Acquis (NPAA) was adopted in 1998. Commitment to EU membership is a stated priority of the Bulgarian government. A free-trade agreement between Bulgaria and the EFTA countries has been implemented. Bulgaria has unilaterally lifted customs duties on the import of textile commodities from EFTA countries, in view of equalizing duty treatment with that of the EU. In July of last year, Bulgaria signed an Agreement on Accession to the Central European Free Trade Agreement (CEFTA) and became a full member. In January of 1999, duties were reduced on 80% of the goods imported from CEFTA countries. Duties on CEFTA imports will be eliminated in January of 2002.

According to trade agreements with Turkey, 90% of trade is duty free between both countries. In July of 1998 Bulgaria signed a Free Trade Agreement with Turkey. Since January of 1999, duties on all industrial goods exported to the EU are free from tariffs. The decreasing of duties on exports improves Bulgarian access to the international market. The effect of the drop in duties on trade integration is significant, in case of higher profitability and competitiveness. However, Bulgarian products are not competitive and revenues from exports are low. For this reason there has been no significant effect from the reduction of export duties on production.

The new Customs Code was adopted in 1998. It provides for customs procedures similar to those in the EU. A process of computerization of the customs system started in 1998, aimed at covering the whole customs procedure, from the customs declaration to discharge of the debt. New institutions were established, aiming at the promotion of exports and further foreign trade liberalization, such as the Center for Export Promotion (founded as a separate part of the Ministry of Trade and Tourism in 1997), a Promotion Bank and the Agency for Export Insurance.

Starting this year, according to Council of Ministers Decree No271, 26.13% of all of the categories of commodities included in the Customs Tariff law are under a licensing regime, while 0.67% are under a permission regime. One of the obstacles to foreign trade liberalization was a 2% import tax (aimed at supporting country's balance of payments). In 1999, this surcharge tax on imports was eliminated. The current foreign trade regime reflects all existing bilateral and multilateral agreements to which Bulgaria is a party.

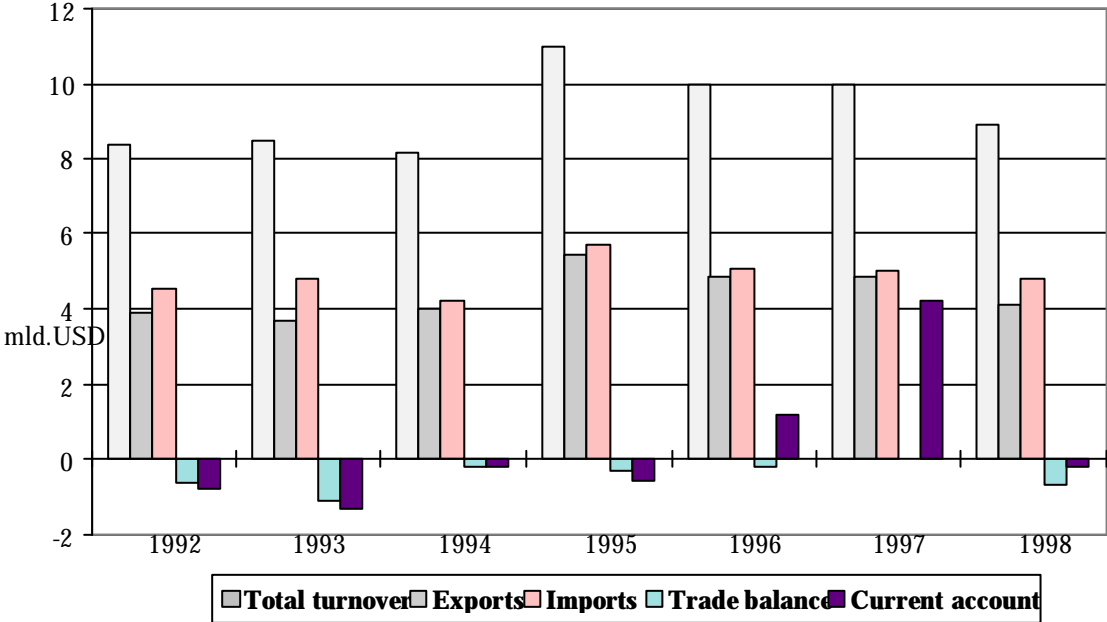
Liberal foreign trade policy in Bulgaria is a prerequisite for economic growth. Protectionist measures had a positive impact on production only in the short term, because distribution by the government could lead to temporary growth in GDP. In Bulgaria the positive effects of restrictions on producers were diminished, because the state supported unprofitable enterprises for a long period, delaying structural reform. Protectionist policies could be used for promoting the export-oriented sectors, especially in the short run. In the long term, protectionism deteriorates the terms of trade because of the increased difference between internal and international prices. Thus, implementation of protectionist measures will lead to declines in productivity of labor and capital, as well as investment flow. The gains from the liberalization of foreign trade up to now have not had an impact on economic performance, because of weak flexibility and adjustment to the domestic and international market on the part of economic agents. Perhaps in the longer term, benefits from trade liberalization will be achieved through enhancing the competitiveness of production and diversification of the export structure with profitable products.

Dynamics of Foreign Trade

In 1991, Bulgaria lost more than half of its markets in the USSR, as a consequence of distortion of the Council for Mutual Economic Assistance (CMEA) market. The geographic structure at the beginning of the market reform differed from that at present. The instability of the region was a barrier to the development of regional integration. The main characteristic of foreign trade dynamics in the last two years has been a downward trend with the main partner, the countries of the former Soviet Union, and an upward trend with the EU countries. The problem regarding trade with Russia was tariff policy.

Key stimuli to further openness and liberalization were arrangements such as the EAA, participation in the WTO, CEFTA and free trade agreements with Turkey and Russia.

Foreign Trade Indicator



Source: NSI, BNB.

Since 1995 the downward trend with regard to exports has continued. The total volume of turnover last year was lower than that for the previous year, but imports from CEFTA countries rose (the value of foreign trade turnover in 1998 was US \$8.9 billion, a decrease of 8.8% compared to 1997; exports decreased by 13%).

This is mostly due to the worsened competitiveness of Bulgaria's exports, resulting from structural reforms, and in particular their slow pace. Imports increased slightly in 1998, but are showing a sustained downward trend. The share of trade with Russia decreased. It was 18.6% in 1997 and 13.5% in 1998. Exports to Russia and other former Soviet republics declined significantly in 1998. Imports from Russia dropped by 27.4%. Nevertheless, Russia remained a main supplier of energy and raw materials. Foreign trade turnover with Balkan countries dropped by 2% in 1998. Since 1995, exports to Balkan countries have been higher than the volume of imports.

The leading countries in Bulgaria's foreign trade are the following EU member-countries: Germany, Italy, Greece and Turkey. Turnover with them amounted to 50% of total turnover.

Foreign Trade Partners of Bulgaria - Export and Import

Exports to, %	1991	1992	1993	1994	1995	1996	1997	1998
EU	15.7	29.4	28.2	35.6	37.8	39.1	43.3	49.7
CEE	57.7	39.2	35.1	33.1	32.4	31.8	26.6	23.1
Balkans	n/a	n/a	n/a	n/a	13.0	10.5	5.9	5.5
CEFTA	n/a	n/a	n/a	n/a	1.8	1.9	2.8	4.9
Former Soviet Republics	n/a	n/a	n/a	n/a	17.3	19.3	17.9	12.7
EFTA	n/a	n/a	n/a	n/a	1.8	1.2	1.1	1.1
Import from, %								
EU	29.2	31.1	30.2	37.5	38.1	31.1	37.7	45.0
CEE	48.4	36.3	36.6	41.2	40.6	43.1	39.4	32.3
CEFTA	n/a	n/a	n/a	n/a	3.2	3.1	4.6	5.6
Balkans	n/a	n/a	n/a	n/a	4.3	3.1	1.9	1.6
Former Soviet Republics	n/a	n/a	n/a	n/a	33.2	31.5	32.9	25
EFTA	n/a	n/a	n/a	n/a	2.9	2.5	1.9	1.6

The Russian crisis, and low prices of some inputs on the international market in 1998, did not influence foreign trade. The share of trade with Balkan countries recorded its highest value in 1998. Trade surpluses were recorded with all Balkan countries (most significantly with Turkey, Greece, Macedonia and FR Yugoslavia).

The following conclusions can be made:

- Bulgarian foreign trade with CEFTA and EU countries will continue to increase, on the basis of the association agreements.
- By eliminating tariffs, trade with Macedonia will be further developed in the future. The data demonstrate that Bulgaria is becoming a partner in demand in the Balkan region. Meanwhile, Bulgarian exports to Balkan countries are higher than imports.

Trade balance with Balkan countries (1992-1998 US \$millions)

	1992	1993	1994	1995	1996	1997	1998
Turkey	179	206	120	279	276	341	204
Greece	-71	61	110	120	143	200	76
Macedonia	124	150	282	256	114	72	60
FR Yugoslavia	113	126	144	81	172	87	58

Sources: NSI, Ministry of Foreign Trade and Tourism, BNB

Despite a slump in foreign trade turnover, Bulgarian trade with Greece and Turkey is considerable, unlike that with Albania and FR Yugoslavia.

Trade share of Balkan countries in total trade turnover (1992-1998)

%	1992	1993	1994	1995	1996	1997	1998
Greece	5.1	4.7	6.3	5.6	5.5	6.2	7.6
Turkey	3.8	4.2	3.5	4.4	4.8	5.6	5.6
FR Yugoslavia	2.8	1.6	1.8	0.8	2.9	1.7	1.5
Romania	2.6	2.3	1.8	1.2	1.2	1.1	1.2
Macedonia	2.3	3.6	6.6	5.6	1.8	1.3	1.5
Slovenia	0.1	0.4	0.11	0.6	0.3	0.5	2.7
Croatia	0.4	0.4	0.3	0.4	0.4	0.5	0.4
Bosnia Herzegovina	1.5	0.2	0.0	0.0	0.0	0.1	0.1
Albania	1.4	1.0	1.3	1.1	0.4	0.9	0.5

Source: NSI, Ministry of Foreign Trade and Tourism.

Relative share of exports to Balkan countries in total exports

%	1992	1993	1994	1995	1996	1997	1998
Greece	4.6	6.2	7.8	6.9	7.1	8.3	9.1
Turkey	6.3	7.6	5.1	7.2	7.9	9.0	8.2
FR Yugoslavia	4.4	3.5	3.6	1.6	4.7	2.5	2.3
Romania	2.8	2.5	1.6	1.8	1.5	1.3	1.3
Macedonia	4.0	6.1	10.3	8.1	3.0	2.0	2.4
Slovenia	0.1	0.2	0.9	0.4	0.1	0.2	2.4
Croatia	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Bosnia Herzegovina	1.4	0.2	0.0	0.0	0.0	0.1	0.1
Albania	1.3	1.0	1.3	1.1	0.9	0.5	0.5

Source: NSI, Ministry of Foreign Trade and Tourism.

Relative share of imports from Balkan countries in total imports

%		1993	1994	1995	1996	1997	1998
Greece	5.6	3.5	4.8	4.4	3.9	4.2	8.3
Turkey	1.6	1.6	2.0	1.8	1.9	2.1	2.9
FR Yugoslavia	1.3	0.1	0.0	0.1	1.1	0.8	0.7
Romania	2.4	2.1	1.9	1.1	1.4	1.2	1.2
Macedonia	0.8	1.6	3.1	3.1	0.6	0.5	0.4
Slovenia	0.1	0.2	0.2	0.2	0.2	0.2	0.3
Croatia	0.0	0.1	0.0	0.1	0.1	0.2	0.1
Bosnia Herzegovina	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Albania	0.1	0.0	0.0	0.0	0.0	0.0	0.0

Sources: National Statistics Institute, BNB

Bulgarian exports have significant import components, so a decrease in demand for exports influences import volume. In terms of import structure, imports of consumer goods increased by 22% in 1998 as compared to 1997, as a result of decreasing domestic output and liberalization of imports. In addition, growth of real salaries contributed to increased imports of consumer goods. Raw materials dominate in the import structure. Imports of investment goods increased in 1998, as a consequence of decreased duties on investment goods from the EU. Exports fell, as a result of internal factors — restructuring the main companies — and external factors — low prices on the international market.

This year, 1999, is claimed to be a special case due to the crisis in Kosovo. However, the picture is as follows. During the first three months of this year, effectively before the war, export industrial sales had already fallen by 26%. Domestic sales fell by 12% over the same period, and GDP went down by 1.2% as compared to the same period for 1998. So poor performance was already evident before the NATO airstrikes on FR Yugoslavia.

The immediate shock was perhaps most obvious in April of 1999, when exports dropped from \$335.1 million¹³ in March to \$283.7 million in April. Imports went down as well, but at a much slower pace: from \$453.7 million to \$442.9 million. The aggregate decline in imports for the first half of 1999 was only 1%, while exports went down by 21.7%. This difference suggests that physically interrupted trade routes were not the lone factor in Bulgaria's worsened competitiveness; although there were delays in deliveries, the impact of longer transport routes was often exaggerated by the government.

Commodity Structure

Bulgarian industrial exports are concentrated on clothing, textile materials, pharmaceuticals and ferrous and non-ferrous metallurgy products, as well as energy. Imports are characteristically industrial equipment, consumer goods, minerals, raw materials and investment goods. The positive trend shown in foreign trade turnover is the increase of the export volume of consumer goods, textiles, leather materials and clothing. Perhaps this is due to the fact that most enterprises in these sectors were privatized, and that in an unstable macroeconomic environment entrepreneurs sought markets with stable hard currencies. Foodstuffs are exported mainly to CEFTA countries and Russia. Bulgaria exports mainly leather materials, textiles, clothing, cement and chemical products to the EU; it exports foodstuffs, beverages, plastics, metals and minerals to Balkan countries.

Low prices of raw materials and chemical products on the international market have a negative effect on export revenues. Therefore, revenue from the export of energy resources decreased by 19% in 1998, compared to 1997. Exports of chemicals, plastics and rubber dropped by 30%; of fertilizers, by 40%; of steel, by 18.3%; and of copper, by 27%. Export revenues from metals decreased by 21% in 1998, compared to 1997.

Regional dynamic of export commodities

Commodities	1992		1998	
	EU	BC	EU	BC
Non-ferrous metals	54.0	35.1	68.5	28.5
Textiles, textile materials	55.7	18.4	78.5	21.4
Chemical products	35.2	26.2	29.8	26.7
Machines	18.1	14.9	45.5	11.4
Food	20.4	10.6	26.1	10.6
Mineral products	28.9	49.3	22.0	57.7

Regional dynamic of import commodities

Commodities	1992		1998	
	EU	BC	EU	BC
Non-ferrous metals	21.9	19.3	39.6	25.8
Textiles, textile materials	65.6	16.7	81.8	21.4
Chemical products	35.2	8.0	53.7	7.6
Machines	49.4	7.9	69.4	5.3
Food	58.1	10.6	32.1	17.2
Mineral products	13.7	16.0	6.8	9.7

Source: NSI, BNB

¹³ March was an exceptionally good month for 1999 exports, the only month to equal the average monthly export volume of 1998; April represents the rough average monthly export for the first half of 1999.

Integration With Balkan Countries

The greatest share of trade is with Greece and Turkey. Bulgaria has positive trade balances with Balkan countries. The share of exports to Albania accounted for 0.5% of total exports during the last year. In fact, however, the Balkan countries maintain import restrictions on exports such as food, textiles and steel. Bulgarian exports to Macedonia and FR Yugoslavia suffered from high duties resulting from the implementation of foreign trade restrictions. Differences in progress toward EU integration among Bulgaria's neighbors impose different dynamic effects on their production and economic welfare. Greece is a member of the European Union, while Romania and Bulgaria have signed association agreements and are included in the pre-accession strategy of the EU. Albania and Macedonia have not signed EU Association Agreements yet, which reflects on product specialization and foreign trade turnover.

There are possibilities for expanding trade between Bulgaria, Macedonia, Albania and other Balkan countries. This could be promoted by their signing bilateral free-trade agreements, aimed at abolishing trade restrictions and further opening their markets. This has recently happened with Macedonia, on the basis of a compromise which preserves the protection of Macedonian-made construction materials for the period of rebuilding Kosovo. Although not yet implemented, the Stability Pact for Southeastern Europe and the debate around it are built on two sets of beliefs:

- free trade areas foster a linkage between the demand of one country and supply by another via trade; and
- creation of such areas will be a first step toward regional integration.

In the case of the Bulgarian-Macedonian free trade agreement, it applies the Stability Pact philosophy because there is a general expectation that the Pact will somehow be implemented.

But policies towards regional integration in the Balkans are political, as well as economic, decisions. From the economic point of view, regional economic association brings immediate benefits and increases the welfare of participating countries, when they are at more or less comparable economic levels and have similar economic potential. In such a case, eliminating trade restrictions between the members of regional integration agreements brings benefits to all. In the longer term, it brings the enlargement of markets and the potential to attract investors.

One possible way to foster trade in Balkan region in the near future would be to sign preferential trade arrangements among Balkan countries. This would increase their manufactures' production, because of changes to the existing pattern of trade. This regional trade would lead to gains for production by coordinating their trade policies with respect to other countries. As a consequence of developing regional integration, market enlargement could be attained, which would allow Balkan countries to exploit economies of scale and develop a competitive product structure. However, there are benefits derived from the dynamic effect of enlarging the regional market. At present, the political and economic situation in FR Yugoslavia is not favorable for strengthening trade integration. An obstacle to the enforcement of cooperation among the Balkan countries is the fact that FR Yugoslavia is not a member of the WTO and has not signed trade agreements with the EU.

Assessment of the EAA signed by Bulgaria

The EU Association Agreement is a crucial point of reference with regard to current political and economic developments in the Balkans. EAA membership is a prerequisite for active participation in the European integration process and intensification of economic relations with the EU.

In 1995, the European Agreement of Association (EAA) entered into force in Bulgaria, and foreign trade policy began to adhere to its requirements: elimination of non-tariff barriers and the gradual liberalization of trade with sensitive goods, such as textiles, chemical products and agricultural products. According to the EAA, the protection of "sensitive products"; the restriction degree would gradually be removed five years after implementation of the Agreement. The Bulgarian market, for some years, has been most open (i.e. imports) to EU member countries' commodities, unlike Bulgarian exports to EU market. At present, following the scheme of liberalization of trade, export tariffs on

industrial goods have been abolished. Opening the domestic market to foreign products puts pressure on domestic producers who face high foreign competition.

Benefits of having signed the EAA are:

- access to EU markets, vital to the development of a market economy in Bulgaria;
- assistance in promoting economic and social reforms and improving economic and social cohesion;
- regulation of foreign trade corresponding to the requirements of Bulgaria's acceptance to the EU;
- assistance in improving the quality and competitiveness of Bulgarian products;
- fostering of restructuring and economic growth;
- increase of exports, based on development of comparative and competitive advantages;
- restructuring of commodity structure on the basis cost-efficient policy; and
- creation of bilateral free trade areas for non-agricultural products, abolishment of quantitative restrictions.

Reduction of trade restrictions contributes to trade diversification and improves the efficiency of resource allocation. In Bulgaria, this effect cannot be felt because of the stage of restructuring. Under the conditions of monopoly structures, any effects from decreasing tariffs on resource distribution are lower than in countries with well-developed property rights. The role of the capital market in the facilitation of foreign trade activity is substantial. However, the capital market is underdeveloped in Bulgaria, with low liquidity, and is not an efficient tool for the accumulation of financial resources.

Foreign Trade Perspectives

For the past few years, Bulgaria has been in a pre-accession period. The expected positive effects of Bulgaria's association with the EU depend upon an interrelationship between restructuring the economy and trade policy. One of the ways to foster this process is by the creation of an internal competitive market and widening the export structure. The liberalization of foreign trade cannot be considered a means for fostering economic growth without significant structural changes of the economy. Bulgarian foreign trade is rather extensive. Its inefficiency derives from sub-products and low value added. Thus, revenues from Bulgarian exports are very low and do not lead to increased economic efficiency. Export products involve high input components, so Bulgarian exports have to modernize through innovation, improvement or diversification of the products and decrease the amount of sub-products and increase the amount of final products. Bulgaria's low competitiveness stems from high production costs. Export revenues are significant for maintenance of the external balance. Therefore, the Bulgarian government should outline a national export policy and its priorities.

We may summarize the following foreign trade priorities:

- improving the efficiency of Bulgarian exports and terms of trade through creation of an export-oriented long-term strategy, based on the branches' competitive advantages;
- creating free trade zones of zero tariffs with most Balkan neighbors;
- modernizing export structure, developing integration on the basis of internal trade;
- stimulating the production of capital-intensive final goods; and
- formulating an efficient export-oriented policy through diminishing economies of scale.

PART THREE

EXCHANGE RATE REGIME: DOES IT CONTRIBUTE TO GROWTH, OR NOT?

The exchange rate has become one of the most important policy indicators for countries in transition. The choice of type of exchange rate has implications for further economic growth and prosperity. It influences economic growth through investment flow and productivity. There are a variety of types of exchange rate regimes.¹⁴

One of the paths to adapting to open-market-based international trade is by introduction of currency convertibility. At the start of reforms, Bulgaria adopted a free floating exchange rate regime. This was in place until July of 1997, when a currency board was introduced. At first, the BGL was fixed to the DEM, and after that it was pegged to the Euro. In theory, under a floating exchange rate, inflation decreases gradually and the social costs are higher, in contrast to swiftly decreasing inflation under fixed exchange rate conditions. The fixed exchange rate has a disciplinary effect and adds credibility. The fixed exchange rate is an appropriate tool for immediately decreasing inflation.¹⁵

The choice of an exchange rate regime was certainly one of the decisive issues faced by Bulgarian decision-makers. The choice of exchange rate regime determines a country's ability to maintain external and internal balance. The appropriate regime is that which stabilizes macroeconomic performance, minimizes the drop in output and real consumption and decreases the fluctuation of domestic price levels.

The option of a managed floating exchange rate in Bulgaria was attractive from the point of view of protecting the economy from internal and external shock. In 1991, the BGL's exchange rate was set at 24 BGL per USD, and Bulgarian currency was depreciated. At the same time, internal convertibility¹⁶ was introduced. Limitation of currency convertibility had a restrictive effect on trade and capital flow. For that period, the domestic currency was convertible, according to Article 14 of the IMF Statutes. There were restrictions against citizens opening bank accounts abroad. The Bulgarian National Bank (BNB) and the Finance Ministry controlled capital transfer and they permitted credits from foreign banks as well as capital export. There were restrictions on currency export by physical persons. The limit was US \$1,000; above this amount the customs authorities required foreign exchange note from a bank.

The constant fluctuation of the exchange rate in Bulgaria stemmed from the high inflation rate in 1997. This inflation had a negative effect on economic growth (by inefficient allocation of resources), on capital productivity and micro- environment. Using the endogenous growth theory for a strong link between inflation and growth, we may conclude that inflation was a considerable obstacle to economic growth in Bulgaria up until 1997.

The choice of exchange rate regime depends on the circumstances of each country, connected with economic performance, amount of foreign reserves, degree of macroeconomic disturbance, structure of international trade and other variables. The choice of a floated managed exchange rate was not appropriate for the Bulgarian economy, because it is not large and well-developed and it faces the challenges of restructuring and unavoidable internal shock, e.g. the implementation of market reform

¹⁴ IMF classifies the following types of exchange rates: floating, managed float, limited flexibility (crawling peg), fixed, and currency board. IMF World Economic Outlook, 1997, p.83.

¹⁵ See: "Does the Nominal Exchange Rate Regime Matter for Inflation and Growth?", IMF working paper 95/121. Ghost, Gulde, Ostry and Wolf studied in detail the relationship between inflation, exchange rate regimes and growth.

¹⁶ Internal convertibility means that residents are free to maintain domestic assets denominated in foreign currency and to convert domestic currency into foreign currency assets. Internal convertibility allows households to legally hold assets in foreign currency and freely sell/purchase foreign currency. This convertibility is a part of the payment system. Under the existing currency regime (Art.14, IMF Status), capital movements are regulated. The freedom of citizens to make financial investments abroad is limited. Permission to undertake investments abroad must be obtained from the Finance Ministry. There is no restriction on capital repatriation (besides a 15% withholding tax) and payments for goods and services to foreign institutions and agents work well.

measures. The cost of implementation of macroeconomic stabilization is higher because of measures taken for gradually reducing inflation. The managed float exchange rate does not guarantee stability of foreign trade turnover and does not contribute to decreasing business and financial risk.

Real Exchange Rate Dynamics

After the introduction of the flexible exchange rate, there was a discrepancy between fluctuations of the nominal and the real exchange rate. The consumer price index rose faster than the nominal exchange rate. The central bank intervened on the exchange market and controlled the movement of the exchange rate. The BGL moved from real appreciation to depreciation. The exchange rate of the BGL rose very fast in 1994, and the BGL was depreciated again. Despite this depreciation, the BGL continued to appreciate in real terms. The reason for continuous fluctuation of the exchange rate was the inconsequent implementation of restrictive fiscal and monetary policy, growth of inflation and others. The real exchange rate of BGL per USD was mainly overvalued. The short periods of deprecation did not have considerable impact upon the trade balance and the competitiveness of Bulgarian exports. The BGL exchange rate for 1991-1997 was not a key factor for achieving external and internal economic balance.

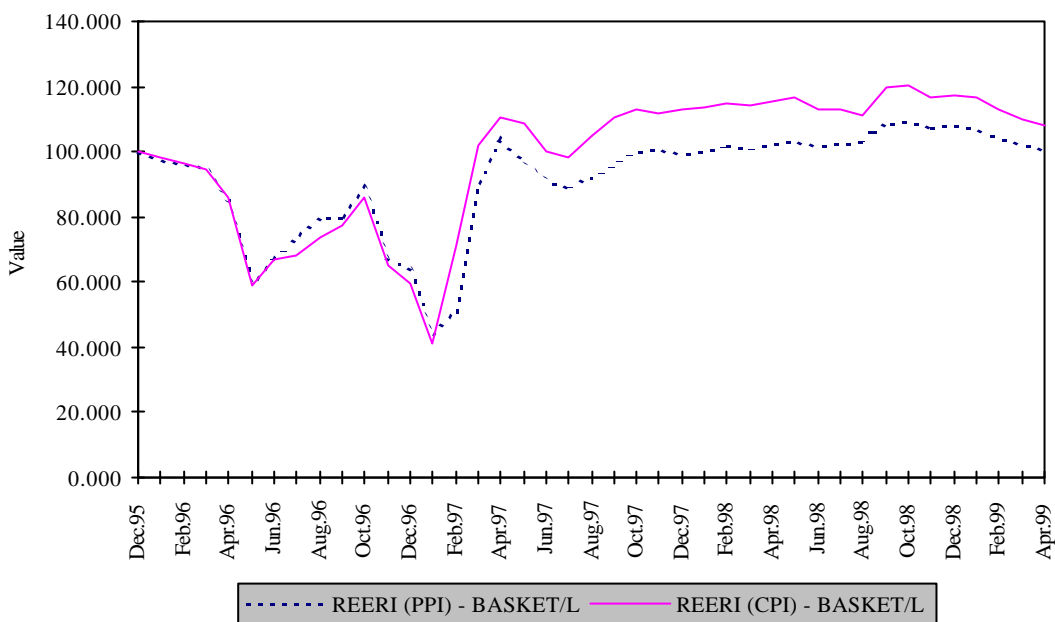
The dynamics of the exchange rate for the period 1992-1996 were characterized by the difference between the nominal and the real exchange rate. The dynamics of the nominal exchange rate did not correspond to the value of the real exchange rate. The BGL depreciated twice, in March 1994 and the last months of 1996. The overvalued exchange rate had positive effects on import products and did not increase producers' costs. The maintenance of an overvalued domestic currency under conditions of recession and economic crisis led to trade balance distortions and increased inflation.

The policy of a managed floating exchange rate did not contribute to financial stability, because of the lack of link between its real value and CPI dynamic. This was due to the overall collapse of the economy and the instability of the banking system.

The trade balance was not sensitive to the fluctuations in the exchange rate because export products involved import inputs and depreciation of the BGL did not provide significant improvement to the trade balance, up to 1997.

The most important change in exchange rate policy took place in July of 1997, with the introduction of a currency board. The stable currency board helped to maintain the fixed exchange rate level, pegged to the DEM. The USD/BGL exchange rate varied throughout the year according to fluctuations in the USD/DEM rate. The Graph below indicates the stability of the exchange rate; the real effective exchange rate index moves in very narrow band. The fixed exchange rate provides greater financial discipline and credibility to the stabilization program in Bulgaria. Under the stable exchange rate regime the overall uncertainty of business activities is reduced.

Real Effective Exchange Rate



Convertibility, Current Account and Capital Liberalization

The Currency Board Arrangement (CBA) has brought about stability. It was the reason why, in 1998, Bulgaria signed Article VIII of the IMF Status of Current Account Convertibility. The existing restrictions on capital transfers were eliminated by that year. A currency is regarded as fully convertible when any holder is free to convert it at market exchange rate into one of the major international reserve currencies. Bulgaria, as a member of the IMF, is required to undertake the obligations on convertibility defined by Article VIII, §2, §3 and §4. Acceptance of Article VIII allows Bulgaria to retain some restrictions on capital account flows and domestic regulations, to determine the degree of capital movements.

The new Currency Law was adopted in September of 1999 and will enter into force in January of 2000. It is a step to further capital liberalization. The regulations on transfer of currency were changed. According to the Currency Law, residents and non-residents have the right to freely export up to BGL 20,000 (US \$10,000). Foreigners can export currency in amounts above this limit without permission from the Finance Ministry, after filling out a customs form. The permission of the BNB is still required for domestic citizens and foreigners for amounts above US \$10,000. Bulgarian citizens have the right to open bank accounts abroad. The law permits local residents to borrow or place funds abroad, and non-residents to have access to the Bulgarian capital market. The benefits to the economy will be improvement of the Balance of payments, reduction of borrowing costs and increased foreign investment. Capital liberalization is a prerequisite for residents to be able diversify their asset portfolios.

One of the major risks of eliminating all restrictions on capital flows is the possibility of extensive capital flight, which will generate negative effects. Therefore, under the newly adopted currency law the BNB will control and register transfers of payments and investments, because of that averse risk.

The Currency Law promotes capital account liberalization, because of a broader choice available to residents to purchase assets and services from abroad. The preconditions for capital liberalization were achieved through the elimination of trade restrictions. Trade liberalization is one of these prerequisites; another is institutional reform, and the lack of a large external imbalance. The introduction of the currency board brought advantages towards capital liberalization — sound macroeconomic policy, a fixed exchange rate, and an adequate level of financial and international liquidity. Thus, sound macroeconomic reform should maintain price stability and interest rate and financial assets stability.

Capital convertibility in a liberal trade environment brings the following benefits: it attracts resources from abroad, increases consumer welfare and allocates resources in a more efficient way. The Bulgarian financial system is weak, so capital liberalization will bring further development of financial institutions, improvement of capital market liquidity and adaptation of corporate finance management to international accounting standards. In support of capital account liberalization, we may note that free capital movements will facilitate the allocation of savings and help channel resources into the most productive areas, thus increasing economic growth and prosperity.

From the vantage point of international trade, this will create better options for financing foreign trade transactions and renovating the export structure through investment.

The elimination of restrictions poses a serious risk for macroeconomic stability, exchange rate movement and the supply side of the economy. At present a fixed exchange rate, significant foreign reserves and sound macroeconomic policy are prerequisites for minimizing the risk posed by elimination of the restrictions on capital accounts.

Bulgaria is not ready to fully introduce liberalization on all capital account transactions. Capital liberalization should occur after the attainment of sustainable economic growth, stable financial institutions and liquidity of the capital market. The maintenance of restrictions on some types of capital account transactions is an unavoidable stage on the way to full capital liberalization. Liberalizing access to international markets requires that government efforts be focused on keeping up the fiscal balance and GDP growth, as well as developing capital and financial structures through forcing privatization of the banking sector, as well as new management skills. Bulgaria needs time to adapt to the world of liberalized capital markets. Overall, capital account liberalization will encourage foreign investment and prospects for return of flight capital.

Conclusions

The lack of structural reform up until 1998 had a harmful impact on exports in 1999 and afterwards. This factor, combined with real appreciation of the currency before 1997, led to a weakening of the balance of payments, a decline in foreign reserves and an acceleration of inflation. Delaying restructuring led to weakened competitiveness and restrained the positive effects of foreign trade liberalization. However, Bulgaria chose an appropriate way to foster economic reform: becoming a member of the EU and liberalizing capital movement.

The Bulgarian experience shows that the adoption of a fixed exchange rate regime is a sufficient factor for the achievement of desired macroeconomic results, and it is effective in restoring internal macroeconomic stability. Accession to the EU will be one of the greatest challenges the Bulgarian economy will face in the coming years.

In the context of an open country, liberalization of trade and investment flow is an appropriate way to achieve economic growth. Gains from liberalization of foreign trade are impossible without decreasing control over capital movement. This assumption stems from scarcity of endowment and the high share of imported inputs in final export goods.

In terms of foreign trade liberalization, Bulgaria needs to intensify the process of demonopolization. The measures taken in 1999 to liberalize exchange and trade restrictions have contributed to growth and investment flow.

The development of trade between Bulgaria and other Balkan countries depends on the degree of liberalization of the foreign trade policies of those countries and the overall economic stability of the region.

The cooperation of Balkan countries with the EU countries will facilitate the establishment of regional trade agreements in the long-run.

The problem in Bulgaria is not economic growth as such, but its sustainability. One of the ways to achieve this goal is through a profitable export structure and competitiveness. The positive effects on economic performance of integration with EU countries will be noticeable only after the achievement of high labor productivity and creditable macro and micro-economic stabilization.

PART FOUR

DEVELOPMENT OF FINANCIAL MARKETS

Financial Markets and Economic Performance

The results of recent research highlight the fact that indicators of financial development, such as high levels of financial assets and capital market capitalization, hold a direct relation to subsequent economic growth. It has been empirically proven that those countries that have followed consistent policies aimed at supporting financial market development have developed more rapidly, and that small countries have found it harder to support well-diversified capital markets.¹⁷ Macroeconomic and financial stability are closely related and their relationship is twofold. Continuously bad performance of the financial system introduces disincentives to save and invest, inefficiencies in the intermediation of savings and disruptions in the payments system, thus affecting the efficiency of investment and the growth possibilities of the economy. On the other hand, macroeconomic instability is an important factor in generating financial crisis. The analysis below aims to draw some policy lessons from Bulgaria's failures and successes and to outline the necessary policy changes.

The past several "transition" years of Bulgarian economic development confirm the importance of the financial system's performance and its correlation with economic slowdown or growth. This must be true for all Balkan countries in transition.¹⁸ In almost all cases the poor performance of the financial system was a contributing factor at the beginning of a macroeconomic crisis and was then also a factor (together with delays in political and economic reform) that helped deepen the crisis. It was easy to manipulate a weak financial system, so governments and insiders took advantage of this fact.

It make sense to study Bulgaria in order to derive lessons for other countries. The main factors contributing to the current status of Bulgaria's financial system are:

1. Institutional:

- inadequate structure of financial markets and dominance of banking;
- poorly developed capital markets;
- clogged payment systems;
- inadequate capitalization;
- lack of adequate law enforcement (especially regarding bankruptcy procedures and capital market regulations);
- institutional weaknesses; and
- poorly developed official supervisory policies and practices.

2. Behavioral:

- inadequate internal controls and procedures;
- high debt burden (both foreign and domestic);
- excessive extensions of credits;
- lack of adequate risk disclosure; and
- insufficient enforcement of prudential regulatory standards.

All countries with systems similar to Bulgaria's have to pay high direct and indirect costs to resolve their problems resulting from a financial instability:

- direct fiscal costs; in Bulgaria, the transfer cost for resolving the banking crisis of 1996-1997 amounted to 14% of GDP;¹⁹
- lost domestic savings;
- erosion of public confidence and resulting misallocation of investment; and
- reduced (and slumped) growth.

¹⁷ See: "Financial Market Development," *Issues, Strategies and Inter-American Development Bank Group Activities*, Inter-American Development Bank, Washington, DC, March 1998.

¹⁸ Noted not only for Bulgaria but also for Albania, FR Yugoslavia, Romania and perhaps Croatia.

¹⁹ See: Caprio, Gerard, and Daniela Klingebiel, "Bank Insolvencies: Cross-Country Experience," The World Bank (unpublished), Washington, 1996.

The fragility of financial markets, as well as lack of transparency and stability, contributed to slackening capital inflows and caused balance of payments problems.

THE BANKING SYSTEM

The transition from a centrally-planned to a market economy, as experienced in Bulgaria over the past decade, involved two important types of changes: changes in institutions (in a formal sense) and changes in patterns of economic behavior. These in turn demanded institutional and behavioral changes in the financial system, and respectively the building of efficient financial markets. The importance of these changes stems from the fact that the banking system and capital markets, because of their linkages to savings and investment decisions, play a great part in the improvement of resource allocation, macroeconomic stability and the performance of the economy. Because of the country's inability to attract a sufficient amount of foreign investment, it obviously needs a mobilization of domestic savings. In this context, the proper design for its financial markets is of great importance. Fragmentation of these markets can be a major impediment to economic growth.

Background

The banking system is of crucial importance to economic performance. A special feature in the Bulgarian case is the predominance of banking and the underdevelopment of capital markets. Due to the limited scope of the market for corporate securities, as an alternative to bank credits for funding capital investment, the predominant part of lending in the country is not securitized. Under such circumstances, banks became the primary institutions to perform assessment and monitoring of the risks and returns of financial intermediation.

The initial conditions regarding market-oriented reforms in the banking sector were not favorable for a prompt transition, and they still have an impact on banking system development.

1. The centrally-planned banking system did not perform most ordinary bank functions. There was one bank, the Bulgarian National Bank (BNB), with a network of municipal branches, which acted rather as a control agent. Before 1981, there were only two other banks: State Savings Bank,²⁰ which held all individual and household deposits, and the Foreign Trade Bank (now Bulbank), which performed all international banking transactions.
2. The state monopoly on banks and enterprises distorted the very notion of bank loans. As Joseph Stiglitz pointed out, "it was like the left pocket owing the right pocket money."²¹ In addition, before 1990, there was no requirement to provision bad loans. As a result, the banking system inherited a significant amount of non-performing credits, which had a negative effect on its development over the last ten years.
3. The need for resolution of bad loans resulted in series of policies undertaken since 1991. The common denominator was a sort of triangle operation: replacing bad loans with state bond issues on the asset side of the banks' balance sheets and replacing bank credits with state claims on the liabilities side of the enterprises' balance sheets. This was implemented in part through special bond issues in 1991 and 1992, which covered the non-performing loans of some 120-130 enterprises. Eventually, the Law on the Settlement of Non-Performing Credits Negotiated Before December 31, 1990 (LSNC) was adopted in December of 1993. It stipulated that government issues bonds were to replace all remaining debts (negotiated before 1991) in arrears for more than 180 days. In more detail: the BGL-denominated ZUNKs (named after the law's Bulgarian acronym) amounted BGL 32 billion (some US \$1 billion, at the end of 1993), while the USD-denominated ZUNKs amounted to \$1.8 billion. Thus, they became a major item of the asset side of the balance sheets of several large state-owned banks.
4. The state monopoly on banks and enterprises impeded, and still impedes, the development of banking strategies in the banking sector.

²⁰ Although State Savings Bank did not have the status of a bank, it was considered to be one.

²¹ See: Stiglitz, Joseph, "Financial Systems for Eastern Europe's Emerging Democracies," ICEG Occasional Paper, 1993. There is a correlation between government presence in the banking system and level of income: in low-income economies government banks control 70% or more of the banking system, in medium-income economies the level is 40-50% and in high-income economies government banks are almost non-existent.

The first signs of reform in the Bulgarian banking sector were noticed in 1981, when Mineralbank was established for the purpose of providing credits to newly-created small and medium-sized enterprises. Then the establishment of seven new banks in 1989 had a serious impact. The main goal of their creation was to extend credits to different industrial sectors. That same year the communist-era central banking system was swapped for a modern two-tier banking system featuring a typical central bank and with commercial banks, though mostly BNB branches. The legal framework came later, with the adoption of the BNB Law (1991) and the Law on Banks and Credit Activity (1992).

In the midst of all this, in 1990 there was a total of 70 banks in Bulgaria. The dynamics of the number of banks over the last eight years are shown below:

Commercial Banks in Bulgaria

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Year-end Total	70	78	59	41	45	47	35	34	34
of which Foreign	0	0	0	1	3	5	7	9	7
Licensed during the year	61	8	2	7	10	4	2	2*	1
of which Foreign	0	0	0	1	2	1	2	2	1
Consolidated banks	0	0	22	29	9	3	0	0	1
Banking groups following consolidation	0	0	1	4	3	1	0	0	0
No. of licenses revoked over the year	0	0	1	0	0	0	14	4	0

Source: BNB

The newly-established commercial banks fall into several categories:

1. Large state-owned banks, specialized in financing the larger industrial sectors. During the period 1994-1995, eight out of nine large banks with assets exceeding BGL 30 billion were state owned. At the end of 1995, these nine banks (excluding State Savings Bank) held 74.9% of all financial assets in the system.
2. Small and medium-sized commercial banks, former BNB branches.
3. Private banks, established in 1990 and afterward, especially active until 1993: these emerged under a very liberal, low capital requirement and close to no-barrier, entry regime. Also, there was no requirement that the origins of the start-up capital be disclosed and proven; therefore, most private banks were started up with borrowed funds. The number of private banks increased significantly (from two in 1990 to 26 in 1995); and their share in total bank assets was 3.1% in 1992, and 22.4% in 1995.

The expansion of private banks had two major impacts on the development of the banking industry:

- it increased the number of players but did not favor the market and competition: new entrants sought refinancing from the BNB to repay their own loans or competed for privilege contracts with the government or “politically sensitive” enterprises in order, again, to ease access to refinancing; thus there was no improvement in performance or quality of services; and
- the amount of large credits and the share of bad loans in private banks increased, as a result of the close connections between most of the private banks with their debtors — shareholders and individuals and firms related to them.

During the period in question, the regulations allowed banks to extend credits to shareholders and/or to persons connected with the shareholders. Sooner rather than later, banks realized this was a perfect scheme for siphoning money via BNB’s and State Saving Bank’s refinancing.

Foreign banks were allowed to operate (getting full licenses) after 1994; they were viewed as a possible means of securing the liquidity of the system. Foreign banks indeed tend to be larger and to have better loan portfolios, higher net worth and higher ratios of operating income to costs. But they were also able to select better corporate clients for themselves; thus, a kind sub-banking industry emerged: better banks had better clients, while the overall soundness of the system improved little.

Foreign banks in Bulgaria confirmed the following obvious benefits of foreign bank entry: greater competition, improved variety and quality of financial services and reduction of the probability of systemic crises.

The Crisis

The above-mentioned legacies of a fragmented banking system, with its large numbers of small state-owned banks and small, undercapitalized private banks, created the conditions for the severe banking crisis of 1996. Almost all of these small banks inherited a significant number of non-performing credits, extended to the enterprises during the Communist era (or after 1990, when neither ZUNKs nor bankruptcies could cure newly accumulated arrears). This development coincided with the BNB's failure to effect sound supervision.

Delayed privatization and restructuring of the real sector, lack of financial discipline and widespread possibilities for state-owned enterprises to use soft credits and thus to transfer their losses to the banking system, combined with poor lending practices and attempts by the BNB to "cure" the situation with "measured" issues of notes, gradually led to the decapitalization of banks and transference of the costs to the general public.²²

The net loss of the banking sector in 1993 amounted to BGL 5 billion, in 1994 it hit nearly BGL 7 billion; the problems were aggravated in 1995, when the net loss increased to BGL 30 billion by mid-year and about BGL 100 billion by the year's end. In 1996, nine of the ten state-owned banks, which held 80% of banking sector assets, reported negative capital.

Profit and Loss Account of Bulgarian Commercial Banks: 1991 - 1995 (BGL, millions)

	1991	1992	1993	1994	1995
Profits	7,201	2,903	1,896	8,702	4,646
Losses	1,845	2,291	4,172	10,056	29,181
Net Profit	5,356	612	-2,276	-1,354	-24,535
Number of banks with losses	2	6	11	15	23
of which private or foreign banks	0	0	5	7	15

Source: BNB

In 1996, real GDP contracted by 10.9%. Accumulated inflation for the year was 310%. The real interest rate on bank deposits was negative: minus 43% (even after the drastic increase in the base interest rate in late September, to 300% per year). The Bulgarian currency depreciated by 624% against the USD and foreign reserves fell below USD 440 million, the level needed for foreign debt servicing. The central bank's monetary policy ceased to be at all effective. Domestic debt increased and the debt service to GDP ratio rose from 10.4% in 1995 to 17.3% in 1996.

Selected Macroeconomic Indicators: 1992-1998

	1992	1993	1994	1995	1996	1997	1998
Nominal GDP (BGL, millions)	200,832	298,934	550,514	867,691	1,660,237	17,055,205	21,577,020
Real GDP Growth (%)	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5
Dollar Exchange Rate (BGL/USD, year average)	23.34	27.65	54.25	67.17	177.9	1,641	1,714
Inflation (CPI, %)	79.5	63.9	121.9	32.9	310.9	578.6	1.0
GDP per capita (USD)	1,008	1,276	1,147	1,537	1,129	1,227	1,700
Money supply — M1 (BGL, millions)	37,833	48,303	75,131	107,886	236,628	23,429	28,261

²² A detailed description of the money transfer mechanism may be found in: Avramov, Roumen and Guenov, Kamen, *Rebirth of Capitalism in Bulgaria*, Sofia, AECD, 1995.

Money supply - Broad Money (BGL, millions)	158,567	234,072	418,009	583,663	1,310,275	220,061	6,597,173
BNB's Forex Reserves (US \$, billions)	0.9	0.7	1.0	1.2	0.5	2.2	3.0
Foreign Debt (% of GDP)	145.6	128.3	117.5	78.1	98.3	96.9	84.1
Foreign Debt (US \$, billions)	12.1	12.5	10.4	10.5	9.6	9.7	10.2
Debt Service Ratio	n/a	16.3	12.6	10.4	17.3	n/a	n/a

Source: NSI, EBRD, BNB, Andrew Kenningham, "Bulgaria: Leveraging off the Deutsche Mark," *Economic Outlook and Fixed Income Investments*, Merrill Lynch, July 1997; OECD Economic Surveys: Bulgaria 1997 and 1999.

These developments were combined with weak banks and loss of confidence in the banking system and the domestic currency on the part of the general public and business, as well as intentions to convert savings into hard currency and keep as much as possible in cash. It is estimated that deposit withdrawals from the banking system during the financial crisis in 1996-1997 totaled US \$830 million. By mid-1997 BGL deposits fell by 88% in real terms and their share of GDP fell from 41% (in 1995) to 13%, while foreign currency deposits fell by 40%.²³ The withdrawn funds were channeled to the forex market, thus putting additional pressure on the lev. Throughout the period 1992-1996, the ratio of savings to GDP was very low — 11% on average, compared with more than 30% in faster-growing economies. Negative real interest rates²⁴ and the limited choice of financial instruments also discouraged savings.

In this situation the central bank was not able to take radical measures against insolvent banks, thus prolonging and deepening the problems. By 1996, the legal framework for bank bankruptcy and deposit protection had still not been developed. Instead of solving the problems of the banks' bad performance, the BNB intensified its lender-of-last-resort function and poured money into illiquid banks. These liquidity injections, together with increased pressure on the central bank to finance the budget deficit, additionally accelerated inflation.

In May of 1996, the legal procedures for bank bankruptcy were introduced. Immediately afterward, 14 banks, representing 24% of total bank assets, were put under conservatorship. Of 27 private banks, the four largest and most well known were put under special supervision. Between May of 1996 and April of 1997, the number of banks closed and those put under special supervision by the BNB rose to 18. This was tantamount to the closure of one-third of the Bulgarian banking sector. In addition to these measures, the bank supervision department took several measures against 19 banks aimed at macroeconomic and financial stabilization, including a ban on the payment of dividends without the BNB's permission, a ban on the extension of new loans, measures to collect loan repayments, limits on interest rates on deposits and reduction of operational costs.

The situation is estimated to be one of the world's worst banking crises in recent history. The reasons for the crisis have already been mentioned above, but they can be summarized as follows:

- delays in real sector reforms and soft budget constraints; the preservation of loss-making enterprises in the public sector was government policy during the period and the state had considerable influence over lending to "strategically important state-owned enterprises"
- a weak private sector;
- over-supply on the banking market;
- inadequate bank management;
- concentration of credit risk and negative structure of credit portfolios, increasing the share of non-performing credits; some 50% of all loans granted by state-owned banks to non-financial institutions were uncollectible, and furthermore, for most state-owned enterprises the only way to service their debts and cover their losses was to take new loans from banks; by the end of 1995, 41% of all loans granted by both state and private banks to non-financial institutions were irrecoverable

²³ See: Yotzov, Victor, Nenovsky, Nikolay, Hristov, Kalin, Petrova, Iva and Petrov, Boris, "The First Year of the Currency Board in Bulgaria," Bulgarian National Bank, 1998, p. 18.

²⁴ In the period between 1991 and 1997, two years showed record negative real interest rates: -24% in 1994 and -43% in 1996.

and only 39% of total lending by private banks was regularly serviced, resulting in net losses and further bank decapitalization;

- lack of an effective legal framework to execute creditor rights and require collateral;
- lack of sufficient information about borrowers and lack of a Credit Register;
- weak banking supervision and a lack of enforcement of existing supervision regulations;
- inadequate bank capitalization;
- institutional weaknesses; and
- inadequate internal controls and procedures.

A total of 33 banks survived (including State Savings Bank and branches of foreign banks), but some of them are small and private and at any rate will have to overcome some serious problems.

The Aftermath

As mentioned above, after seven years of delayed structural reforms, several failed attempts to implement a coherent stabilization policy and a chronic lack of financial discipline, Bulgaria experienced the most severe financial crisis since the start of reforms: a paralyzed banking system, undermined credibility of key institutions, substantial depreciation of the Bulgarian currency and several months (December 1996 - February 1997) of record hyperinflation. Overcoming this situation required a combination of policy measures, affecting the exchange rate, money supply and state budget, to restore confidence in the financial system.

A consensus was reached that such a combination of policy measures should include the adoption of a currency board arrangement (CBA), as a rule-based mechanism for enforcing financial discipline. This stabilization mechanism included fixing the exchange rate, balancing the budget and ensuring the independence of the central bank.

The currency board was introduced in Bulgaria on July 1, 1997. The Bulgarian lev was legally fixed to the reserve currency, the DEM, and became automatically convertible into reserve currency. From the beginning of 1999 the lev was fixed to Euro at 1,9558 BGL/Euro. The monetary base (and thus currency issues) is fully covered by foreign reserves. Money supply is determined by money demand and is outside the BNB's control. This means that money supply became dependent on capital movements (inflows and outflows) and the balance of payments status.²⁵ Thus money supply reflects the health of the financial sector. The BNB became much more independent, as it was prohibited from extending credits to the state or to any state agency. A special feature of the CBA is the inability of the economy to respond to external shocks through exchange rate adjustment.

The CBA proved to be efficient for the country's financial stabilization. The annual rate of inflation (CPI) decreased sharply, from 578.6% to 1% in 1998. That same year GDP showed 3.5% growth (the highest in the transition period), after a 6.8% decline in 1997. Foreign reserves increased to DEM 5.2 billion in June 1999. A more detailed survey of the currency board's design and implications is beyond the scope of this analysis. We will rather concentrate on its impact on the development of financial markets.

For the Bulgarian banking system, adoption of the currency board imposes the necessity for considerable changes in commercial banks' behavior. Some of the factors behind such changes becoming essential are:

- an extremely limited lender-of-last-resort option for banks in financial difficulty; there is very strictly defined possibility for the BNB to provide limited, highly collateralized credits, only to solvent banks with a temporary shortage of liquidity; the fact that banks cannot rely on central bank refinancing means that they have to improve their liquidity and risk management in order to maintain adequate liquidity and solvency, and this also means increased importance for foreign banks, because they settle most payment transactions through their headquarters and can rely on their headquarters for liquidity support;
- the adoption of prudential regulations;

²⁵ See: Avramov, Roumen, "The Role of a Currency Board in Financial Crises: The Case of Bulgaria," BNB Discussion Papers, 6/1999.

- stricter supervisory policy;
- higher requirements concerning banks' solvency; and
- the elimination of soft credits and enforcement of hard budget constraints.

The current situation

As a result of the BGL's depreciation and the brief period of hyperinflation, the capitalization of the banking system has improved since 1997. The depreciation of the domestic currency helped banks to restructure their portfolios and to clean up their balance sheets. The main tool for the banking system's recapitalization was revaluation of the gains from banks' assets denominated in foreign currency, while the real value of liabilities denominated in BGL was essentially reduced. Commercial banks' profitability was also improved during the period of the lev's devaluation. The decline in net income from valuation adjustments conforming with the currency board's introduction is the main reason behind the current decline in profitability ratios related to 1997.

Currently, the Bulgarian banking system comprise 35 banks (including Promotional Bank and the branches of foreign banks). These banks can be divided into three groups.

The **first group** consists of seven banks: United Bulgarian Bank (UBB), Expressbank, Bulbank, Bulgarian Post Bank, State Savings Bank (SSB), Biochim and Hebrosbank. They represented 70.7% of banking system's assets as of the end of June, 1999. This means that these banks (four of them are still state owned) are crucial to the banking system's stability and overall performance. One state-owned bank, Bulbank, holds 26.8% of total banking system assets. At the same time, 44.8% of Bulbank's assets represent claims on banks and other financial institutions, bearing a resemblance to the central bank's refinancing function.

Main Balance Items of Some Bulgarian Banks, as of June 30, 1999

Items (BGL, mln.)	Bulbank	Post Bank	Hebros bank	Express bank	UBB	Biochim
Cash	261,730	41,598	37,722	35,340	115,597	83,944
Claims on banks and other financial institutions	899,696	153,990	50,971	38,667	345,131	97,135
Claims on non- financial institutions	221,740	68,643	103,285	160,848	140,216	72,235
Attracted deposits	1,252,387	323,396	225,982	228,441	603,768	353,060
Own capital	254,148	20,571	22,949	27,109	94,700	3,010
Reserves	54,823	10,676	17,869	34,440	148,900	18,301
Profit	87,703	1,064	6,738	24.7	18,724	-19.7

Source: BNB

The **second group** consists of mostly private banks, which hold up to 19% of total banking system assets. The **third group** is comprised of nine branches of foreign banks and their subsidiaries, representing approximately 10.6% of the banking system assets in Bulgaria.

According to the Banking Act, which replaced previous Banking and Credit Act and the Basle Accords, the BNB issued Regulation N8 dealing with capital adequacy and minimal founding capital requirements. All banks in Bulgaria were obliged to have 8% capital adequacy ratio by the end of 1997, a 10% capital adequacy ratio by the end of 1998 and 12% by the end of 1999.

Since the introduction of the currency board and new banking regulations, a tendency toward maintaining a high level of capital adequacy has been observed.

Total capital adequacy ratio of Bulgarian commercial banks (%)

Groups of commercial banks	1995	1996	1997	1998	End-March 1999
Group One	10.2	15.4	28.77	38.95	44.8
Group Two	18.8	13.4	23.61	34.76	40.2
Group Three	98.4	52.2	17.17	26.98	24.7

Source: BNB

Most of the banks operating managed to improve their capital adequacy by provisioning most of their bad debts. We should stress the fact that the commercial banks managed to increase the volume of their provisions for classified credits thanks to the high net incomes they accumulated as a result of exchange rate divergence, incurred by the devaluation of the BGL. The revaluation of the current-exchange bad debts and other current-exchange assets also resulted in the growth of legal provisions. Among the sources for improvement of capital adequacy are the retained profit from the past two years and shareholders' additional capital contributions.

At the end of June, 1999, the average level of capital adequacy for the overall banking system was extremely high, at 41.7%. The three largest Bulgarian banks (Bulbank, UBB and SSB) reported an even higher capital adequacy ratio, of 54.16%. Such expansion in banks' capital adequacy means not only an improved capital base, but also an increased share of low-risk (and low-yield) investment.

Limitations on the granting of credits (imposed by the economic crisis and the activities undertaken by the executive power and the Bulgarian National Bank), combined with the real devaluation of bank liabilities resulting from the hyperinflation of 1996-1997, were the determining factors for the improvement of liquidity in 1998. This high liquidity, combined with low credit demand and low budgetary demand for inside credit granting, is the main reason for the record-breaking low interest rates in the last two years.

Regardless of the reforms that have been carried out in the banking sector since 1997, there remain a lot of problems to be overcome. Among the major ones are:

- **Small scale of the banking sector.** The total assets of the banking sector in Bulgaria, which equaled about 43.4% of GDP in 1997, dropped to 34.9% of GDP in 1998, which is far below the standard in developed countries (where this proportion is normally more than 100%).
- A lack of sufficient **confidence** in banks.
- **Low quality and extremely restricted variety** of bank services, which for most Bulgarian commercial banks are extremely restricted and include: taking deposits, extending limited volume, very short-term credits and intermediation in payments in Bulgaria and abroad. The main reasons behind this situation could be indicated as a lack of sufficient banking know-how for most of the banks, as well as the low level of competition in the banking sector.

An IME survey among small and medium-sized private companies in five regions of Bulgaria presents some interesting results concerning the quality of bank services. When asked *what made you choose the bank that you use at the moment*, respondents pointed most often to a factor that is only indirectly related to bank service quality: 61.9% of the companies surveyed selected their bank for its **security**. This is understandable, in light of recent bank closures and the resulting lack of sufficient confidence in banks. It is probably more important (but not surprising) that the second most frequently mentioned factor was **convenient bank location** (39%). The **quality of services** (37.6%) only came in third place, and another quality-related factor, the **speed of service**, came in fourth with 18.1%.

- **Inadequate profit** from bank activities. At the moment the average profitability of banks' portfolios is considerably below interest rate level, since part of banks' assets (bad loans, buildings, etc.) pay no income.

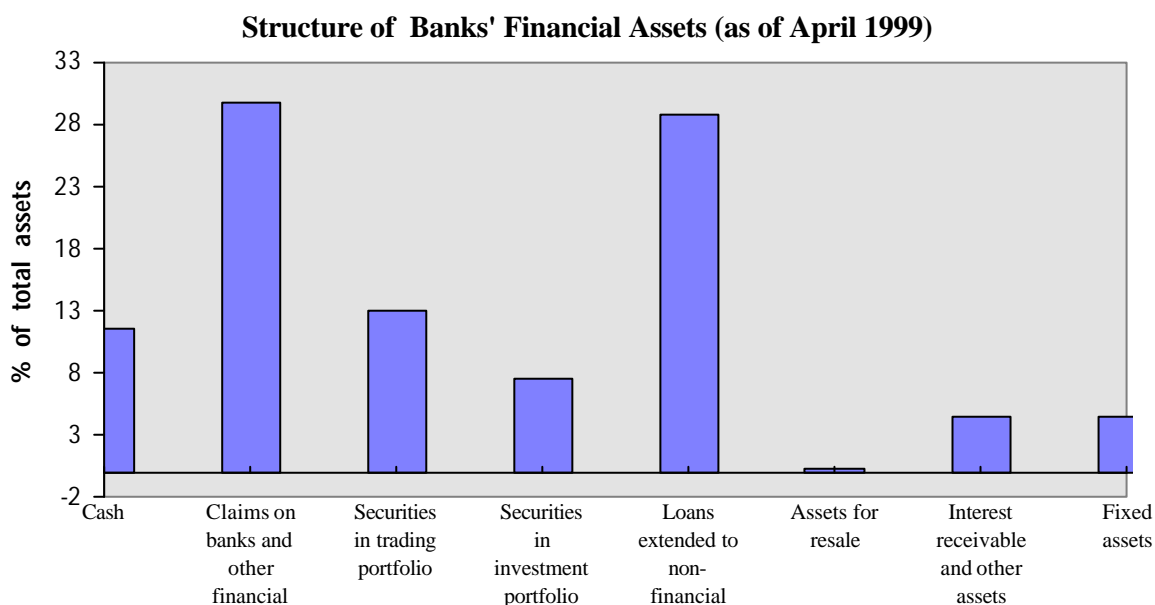
Average Ratio of Net Interest Income to Total Bank Assets

	1993	1994	1995	1996	1997	Average
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Bulgaria	-0.1	-3.1	1.7	5.7	2.4	1.3
Croatia	13.9	2.7	2.6	3.4	3.2	5.2
FYR Macedonia	16.0	16.0	10.3	8.9	6.2	11.5
Hungary	3.7	4.8	4.9	4.2	3.1	4.1
Poland	3.8	4.7	5.1	4.9	2.3	4.2
Romania	9.5	6.4	7.3	5.1	10.7	7.8
Slovenia	5.9	1.9	3.4	4.1	4.3	3.9
Estonia	5.4	5.9	5.1	4.8	4.1	5.0
Lithuania	10.5	8.9	6.8	5.3	3.9	7.1

Source: Fabrizio Coricelli, "Financial Market Development and Financial Liberalization in Economies in Transition: Tales of Failure and Success," University of Sienna, CERP and Central European University, March 1999.

The lack of opportunities to invest banks resources is resulting in an orientation toward keeping mainly high liquidity assets: cash, assets in bank accounts and government securities. By April of 1999, the greatest part of banks' assets (32.4%) was in deposits with other banks, particularly abroad. The relative share of cash balances on the banks' balance sheets was 11.5%, and government securities represented some 21% of banks' assets. Most likely, banks will continue to maintain high liquidity and greater opportunity costs.



A positive sign is that in 1998 the banking sector as a whole operated at a profit. However, profit margins were very low, although only 12 out of all 35 banks operating in Bulgaria reported losses for the first half of 1999. The interest rate differential between interest rates paid on deposits and the rates received on domestic or foreign securities remains a major source of profit.

- Extremely **limited credit activity**. Banks' credit portfolios saw their most dramatic decrease over last few years, thus becoming one of the most serious impediments to economic growth in the country. The share of credit extended to the real sector in the total assets of the banking system dropped from 35.4% in mid-1997 to 28.3% in May of 1999.

Bank Credit Dynamics Relative to GDP (%)

Year	Credit to the real sector/GDP	Credit to the private sector/GDP
------	-------------------------------	----------------------------------

1991	83	9.5
1992	75	8.9
1993	66	12.0
1994	49	14.6
1995	40	21.6
1996	63	36.9
1997	20	13.1
1998	17	12.8

Source: BNB, IME calculations

In fact, the scarcity of commercial credit is not extraordinary, given the lessons of the past few years, the low level of confidence in banks and the limitations imposed by the currency board. The main factors for such behavior are:

- lending is still considered to be too risky an activity, because the business environment has not improved significantly and the risk in the real sector remains relatively high: there are expectations that the current liquidity problems in the real sector might cause an additional deterioration in commercial lending; in addition, the largest SOEs are under a program of isolation from bank credits, while at the same time, most private companies have a very short track record;
 - the insufficient quality of investment projects;
 - the execution of creditors' rights is extremely slow and banks face problems in collecting on non-performing loans; there are limited opportunities for realization of the collateral;
 - restrictive banking regulations concerning commercial lending: banks are restricted from extending "big" loans, exceeding 25% of the bank's own capital (this barrier is especially valid for smaller banks, whose capital levels are low), there are strict provision requirements and requirements for collateral, etc.;
 - limited growth of the amount of funds attracted to banks and relatively limited credit resources; and
 - the limited extent to which the BNB is allowed to refinance commercial banks.
- The quality of **banks' credit portfolios** has not yet improved significantly. This is mainly due to their low capital base and their unwillingness to take risks associated with investment lending. Despite cautious lending, there is a tendency toward increasing the share of credits that are not regularly serviced. While the share of regular credits in banks' portfolios was 87.3% in as of the end of 1998, by mid-1999 this share had declined to 83.1%. Also, 7.7% of all credits extended by the banking system are classified as uncollectible.
 - The low level of **competition** among banks. The banking system is dominated by a small number of banks that are still state owned. The presence of foreign banks is modest in comparison with that in other transition countries.
 - The predominance of **state ownership** in the banking system (most of the major Bulgarian banks are still owned by the state) continues to have a negative influence on the operation of the banking sector. The large state banks suffer from the "surplus bureaucracy disease" and poor organization, the quality of bank services is low and management is not sufficiently motivated to increase the banks' efficiency and profitability.
 - There is a lack of typical **investment banks** and **mortgage banks** operating in Bulgaria.
 - There is a lack of major **international financial institutions** on the Bulgarian market to improve the quality and availability of financial services, increase competition and provide modern banking know-how, skills and technology.
 - The lack of sufficient **skills** on the part of bank staff leads to **inefficient asset management**.
 - There still exist comparatively **close commitments** between some of the small and medium-sized banks with their shareholders' firms.

Although some progress in bank privatization has been made, the major efforts are still forthcoming. In accordance with the agreements with the IMF and the World Bank by the end of June, 1997, the first privatization deal was finalized: that of United Bulgarian Bank. As a result of its privatization and

consequent increase in capital, UBB rose to the top of the list of Bulgarian banks, as ranked by equity in 1997.

In February of 1998, the Bank Consolidation Company (responsible for bank privatization) adopted a resolution strategy for the privatization of state-owned banks that shifted the strategic focus to one of selling the best banks first, in order to attract additional capital and expertise.

On August 14, 1998, a stake of 78.23% of the capital of Bulgarian Post Bank was sold to American Life Insurance Company (ALICO) and the Greek Consolidated Euro-Finance Holdings. They acquired the PostBank shares for US \$38 million.

The privatization of a third state bank, Expressbank, was negotiated in September of 1999. The buyer is the French Societe Generale. There are still significant delays holding up privatization of the largest Bulgarian bank, Bulbank.

If we try to assess the Bulgarian banking system according to the main characteristics of an effective banking system,²⁶ we can summarize our conclusions as follows:

Characteristic	Grade ²⁷	Observations
Banking services	Low	Narrow market of bank services
Market-driven interest rates	Low	Lack of sufficient depth of financial markets and improperly developed mechanism for market-set interest rate.
Widely distributed private ownership of banking institutions	Low	State-owned banks are few in number but hold some 70 % of the sector's total assets.
Presence of a competitive, level playing field for all banks, both domestic and foreign	High	All regulations affecting the cost of doing business are the same for domestic and foreign banks and do not favor individual institutions.
Presence of efficient, safe and liquid money, debt and equity markets	Low	Some progress is being made but markets still need major efforts in order to be improved.
Payment system	Medium	Reasonably good progress, but delays still occur.
Legal framework	Medium	Low in the area of creditors' rights protection and bankruptcy procedures (adding considerably to credit costs) High in the area of new banking law and prudential regulations.
Banking supervision	Medium	Significant progress has been made but problems remain, especially with bank examinations.
Deposit insurance	High	
Independent central bank	High	

Policy Options

There are several lessons that may be drawn from the development of the Bulgarian financial sector over the past decade.

- More prolonged restructuring causes more damage to the economy and requires more costly stabilization measures.
- Continuous structural weakness of the financial system produces a crisis environment. Delays in financial sector restructuring are a contributing factor to significant delays in overall economic development.

²⁶ See Corrigan, E. Gerald, "Building Effective Banking Systems in Latin America and the Caribbean," Inter-American Development Bank, May 1997.

²⁷ IME's assessment.

- Financial stability requires stable financial institutions, a high degree of confidence, stable markets, a dynamic private sector and a supportive legal framework that contributes to effective internal governance of financial institutions and external discipline by market forces.
- A stable and efficient financial system is a necessary but not the only condition for sustainable economic development. This also requires well-developed and adequate macroeconomic policies.
- The absence of effective reallocation of resources and a supporting credit system are an impediment to the efficient restructuring and growth of enterprises.
- An important precondition for the development of financial markets is an effective legal system, ensuring the protection of private rights and contract enforcement.

Policy Options for Strengthening the Banking System

Currently, the Bulgarian financial sector does not provide the effective intermediation necessary for sustaining growth. The further development of financial markets could contribute to the resolution of the problems of liquidity and the low level of investment in Bulgarian enterprises. Under the current situation, with its lack of sufficient inflow of foreign direct investment, scarcity of credit resources and the insignificance of the capital market as a source of external financing, the only possible source of investment remains companies' retained earnings.

Expansion of banks' credit activity is one obvious factor for achieving economic growth. However, there are no clear signs that in the short run commercial banks will reverse their attitude toward such expansion of commercial lending. Several possible measures could have a positive effect on the credit capabilities of banks. Among these measures are:

- amendments to the legal framework, whose purpose should be the protection of the creditor's rights: this includes empowering banks to take concrete steps toward collecting their claims in the case of default, further development of bankruptcy and liquidation procedures; without a legal regime that clearly defines and protects property rights, the development of a modern banking system, with banks functioning as real financial intermediaries, is almost impossible;
- establishment of a Credit Register, in which detailed information about all borrowers should be collected and further should be subject to free circulation among the banks: such a gathering and processing of information about the borrower's current creditworthiness would improve the management of credit risk;
- stricter asset classification and adequate provisioning practices against loan losses, to minimize the delay in recognizing bad loans;
- development of sufficient skills on the part of bank staff with regard to project appraisal, project monitoring, risk assessment and risk management;
- requirements for higher bank capital, which would provide better incentives against excessive risk-taking than exist at present; and
- following the adopted regulation policy, which is aimed at protecting banks from the establishment of long-term relationships and extension of large credits to companies owned by or connected with the banks' own shareholders, or to other state-owned or private companies.

The involvement of banks in financing the real sector, however, depends not only on institutional and legal measures, but also on the current state of the restructuring of the real sector. A strong influence would be exercised on banks' activities by the ongoing process of privatization, isolation and liquidation of loss-making state-owned enterprises.

The inflow of foreign investment would also positively influence the banking sector, by providing new credit resources to the banks and creating the preconditions for the growth of credit demand on the part of reliable clients.

Apart from the above-mentioned measures, there are a lot of steps that can be taken in order to ensure further financial market development. Among these steps are:

1. Establishment of a *supportive environment* for private sector operation;
2. *Fostering the privatization* of the remaining state-owned banks: it is important for Bulgaria to attract serious foreign investors to buy the largest Bulgarian banks, thereby providing fresh money inflows, to increase the investment potential of the banking system, to improve bank management (including staff technical skills) and to make these banks competitive and profitable;

3. **Consolidation of banks:** consolidation could contribute to restoration of the intermediary functions of most small and mid-sized private banks, as well as to overcoming their problems of a low capital base;
4. Improvement of *supervisory standards* and practices;
5. Development of *asset-backed securities* (mortgage bonds, pass-through bonds, etc.) in order to enhance liquidity;
6. Enhancement of *competition in banking*;
7. Development of the *capital market*: this would have serious impact on commercial banks because of the creation of additional tools for risk management and increased profitability of bank services; and
8. Creation of possibilities for banks' *clients to monitor* banks' activities, in order to be able to choose between institutions: in this context it is important that the quality and accessibility of information be improved and that a bank rating system be established .

The Balkan context

Among typical features of the transition countries in the Balkans are: small markets, low domestic demand, high unemployment rates, unstable local currencies and a tendency toward currency substitution (mainly DEM and USD), and extremely low levels of savings, investment and capital formation. All of these countries are characterized by unsustainable macroeconomic variables, high current account and trade deficits, significant problems with fiscal deficits and extremely low levels of financial depth.

Perhaps the most important feature of the region is that there are no stable links among the Balkan countries, in an economic sense. Intra-regional trade and intra-regional financial flow are insignificant. The banking sector in all of these countries is in bad health. There is no effective mechanism for the settlement of payments within the region. Intra-regional investment is practically nonexistent.

One thing that could contribute to stability and prosperity in the Balkans would be the integration of these small economies and the encouragement of free movement of goods and capital. For all of the countries in the region it is important that they liberalize their financial systems and strive for regional cooperation and integration of the financial markets within the region and with the European Union. The obvious benefits of such integration are the potential for more efficient movement of financial resources and private sector investment and thus for better economic performance and growth. The ability to invest in the markets of several countries reduces the country-specific risk for investors and allows risk diversification.

The following is a list of key factors in creating an environment for integration:

- economic and political stability;
- comprehensive and fair systems of laws;
- adequate contract enforcement;
- transparency of economic, financial and regulatory systems;
- a joint strategy for strengthening regional cooperation; and
- the creation of a currency area via adoption of the Euro as legal tender. There are several rationales for adopting the Euro. First, almost all of the Balkan countries' foreign trade is highly dependent on EU markets. Second, the local currencies are unstable, and there is actually a process of currency substitution — some countries have already pegged to the DM. Third, most of the countries in the region are used to denominating a large number of international contracts in Euro.

CAPITAL MARKET

Emergence of the Capital Market

As mentioned above, the capital market in Bulgaria is still in its infant stage of development. Capital market trading is not an incentive for structural reform and economic growth.

The capital market in Bulgaria was well-developed during the period 1914-1947. The concept of the reintroduction of an organized securities market was initiated at the very beginning of the economic transition. The stock market emerged spontaneously under the general regulations of the Commercial Code. A not-quite-successful attempt at restoring the capital market was made between 1991 and 1995. Two main players appeared on the market, the First Bulgarian Stock Exchange and the Sofia Stock Exchange, which performed a low level of transactions because of the delay in privatization, lack of transparency and instability of the financial system during that period and last but not least, weak investor interest.

Mass privatization was a prerequisite for the creation of the institutional framework and legislation for capital market development in Bulgaria.

The development of the organized capital market can be divided into two stages, according to the degree of regulation of transactions on the stock market.

The first stage was connected with the first wave of the mass privatization process, including licensing of privatization funds, and created some rules among the economic agents on the capital market. The second stage is marked by the merger of the two existing stock exchanges, the Bulgarian Stock Exchange and the Sofia Stock Exchange into one, the Bulgarian Stock Exchange Sofia (BSES), founded as a joint-stock company.

At the beginning, trade on the stock exchanges was carried out among the privatization funds, which exchanged minority and majority stakes. This was a positive development in terms of concentration of the property of privatized enterprises. The legal framework was changed, with respect to dealing rules and the responsibility of financial intermediaries and investors.

There is a larger amount of transactions on the non-registered market than on the official segment of the stock market. In 1998, cross and swap transactions dominated the market. They accounted for approximately 90% of the total number of transactions. These transactions did not contribute significantly to improvements in the capital structure of companies, they only increased the volume of deals.

Indicators of Stock Market Transactions (in BGL)

INDICATORS	1998	1999
Number of shares traded		
Am block trade*	8,863,858	6,152,607
Free trade	17,299,987	3,067,568
Total	26,163,845	9,220,175
Number of deals		
Am block trade	442	93
Free trade	19,088	10,547
Total	19,530	10,640
Stock turnover (BGL)		
Am block transactions	60,763,638,111	54,916,503,179
Free negotiated transactions	153,314,592,914	27,538,461,591
Total	214,078,231,025	82,454,964,770
Market capitalization (BGL)		
Official market A	n/a	30,807,864,322
Official market B	n/a	102,734,606,997
Official market C	n/a	144,478,037,380
Official market total		278,020,508,699
Free market	n/a	1,483,436,983,749

Source: Bulgarian Stock Exchange Sofia

* 'Am block' trading means that transactions of majority stakes are pre-negotiated between the buyer and the seller.

Indicators of Capital Market Efficiency

In 1998, total trade turnover on the stock market amounted to BGL 214 million. The number of a block trading transactions decreased in 1999 and they were substituted for by the free trade of privatized enterprises' shares.

Most Bulgarian companies are listed in Segment C, on which trading is more active, as compared with the other segments. An increase in trading on market Segment C can be observed lately, resulting from the growth of shares of privatization funds and the further distribution of ownership.

The main feature of the stock market in Bulgaria is an imbalance between supply and demand, in terms of volume and qualitative shares. Privatization did not stimulate deals on the stock exchange as initially expected, because of lack of public offerings of shares of state-owned enterprises. In addition, demand is weak as a result of existing procedures; only profitable enterprises supply their shares on the market. Most state-owned enterprises do not fulfill the requirements for transactions on the official market. Only a few enterprises have been sold by public offering.

On the stock market, two main categories of deals have been distinguished during the last year: the transfer of minority shares of privatized enterprises and the purchase of these shares by investment intermediaries — commercial banks, investment intermediaries and investors (insurance companies, other companies, and private pension funds do not yet actively participate on the stock market).

In 1998, the value of registered deals on the stock market was equal to 10%²⁸ of GDP. For comparison, the same ratio is approximately 86% in France, 55% in the United States and 30% in Poland. Hence, the figure above shows that the liquidity of the stock market is very low, the market is small and the trade is not active. An appropriate way to improve liquidity would be to create possibilities for better portfolio diversification by issuing qualitative shares and increasing the number of domestic investors.

Capital market is not a source of new financing

Bulgaria is one of many examples of successful macroeconomic stabilization and a still-weak capital market, which does not play a significant role in the allocation of free capital. Transferring shares between minority and majority shareholders on the stock market under unclear rules and regulations provides flawed information. All of the above leads to moral hazards and adverse selection problems.

The following key reasons for unfavorable capital market development are present in Bulgaria:

- delays in the adoption of proper regulations – the law on public share offerings and private pension funds has yet to be adopted by Parliament;
- a limited supply of state and privatized enterprise equities ;
- the tax system does not stimulate deals on the stock market;²⁹
- a lack of enough institutional investors (such as insurance companies, pension funds and others);
- weak interest on the part of the population, because of the low rate of savings and unclear tax procedures concerning taxable revenues from stock market deals;
- minority shareholders' interests are not properly defended under existing legislation;
- a lack of competition among financial institutions on the equity and bonds market;
- unstable rules of trade on the capital market (little confidence in legislation) are a reason for low interest from domestic investors;
- the number of companies listed is not sufficient for to encourage trade and investor interest; and
- interest in the second wave of privatization is very low and it is not a factor for enforcing stock market transactions.

Recommendations

Up to now, the capital market in Bulgaria is not fulfilling its main functions of redistributing free resources, attracting portfolio investors and reinforcing the privatization process through public

²⁸ Stock market turnover ratio is defined as the ratio of the value of total traded registered deals to market capitalization. This indicator measures the liquidity of a stock market compared to its size.

²⁹ Under the Corporate Income Tax Law, a 15% final withholding tax is imposed on dividends, all capital gains are considered to be taxable income and general taxes are levied.

offerings. The capital market is not being used as a tool for the development of corporate business strategy through mergers and acquisitions of companies.

The problems existing on the capital market could be solved by creating and enforcing effective legislation, a legal structure that allows equal protection for minority and majority shareholders against fraud and rules that provide transparency and discipline on the stock market.

Further efforts to develop the stock market should be focused on stimulating public offerings of shares, improving the tax procedures regarding capital gains and developing trade in debt instruments (government, municipal, corporate and mortgage bonds). One possible way to improve liquidity is by offering profitable enterprises for purchase.

The reinforcement of public offerings will allow revenues from privatization deals to become a source of financing privatized enterprises, rather than being accumulated and distributed by the state in an inefficient way. In addition, the benefit of public offerings stems from concentration of the property in the hands of majority shareholders, as well as providing for improved management.

PART FIVE

PUBLIC DEBT DYNAMICS

The General Picture

In 1990, immediately after the beginning of the transition, the Bulgarian public sector was heavily indebted, as the foreign debt totaled over US \$10 billion. Then a moratorium on official foreign debt servicing was imposed, which lasted until 1994. At the same time the official foreign debt increased, reaching US \$12.3 billion in late 1993. Since then several trends in public debt dynamics have prevailed, which we may outline as follows:

- the total volume of the official debt (foreign plus domestic) has been constantly decreasing;
- the share of domestic debt in the total debt has decreased, from 25% in 1993 to 16% in 1999;
- the structure of the foreign debt has changed drastically, as long-term debt, which made up 78% of the total foreign debt in 1993, had fallen to 17% by 1999.

The domestic side of the public debt is determined by the debt of the government to the central bank, commercial banks and the holders of government securities. The structure of the domestic public debt has changed since 1992 due to: 1) a series of government securities for structural reform emissions prior to 1994, and 2) the introduction of the currency board arrangement.

Structure of the Domestic Public Debt (percentage shares)

	BNB	Commercial Banks	Government securities for deficit financing	Government securities for structural reform
1992	57	12	20	11
1999	46	0	19	35

Source: BNB, Finance Ministry

The change in the structure of the government's domestic debt occurred in three directions:

- 1) The share of debt to the central bank has decreased, the main reason being the introduction of the currency board arrangement.³⁰
- 2) The share of debt to commercial banks has disappeared.
- 3) The share of government securities for structural reform tripled, as the state issued the so-called ZUNK securities against the claims of state-owned banks on state-owned companies.

The volume of the domestic public debt actually decreased, from roughly US \$4 billion in 1993 to US \$1.7 billion³¹ in 1999.

Also, the official foreign debt fell significantly after 1993, from US \$12.3 billion at the end of 1993 to US \$8.7 billion in mid-1999. This is virtually a 45-percentage-point decrease in foreign governmental debt as a percentage of GDP (see table below).

Official Foreign Debt by Years

	1993	1994	1995	1996	1997	1998	1999*
USD, billions	12.3	10.4	9.4	9.0	9.2	9.3	8.7
% of GDP	114	108	72	90	90	76	69

Source: BNB, Finance Ministry

**Forecast GDP was used for 1999.*

The structure of the foreign debt improved in two directions: 1) the share of short-term debt decreased, from 78% in 1993 to 17% in 1999, and 2) the share of debt to private creditors fell from 71% at the end of 1993 to 59% in mid-1999 (the rest of the debt is to the IMF, World Bank, EU, EIB, EBRD, Paris Club

³⁰ The currency board was introduced with the Bulgarian National Bank Act of 1998, Article 45 of which states that the central bank cannot finance the government except in the cases of SDR purchases from the IMF.

³¹ Figures are given in current dollar values for the respective year, for easier comparability.

and other official creditors). The main cause behind the decrease, as well as the change in the structure of the foreign debt, was the agreement between the Bulgarian government and the private creditor banks of the London Club, signed in 1994. According to the agreement, Bulgaria issued Brady bonds of US \$5.137 billion against the claims of its creditors, of which 36.3% are discount bonds (DISCs), 32.3% are front-loaded interest reduction bonds (FLIRBs) and 31.4% are interest arrears bonds (IABs). As part of the agreement Bulgaria repurchased US \$1.027 billion of its debt at a price of 25 3/16 cents per dollar.

Basic Features of Bulgarian Brady Bonds

	DISCs	FLIRBs	IABs
Ownership form	Registered	Bearer	Bearer
Maturity date	July 28, 2024	July 28, 2012	July 28, 2011
Principal payments	At maturity	2003–2012: 21 equal half-yearly installments	2002–2011: 21 equal half-yearly installments
Interest payments	Every six months	Every six months	Every six months
Interest rate*	6m LIBOR + 13/16	1999: 2.50 % 2000: 2.75 % 2001: 3.00 % 2002 – 2012: 6m LIBOR + 13/16	6m LIBOR + 13/16
Accepted value of US \$1 face value in privatization deals	1	0.5	Not accepted
'Bid' quotation (US cents per US \$1) **	69.500	64.000	71.625

* The interest rates for the first four years were: 2.00% in 1995–1996 and 2.25% in 1997–1998.

**As of September 23, 1999.

The Brady bonds issued in 1994 had a total face value of US \$5.137 billion. Since then the Bulgarian government has repurchased a small portion of the Brady bonds, with a face value of US \$160 million. The outstanding Brady debt currently totals US \$4.977 billion.

Foreign debt servicing for 1999 amounts to some US \$882.6 million, the major part comprising interest payments on the Brady bonds (US \$273.1 million), principal payments to the IMF (US \$169.2 million) and principal payments to the Paris Club creditors (US \$172.9 million). This figure is expected to change slightly in the next few years, as principal payments on the Brady debt will be due from the year 2002 on, while interest payments to the official creditors will decrease.

Current Foreign Debt Ratios (%)

Public Foreign Debt / Exports*	203.0
Foreign Debt Servicing / GDP**	6.8
Foreign Debt Servicing / Exports	20.6

Source: BNB, IME's own calculations

*Exports for 1998.

**Forecast GDP for 1999.

Since October of 1998 a three-year agreement with the IMF is in effect, which guarantees US \$1.6 billion in support for Bulgaria's balance of payments until the year 2001, as long as the government sticks to the policy framework stipulated by the fund. This will maintain the IMF and the World Bank as the largest-scale creditors of the Bulgarian government, and consequently the structure of the foreign debt is not likely to change significantly. The share of foreign debt in the GDP is expected to fall to some 45% by 2004, as the current monetary policy requires fiscal austerity. This, in turn, will allow for a decrease in the interest-payment burden, and thus in overall expenditures in the central government's budget.

PART SIX

DEVELOPMENT OF THE PRIVATIZATION PROCESS

Institutional Framework

The legal launch of Bulgarian privatization took place in April of 1992, when the Transformation and Privatization of State-Owned and Municipal Enterprises Act (in short, the Privatization Act) was adopted. It established the institutional framework — the procedures, rules and administrative bodies — within which the political transfer of property should take place. The Privatization Act preceded the adoption of a number of regulations dealing with concrete aspects of the privatization mechanism, such as the different procedures, the evaluation of state-owned companies, access to information, privatization funds, etc. Additionally, a large number of amendments concerning privatization were made to existing regulations.

The Privatization Act itself has been amended 20 times over the last seven years. The main principles, however, remain unchanged:

- the privatization of state-owned companies is conducted by central government bodies (including the Privatization Agency) and the privatization of municipal property and enterprises is conducted by the respective municipal authorities;
- the privatization authorities have a large number of privatization schemes at their disposal; and
- the activity of the Privatization Agency (responsible for the largest-scale deals) is under the direct supervision of the Council of Ministers.

There are seven types of legally defined procedures in the Privatization Act for selling state-owned and municipal stocks and shares:

1. Auction;
2. Competitive tender;
3. Direct negotiations;
4. Public offerings of stock on the Stock Exchange;
5. Centralized Voucher Auctions;
6. Preferential sale of up to 20 percent of the state-owned or municipal stake to insiders; and
7. Sale to insiders without tender or auction.

Only two of the procedures can be said to give the best possible conditions for fast, transparent and efficient privatization: the auction and the public offering, or to use the common term, the ‘open’ procedures. Their regulation is quite simple; namely, the buyer is selected on the basis of the price offered. The other methods (except for the centralized voucher auctions) allow almost total discretion on the part of the privatization officials, as they include a number of criteria that are often impossible to compare with each other, thus making the process slow and unclear. Besides the above-listed types of procedures, two other schemes have found their place in privatization practice, even though they are not outlined in the Privatization Act. The first is the legal *liquidation of a company and sale of its assets*; and the second is by an *increase in capital* of a state-owned joint-stock company, in which the new shares are sold to private persons.

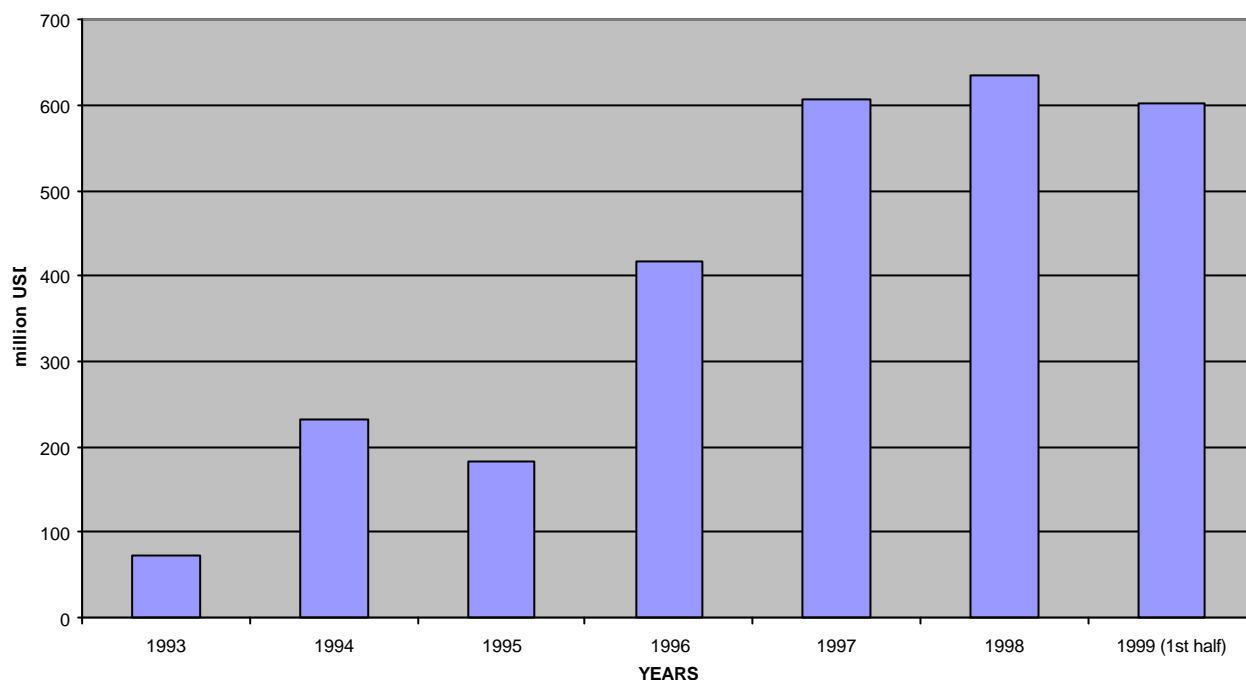
According to the Privatization Act, insiders enjoy special preferences in the following respects:

- they may purchase up to 20 percent of a company’s shares at half of their estimated value;³²
- no tender or auction procedure is opened when a company formed by insiders agrees to buy the enterprise at its estimated value; and
- preferential terms of payment apply for management-employee buy-outs (MEBOs).

The Background

The actual start of privatization occurred in May of 1993, when the first deal was contracted. Since then a total of 3,249 privatization contracts for the sale of state-owned companies have been signed, almost

³² The evaluation of the objects (whole companies or detached units) to be privatized is made by auditing companies appointed by the respective privatizing state body. The wide variety of evaluation methods that may be used are outlined in a special regulation.



Source: Privatization Agency

half of them for whole companies and the rest for detached units of liquidated or still-existing enterprises. The Privatization Agency, responsible for the sale of shares in the largest state-owned companies,³³ conducted 663 of the deals, while the rest were contracted by various ministries and committees.

Number of Privatization Deals by Year

	1993	1994	1995	1996	1997	1998	1999 (1st half)	Total
Total # of Privatization Deals	62	165	309	515	590	1,110	498	3,249
All Ministries	51	129	240	369	507	931	358	2,585
Privatization Agency	11	36	69	146	83	179	140	664

Source: Privatization Agency

The direct financial effect from the privatization of state-owned companies, i. e. the payments contracted plus liabilities undertaken by the new owners, totaled some US \$2.75 billion by the middle of 1999. The total of investments promised by the investors amounted to about US \$2.55 billion, making the sum total financial effect from the transfer of state-owned property into private hands US \$5.3 billion for the entire seven years of privatization.

Source: Privatization Agency

The Privatization Agency has contracted 78 deals with foreign investors, the cash revenues from which totaled US \$721 million, or 33 percent of all foreign investment for the period. The largest deals to date were completed in 1997, when the chemical producer *Sodi-Devnya* (US \$160 million), the copper producer *MDK-Pirdop* (US \$80 million) and the cement producer *Devnya Cement* (US \$44.5 million) were sold. The ten largest-scale deals with foreign buyers have brought a total of US \$443 million cash revenues (see table below).

³³ The threshold of a company's fixed assets which determines whether companies should be considered "large" is stipulated in the Privatization Act. The latest amendment fixed the cut-off at one million new BGL (or DEM 1 million).

The Ten Largest-Scale Deals with Foreign Buyers³⁴

Company Name	Sector	Shares sold (%)	Revenue (USD, mln.)	Buyer	Year
<i>Sodi – Devnya</i>	Chemicals	60	160.0	Solvay	1997
<i>MDK – Pirdop</i>	Copper	56	80.0	Union Miniere Group	1997
<i>Devnya Cement</i>	Cement	70	44.6	Marvex	1997
<i>Sopharma - Sofia</i>	Pharmaceuticals	67	32.0	Nova Technology	1999
<i>Balkan – Sofia</i>	Tourism	67	22.3	DAEWOO	1996
<i>SOMAT – Sofia</i>	Transport	93	21.9	Willi Betz GmbH	1998
<i>Zagorka – Stara Zagora</i>	Brewery	80	21.7	Brewinvest SA.	1994
<i>Tsarevichni Producti – Razgrad</i>	Food	81	20.0	Amylum	1993
<i>Intrerpred WTC - Sofia</i>	Trade	70	20.0	DAEWOO Group	1997
<i>Druzhiba – Plovdiv</i>	Glass	51	20.0	Black Overseas	1998

Source: Privatization Agency

The Practices

Although the number of deals and the financial effects of privatization have both been constantly on the increase since 1993, it was not until mid-1999 that the greater share of state owned assets had already been transferred to private hands. Several reasons for the slow pace of the process can be discerned, the leading one being the institutionally determined obstacles to it. First, the privatizing authorities have chosen to use predominantly ‘closed’ procedures, such as direct negotiations, tenders, and MEBOs without tender or auction, which are the least regulated and outline no clear criteria for buyer selection. Thus the process has turned out to be slow, not enough transparent, and extremely dependent on the discretion of the privatizing officials. The main motive for choosing the closed types of procedures has usually been the search for a ‘strategic investor’, based on the misunderstanding of privatization as a long process of finding the best possible new owners.

Types of Procedures Preferred by the Privatizing Bodies in 1998

	Privatization Agency	Ministries and committees
<i>Open procedures*</i>	20%	15%
<i>Closed procedures**</i>	80%	85%

*Open procedures are auctions and public offering on the stock exchange.

**Closed procedures are competitive tenders, direct negotiations, and MEBOs without tender or auction.

Moreover, the enormous number of players in the process, combined with the legal chaos, resulted in the total lack of coordination between the different privatizing state bodies. Even within the Privatization Agency itself, conflicts of interest could undermine a deal, resulting at the very least in a long delay. Two waves of mass privatization took place (the first in late 1996 and early 1997, the second in 1999), which were quite unsuccessful in comparison to the same mechanism in the Czech Republic, for instance. Of 1,040 companies offered in the first wave, only 666 were privatized (that is, 67% or more of

³⁴ These deals with foreign investors are ranked according to the amounts of the payments contracted, regardless of any liabilities undertaken or investments promised.

their shares³⁵). A number of privatization funds emerged, which generated about 90% of the vouchers in the population. The immediate result of the first wave of mass privatization was that a large number of funds ended up holding stakes (most often minority ones) in different companies. The ultimate result, however, was the slow transfer of the property to the final new owners, as well as low revenues for the state from the sale of the residual stakes in the companies offered.

Preferences for insiders, as well as the fully discretionary procedures preferred in Bulgarian privatization (both legally determined), have been the prerequisites the great majority of MEBOs. In 1998 alone, there were 716 sales to insiders, or 62% of the year's deals, including those for the sale of detached units of companies. While only 17 deals were completed without an opening auction or tender procedure, 73.6% of the deals for whole enterprises were negotiated with insider companies. The main consequences of MEBOs are: first, lower than expected revenues to the state budget,³⁶ and second and more important, bad management practices will continue to be persistent for some time to come in some if not most of the privatized enterprise.

Prospects for the Future

By the first half of 1999 a huge part of the largest state-owned companies had been sold (although some of the deals are still to be formally finalized), including the *Bulgarian Telecommunication Company (BTC)*, the air transportation company *Balkan*, the steel-producer *Kremikovtzi* and nine companies from the defense industry. Among the largest companies whose privatization perspectives are still unclear are the oil refinery *Neftochim* and the tobacco producer *Bulgartabac Holding*. Also still to be privatized is a set of detached units (31 hydroelectric stations) from the *National Electric Company (NEC)*.

If the privatizing authorities stick to the government's Program for the Privatization of State-Owned Companies in 1999, then the privatization process' prospects look quite optimistic, as 2/3 of state-owned assets will have been privatized by the year's end. This would virtually mean the end of privatization, since about 35% of state-owned assets are in sectors that are (according to the Bulgarian constitution or other regulations) subject to state monopoly, such as rail transportation, electricity transfer, natural gas transfer and conservation, electricity production at nuclear power stations, et al.

The Lessons

The post-socialist privatization of Bulgarian industry seems to be reaching its end. However, the process has taken eight years so far — a snail-like pace, compared to the other European countries in transition. Moreover, the transfer of property to the final new owners, who are expected to undertake steps toward the actual restructuring of their companies, is far from complete. A large number of the companies already privatized are now owned by management-employee companies, most of which it is difficult to view as investors with long-term perspectives.

The reasons for the slow pace of the privatization process, as well as of the delays in the transfer property to the final owners, are legally determined. Bulgarian legal regulations concerning privatization outline no strict, clear rules regarding the selection of buyers, making the privatizing authorities' selection process fully discretionary and unclear. This ambiguity predetermines the slowness of the procedures. Furthermore, the Privatization Act introduced various preferences for insider companies, which led to MEBOs for the prevailing part of the deals for privatizing whole companies.

Few public officials in Bulgaria seem to perceive privatization as a political process of property transfer. Since the prevailing philosophy (at least formally) among the privatizing state bodies is the search for "strategic" investors, it is predominantly closed procedures that are being used to sell state-owned companies. The immediate results of these practices and MEBOs have been a slow process of property transfer, delayed restructuring of many companies and low privatization revenues.

³⁵ According to the Bulgarian Trade Law, full control over a company can be executed if one holds more than 2/3 of the shares. Thus, even when 51% of a company was offered the state retained a certain degree of power in it.

³⁶ According to the Privatization Act, the terms of payment applicable for MEBOs are: a 10% initial cash installment and 10-year deferred payment.

PART SEVEN

BUSINESS ENVIRONMENT

General Picture: The state of the Private Sector

The development of the private business sector in Bulgaria began amidst a dominant public sector frozen by delayed privatization and quasi-fiscal subsidies. Politically-set priorities made the state manufacturers operate at low profit margins, meaning low production prices. This enabled high retail profit margins and actually created numerous private businesses. At the same time, private businesses also began to act as suppliers, and due to both weak government supervision over state-owned enterprises and intentional policies, the latter suffered significant losses from this “cooperation”. The private sector also began to take part in foreign trade activities, which had previously been monopolized by centralized state companies. Combined with the various tax and duty preferences for different entities (e.g. student cooperatives) in existence at the beginning of the transition, this provided enormous profit opportunities. Similarly, private financial institutions were established, using credits from state-owned banks. Understandably, those banks’ credit policy was to provide “friendship” credits to their own managers or shareholders, which will be never paid back. This fact is of ultimate importance to the overall picture of the emerging Bulgarian market. It turned out to be easier to siphon off assets from public enterprises and financial institutions than to invest in a green field.

Not surprisingly, all of this affected the major characteristics of the private sector. There is strong evidence that the fixed capital of small private firms is mainly financed from personal and family sources. Personal savings, family property or inheritance, assistance from acquaintances (or, presumably, non-institutionalized — informal — start-up credit) are the most often-used means of support for starting businesses. A survey conducted by IME in 1996 proved that 82.4% of the private companies surveyed were financed mainly by personal, family or friends’ savings.

The structure of credit deserves special attention: 62% of firms have not resorted to credit at all, while 41.5% have been financed “by acquaintances.” Inter-firm credit is probably included within this group. Naturally, businesses having been started up in an unofficial way affects their consequent unofficial practice. Another strange fact is that 20% of those interviewed in early 1996 declared that they do not have any bank account at all.

Data from the Central Bank provide similar information:

Private Sector - Dynamics of the Share of Extended Credit in GVA (% of total)

	1993	1994	1995	1996	1997	1998*
Share of credit extended	12.40	13.90	25.90	21.21	57.49	63.3
Share of enterprise investments (expenditures for purchasing fixed assets)	22.76	39.04	44.45	38.53	54.40	n/a
Share of GVA	35.40	39.40	48.00	52.50	58.80	63.7

* Preliminary

Source: BNB, NSI and IME calculations

The table above suggests two major conclusions:

First, until 1997 the private sector’s share in total bank credit was substantially lower than its contribution to GVA. This could either mean that private companies were achieving higher capital efficiency, or that they had access to non-institutionalized credit. The situation in 1997 and 1998 had changed, and the figures show an almost equal private sector share in credit and GVA. The reason, however, is not that commercial banks have significantly increased the amount of credit extended to private companies, but rather that most public sector enterprises have been denied access to new loans. Central bank data prove that in 1998 public sector companies received about 36% of the short-term and 4% of the long-term credit extended during that year.

Second, the share of investment in fixed assets in private companies is lower than the value added they produce. This could mean that private entrepreneurs utilize their assets better than public sector managers do, while, on the other hand, private firms engage in labor-intensive rather than

capital-intensive activities. Given that labor productivity in private firms has been consistently higher than that in state-owned ones, it turns out that private entrepreneurs generate higher income with the same amount of fixed assets.

At the same time, large state-owned enterprises' performance was on the decline. In 1998, a year with real GDP growth of probably 45%, sectors in which state companies dominated suffered severe declines in sales and profits. Sales in the oil-refining and chemical (basically fertilizer plants) industries shrank by some 27-28% in 1998 compared to 1997, those in the steel industry by about 10%, etc. Large state enterprises continued to accumulate bad loans. The difference this year is that the major lenders appear to be the government (through tax arrears) and energy suppliers — Bulgargas and the NEC — state monopolies themselves. Government estimates show the level of this kind of bad loans to be about DEM 1.5 billion, or six times more than the structural reform funds planned for in the 1999 Budget.

Private business by activity in 1997

Companies	Indus-tr y	Agricul- ture & Fores-tr y	Con-stru- c-tion	Trade	Trans-p ort	Ser-vice s	Fin-ance s	Other	Total
Total (number)	23,110	6,620	7,617	11,3956	12,899	16,721	1,082	6,676	188,681
%	12.25	3.51	4.04	60.40	6.84	8.86	0.57	3.54	100.00
Total (employed)	379,087	90,449	55,594	244,150	34,394	45,007	11,948	25,114	885,743
%	42.80	10.21	6.28	27.56	3.88	5.08	1.35	2.84	100.00

Source: NSI and IME calculations

The sector distribution of private companies leads to several conclusions.

Most companies are engaged in trade (60.4%), industry (12.25%) and services (8.86%). This is not surprising if we recall the legacy of credit and fixed assets in the private sector. Since privatization was delayed, access to credit was restricted and few incentives for investment were provided, private entrepreneurs specialized in sectors with low capital consumption.

Private sector by number of companies and level of employment, 1995-1997

Firm Size by no. employ-ed	1995		1996		1997	
	number of firms	share of employed	number of firms	share of employed	number of firms	share of employed
1-9	96.1%	42.6%	95.3%	37.8%	94.0%	30.6%
10-49	3.1%	22.5%	3.8%	24.3%	4.6%	20.2%
50-99	0.5%	11.2%	0.5%	11.7%	0.7%	10.5%
100 +	0.3%	23.7%	0.4%	26.3%	0.7%	38.8%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: NSI and IME calculations

Due to various entry barriers, high transaction costs, and the sector orientation of the private sector, the share of small firms, and especially of so-called microfirms, is extremely high. About 95% of the businesses in operation are employ nine or fewer people. Companies having more than 100 workers represent less than 1% of the total (even in 1997, when privatization was accelerated and numerous large enterprises were for the first time counted as private). Companies having fewer than 100 employees provided jobs to 77% of all those employed by the private sector in 1995, with the share down to 62% in 1997. This, together with the credit statistics for the period, proves that there are barriers that keep businesses small, both in terms of employment and in terms of assets.

Government policies that most affect the business environment

1. Quasi-fiscal subsidies

Of the various mechanisms that governments have used to subsidize enterprises, we will here outline only a few:

- Via exchange rate policy. Prior to February 1991, the Central Bank discretionarily provided foreign currency at rates several times lower than the black market to only a limited number of companies. The latter then reaped the retail profits. The same scheme was later applied to selected commercial banks in periods of shortage of foreign currency in the country (1994, 1996). This policy had serious negative impact; it distributed wealth according to political criteria, thus hampering market competition and keeping ineffective enterprises afloat.
- Via the banking system. Political pressure made banks lend freely to state-owned enterprises without submitting them to prudent credit analysis. In 1994-1996 the semi-official government policy toward state-owned enterprises was to allow them to cease loan repayments. Acting as a lender of last resort, the BNB bailed out commercial banks up until 1996. The outcome was severe inflation from printing more currency, the obliteration of savings through devaluation and bad investment, and finally the decapitalization of further sources of capital for private investment.
- Via monopolies on utilities and energy. Two major patterns can be distinguished here. Before 1997, the scheme involved administrative control over prices, which provided for cheap supplies of energy and raw materials to the ineffective heavy industries, so as to avoid restructuring them. The suppliers, on the other hand, were compensated with easy credits from the banking system. The second mechanism was “invented” later, in 1997 when, forced by the International Financial Institutions (IFIs), the government had to allow for pricing of the monopoly-provided energy and utilities that at least covered costs. As a result, ineffective state-owned companies merely suspended payment on deliveries. Government estimates in the middle of 1999 show the level of this kind of bad loans to be about DEM 1.5 billion, or six times more than the structural reform funds planned for in the 1999 Budget.

2. Price Controls

The Price Law of 1995 was significantly amended in 1997 and price controls were again basically eliminated. In 1998, only 15.8% of the consumer basket remains under such control. In previous years price controls (as a percentage of the consumer basket) were as follows:

Share of controlled prices as percentage of consumer basket

Year	Share
1991	14.0%
1992	13.4%
1993	16.5%
1994	18.9%
1995	49.0%
1996	52.4%
1997	45.0%
1998	15.8%

Source: NSI, IME calculations

However, policies are still mixed: there is an active Decree of the Council of Ministers, No. 269 (of July, 1997) that regulates the prices of basic consumer commodities — bread, meat, cheese, milk, meat, sugar, eggs, vegetable oil, etc. — requiring that all transaction contracts for these goods provide for a so-called “final” (or retail) price at which they are purchased by the consumer. The share of commodities whose prices are regulated by the government equaled 2.78% of GDP in 1998.

Price controls on some foods — bread and dairy products — were eliminated in 1999. The outcome of the price controls maintained in 1995-1996 was an enormous shift to informal operation by a huge portion of retail companies.

3. High transaction costs

In Bulgaria, these costs have not been measured in any detail. The only attempt at measurement³⁷ was initiated by the IME in mid-1996, when we surveyed small and medium-sized private firms.³⁸

Costs of contract enforcement

- The firms surveyed determined that the average amount of time to prepare a contract is 14 days. It is the job of 77% of company owners, who spend 10 days per contract.
- of the businesses interviewed had had no cases of unfair execution of a contract. But cross-tabulation shows that among these were all of the companies that prefer to rely upon "family" and "acquaintance" resources.
- The protection and insurance markets marked a fast development after the political changes of 1989-1990. 65% of firms in the sample reported they had not suffered from defaults on contracts, while 65.7% had insured their firms' property.
- Despite negative press and public attitudes, private businesses found security and protection expenses inevitable. 34.9% of those in the sample had incurred additional protection expenses and 10.6% had resorted only to security firms' services.

Costs of dealing with the government

- One-fourth (24.5%) of the firms surveyed admitted to keeping "secondary" accounts. For most of these firms (60%), the separate accounting is necessitated by cash payments. Two-thirds of firm owners themselves (or persons hired specifically for the purpose) spend up to one month of their annual working time handling liabilities to the government. The average amount of time spent for this purpose within the firm is about two months.

Taxation

Tax Cost of formal employment

	Avg. wage in public sector (BGL ³⁹)	Personal income tax due (BGL)	As % of avg. gross wage	Obligatory social welfare contrib. paid by employee (BGL)	As % of avg. gross wage	Obligatory social welfare contrib. paid by employer (BGL)	As % of avg. gross wage	Cost to employer per 100 BGL net income recd by a worker
1991	959	116	12.1%	n/a	n/a	354.83	37.0%	155.85
1992	2,047	301	14.7%	n/a	n/a	757.39	37.0%	160.62
1993	3,231	445	13.8%	n/a	n/a	1,195.47	37.0%	158.88
1994	4,960	700	14.1%	n/a	n/a	2,083.20	42.0%	165.33
1995	7,597	969	12.8%	n/a	n/a	3,190.74	42.0%	162.76
1996	13,965	2,522	18.1%	279	2.0%	5,865.30	42.0%	177.63
1997	141,640	20,514	14.5%	2,833	2.9%	59,488.80	42.0%	170.03
1998	187,438	30,959	16.5%	3,749	2.9%	76,099.83	40.6%	172.55

³⁷ The survey was conducted in April and May of 1996, and is representative for private enterprises in the cities of Sofia, Plovdiv, Varna and Silistra.

³⁸ We classify firms according to their turnover: 96% of firms in the sample had turnover of less than 60 mln. old leva, with the following distribution:

up to 1 mln:	22.1%	10-15 mln:	8.5%
1-3 mln:	23.8%	15-30 mln:	11.9%
3-5 mln:	11.0%	30-60 mln:	10.2%
5-10 mln:	10.2%	over 60 mln:	3.4%

Certainly, these figures reflect only that part of turnover that owners are willing to declare. Keeping this in mind, we introduce the following distinction according to turnover: "small business" = up to 3 mln (45.9% of sample); "medium-sized business" = 3-30 mln; "big business" = 30-60 mln.

The same method has been used to define "high" and "low" costs (both formal, e.g. wages, rents etc., and informal, e.g. "commissions in cash," "customs duties reductions," cash payments, etc.); i.e., a simple arithmetic rule was applied: "half below / half above."

³⁹ In old leva.

1999	210,000	32,508	15.5%	4,200	4.5%	86,520.00	41.2%	171.11
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Source: IME

The table above illustrates the dynamics of total labor costs imposed by the government by the tax and social welfare system. The last column shows the total cost to the employer per BGL 100 of net income received by the worker. With few exceptions, the cost has been consistently rising over the past nine years. Moreover, the government plans a further increase in health insurance contributions, from this year's rate of 6% to 12%. The effective personal income tax burden (against average salary) being relatively stable, the overall increase in labor costs imposed by the government is mainly due to the social welfare system. The policy behind this tendency is one of increasing revenues by increasing tax (contribution) rates. The result is a vicious circle of fewer and fewer legally employed workers, and higher and higher tax rates over the years. Naturally, in order to maintain informal employment, businesses also need to be able to collect informal revenues, and thus activities go into the "shadow" economy.

Effective corporate income tax rate

Tax Obligated Entities	1989 - mid-1996	Tax Obligated Entities	mid-1996 - end 1997	Tax Obligated Entities	1/1998 - end 1999	Tax Obligated Entities	from 1/2000
Corporations with no state or municipal ownership		All legal entities		All corporations (except insurance companies)		All corporations (except insurance and gambling companies)	
Taxable profit of up to BGL 1 million	30%	Taxable profit of up to BGL 2 million	30.81%	Taxable profit of up to BGL 50 million	28%	Taxable profit of up to BGL 50 million	28%
Taxable profit of more than BGL 1 million	40%	Taxable profit of more than BGL 2 million	40.16%	Taxable profit of more than BGL 2 million	37%	Taxable profit of up to BGL 50 million	34.30%
Corporations with state or municipal ownership	52%			Insurance companies	7% over gross premium income	Insurance companies	7% over gross premium income
Banks and non-bank financial institutions	50%					Life insurance companies	5% over gross premium income
Foreign persons	40%					Gambling on sport events	8% over gross wager income
Non-profit organizations	40%					Other gambling	12% over gross wager income
State Savings Bank	70%						

Source: IME

The table above provides a brief overview of the profit tax burden in Bulgaria. In absolute terms the effective tax rates are decreasing. The basic tendency in the corporate tax system is to abolish tax exemptions and reliefs. During the 1992-1996 period all exemptions for investment in certain categories of assets were canceled. Since 1998, there are no exemptions for newly privatized companies, and since 1999 no exemptions for certain groups of foreign investors exist. Moreover, over the last two years, the

scope of tax-deductible expenses has been significantly reduced. The impact of the abolishment of investment tax exemptions is twofold: first, it places a barrier before start-up businesses, which have a clear incentive to start with labor but without capital-intensive activities; second, together with the rigid credit environment, the incentive to finance investment through informal activities (avoiding tax payment) is higher.

Entry barriers for private businesses

Licensing requirements impose entry costs upon start-up entrepreneurs. Thus, they increase the overall cost of doing business, and at the same time reduce competition. The table below demonstrates a steep upward trend in the number of activities requiring licenses or permits.

Number of activities requiring licenses or permits

Year	Newly enforced licensing requirements	Total licensing requirements in place
Until 1989	2	2
1989	4	6
1991	3	9
1992	1	10
1993	5	15
1994	6	21
1995	21	42
1996	13	55
1997	10	65
1998	21	86
1999	20	106

Source: IME calculations

Since most of the requirements imposed in 1998 and 1999 were justified by harmonization of Bulgarian legislation with EU directives, this tendency is expected to continue. The overall impact of following such policy hand-in-hand with foreign trade liberalization is diminishing the competitiveness of domestic entrepreneurs.

Conclusions

The private sector's share in the economy has reached almost two-thirds; up until 1996 it grew significantly faster than the amount of credit received and fixed assets employed.

Stringent personal and corporate income taxation, combined with delayed privatization and high entry barriers, have resulted in a huge informal sector; also, private businesses are predominantly small and engaged in labor-intensive activities.

Since 1997, the state has abandoned discretionary policies that affect the macroeconomic environment; however, it is expanding its role in the direct regulation of business activities with an increased scope of licensing, or at least registration, requirements.

PART EIGHT

SOME INSTITUTIONAL ISSUES

PROPERTY REGISTERS IN BULGARIA – PROBLEMS AND PERSPECTIVES

Land Register

A land register is an important issue for any society that is characterized by a multitude of property rights bearers. During the 1991-1992 period, Bulgarian legislators adopted a sequence of laws regulating the restitution of real estate. A direct result of this process was an increase in the total number of parcels, as well as of real estate owners. In terms of quantitative and qualitative changes, those in relation to arable land are fundamental. These qualitative changes, combined with the present trend of recognizing private ownership as the basis of the market economy and guarantee of equality of all forms of ownership, created a demand for credible information regarding real estate ownership, defined by strict criteria. All of the above identified a need for a new system of registering land ownership. The necessity arose to change the entry system from a person-based to a parcel-based one.

The goal of this section is to study and analyze various land register systems, and also the possibilities for a transition to parcel-based registers in Bulgaria.

1. Land Register Systems

There are two main categories of legal systems of land registers used in the world: 1) person-based and 2) real. The *person-based system* is applied mainly in countries having consensual legislation. This system stipulates that civic and property rights originate as a consequence of a concluded property transaction, independent of registration. In most cases, entries in a register are not obligatory, but their consequences are resisting the concluded deal to third parties, but when present they prevent third parties from contesting a concluded transaction. In this type of system, by entering the deal, the owner's rights are guaranteed; thus, registration is in his interest. Another result of this system is the fact that real rights transfers are declared, as well as all deeds related to these rights and the burden of proof over the parcel. The public accessibility of the register according to this system more or less guarantees third parties' rights.

The second type of system is called a *real or parcel-based register system*. According to such a system, each plot has a consignment in which all transfers are entered: any establishment of real rights over the plot, including those acquired by inheriting ownership (inheritance by law or by testament), as well as the prescription of real rights over alien estate, long-term contracts for rental and leasing, and burden of proof. There is no possibility for the execution of an ownership transfer (acquisition by inheritance, marriage, etc.), without entry in the register.

The obvious advantages of the real system notwithstanding, Bulgaria adopted the Belgian person-based system, with the Law on Privileges and Mortgages (in force since September 1, 1910). This choice was upheld in 1951, with the adoption of the Law on Ownership. Preference was given to this system, because there were no prerequisites for adopting the other system, i.e. Bulgaria had no existing land register covering the country's entire territory, and preparing one would have required enormous resources.

At present, the factors influencing land register issues are almost identical to those existing at the beginning of the century. As a consequence of the land reform now in process, some radical changes in land ownership took place. A land register (of agricultural and forest land) is now in the process of preparation, while no uniform estate register (of developed real estate land) exists, to be used as a base for the registration of land.

After assessing the general conditions and discussing the options, the Council of Ministers issued Decree N394 in 1994, wherein the concept of a new land register system was introduced. The basic features of this concept are:

- The land register should be based upon the real system.

- All subjective property rights are to be entered in the land register (unlike previously, when only private documents for the acquisition of real rights over real estate were registered).
- Registration will have constitutional action, which means that a non-registered deed is idle and cannot be transferred or constitute real rights over a piece of real estate. This is a fundamental amendment to the presently applied principle, which specifies that entry is a precondition for a real estate transaction's validity. This amendment makes registration compulsory and will ensure the reliability of entries. In order to guarantee buyers' interests, a *"preliminary entry" is being introduced, as presently operational in Germany*. Thus, after entry in the, the estate cannot be transferred to another person within a certain period of time.
- The register will have absolute power of proof only concerning third parties. Again, in order to secure rights, before executing a transfer of the estate to a third party, the owner has the right to make an amendment to the entry.
- The land registration authority is responsible for any entry errors, and indemnifying for any damages caused.
- The land register is public. (Of course, its public accessibility is quite conditional.) The law should introduce some limitations regarding the disclosure of information in it, in order to secure owners' interests.
- The register is to be kept by special bodies within district courts.

Up to now, no law regulating a uniform cadastral and land register has been adopted in Bulgaria. The main objective of such a law should be to replace the presently applied person-based system with a parcel-based system. So, the important issue is whether or not the land register (regardless of which system is to be applied in the country) will be supplemented by a cadastral register. If the cadastral register is well-organized and entries are integrated into the land register system, a good basis for the introduction and effective operation of a real system will have been established, wherein the main unit is the parcel itself. We believe that the real system is relevant to the present situation in Bulgaria. Considering the fact that a parcel's borders can be specified only by the means of geodesy and mapping, a close link between the cadastral function and land register is assumed. The best way to guarantee their interaction and complementary function is to regulate both by a single law and organize them into a uniform structure. In the event that this is accomplished, the efforts of coordinating their operation will constrain.

The major issue related to the land register system is: *does this system provide for adequate confidence in the country implementing it?* Achieving a positive answer to this question will require a supply of high-quality information, as well as exhaustive data concerning the country's territory; updating all changes in estates statute.

The introduction of a land register brings the following advantages:

- it decreases the chances of owners being sued after registration; and
- it increases their possibilities for receiving credits against collateral.

At the same time, if the entry procedures are too slow, expensive and bureaucratic, then landowners will endeavor to get around them, thus creating an informal sector.

2. Problems with the Introduction of a Real Land Register System

Organizational Problems

Organizational problems arise in preparing new cadastral plans of settlements and expanding existing ones (related to preparation of a uniform cadastral plan for the entire country). The bulk of the information is unavailable due to a lack of ownership papers. The possibility exists of using information gathered by the Justice and European Integration Ministry or by the Finance Ministry, by combining data in a single database. Thus, problems like shortages of data on ownership or gathering more than needed requisites for the cadastral register would be avoided. In EU member-countries, cadastral plans contain only information related to parcel boundaries and building contours. According to Ordinance N7, cadastral plans in Bulgaria are supplemented by topographic data. This ordinance is ancillary to the Territorial and Urban Planning Act and its statute, and does not correspond to the objectives of cadastral records (it actually introduces traditional topographic symbols used for preparing topographic plans of settlements, mistakenly called cadastral plans in Bulgaria).

Technical Problems

Technical problems arise when combining data on parcels from the cadastral plans of different settlements with the data on arable land plots in general databases organized by settlement. Some tests of combining settlements' plans with land allocation were made, and the results show many cases of discrepancies and overlaps in border zones. The land allocation plans were prepared prior to the settlements' plans, and thus used inaccurate data on building boundaries. During the drawing up of these plans, no appropriate procedure for incorporating settlements' building boundaries was introduced. All of the above led to inaccurate digital data and the use of different coordinate systems. The cadastral plans of settlements contain a picture of the terrain, which sometimes does not correspond to defined building boundaries. Existing discrepancies in border zones should be overcome via uniform regulations and procedures for the whole country's territory.

The preparation of a uniform cadastral map will require eradication of conflicts between boundaries with neighboring plots.

Institutional Problems

A cadastral and land register system integrated in this manner is logically an aggregate system, consisting of two parts: informational systems regarding the cadastral register and regarding the land register. Two major contradictions appear: according to the legislation, sale transactions consider the surface entered in the papers, that are being registered. The digital cadastral model is unclear about an estate's surface; it can be calculated by the coordinates of the angles of boundaries. The concept of using paper surface is old, and digital models are not widely used anymore. For this reason, it is necessary to amend the legislation on this issue.

3. Comments on the Draft Law on the Cadastral and Land Register

1. The draft law on the cadastral and land register does not aim to meet and serve the interests and requirements of a modern land administration, nor does it answer to consumers' needs. In other words, this draft law does not support the interests of its main consumers: owners of agricultural land, financial institutions (as farming land may be used as collateral and mortgage), potential foreign investors willing to buy land, ministries (Ministry of Agriculture, Farming and Agrarian Reform, which possesses the only database covering land reform, while the Finance Ministry has the only one regarding taxes levied on acquired ownership) and participants on the land market (brokers of arable land, lawyers involved in transactions regarding farming land, surveyors). The draft law as it has been presented will not favor the development of the land market.
2. The proposed draft law consists of two separate laws, which are not merged in any land register legislation across the developed world, complemented with a cadastral register. Over the last decade countries with person-based land registers have been in the process of transformation to plot-based land register systems, supplemented by a cadastral register. Examples supporting this are ongoing programs in Greece, Scotland, Russia, Albania, Romania and Poland.
3. The draft law proposes the preparation of a cadastral system that is too expensive, the keeping of which would not be economically-based or institutionally sustainable. The proposed draft law does not correspond to the potentialities of the state budget, especially with regard to initial preparation, maintenance and feasibility of covering the costs of the information supplied to consumers, in view of their (lack of) willingness to pay a market price for it.
4. In the cadastral section of the law, there are no requirements from the major user, the land register. In its suggestions, the draft law does not allow to relate the execution of land deals to the making of necessary relevant amendments in cadastral maps. Also, it stipulates a systemic approach to establishing cadastral maps without taking into consideration the legislative requirements of the land register. Thus, previously produced cadastral plans of farming land will not be considered, but rather new work is to be done. Furthermore, all the data gathered by the Finance Ministry (tax authorities) relating to the estates register will be neglected.
5. The draft law foresees the simultaneous use of two databases: that of the Justice and European Integration Ministry and that of the Regional Development and Construction Ministry. This will, no

doubt, lead to conflicts. At the same time, all of the data on land ownership gathered by the Municipality Land Commissions will be neglected .

Recommendations

1. Adoption of a uniform law, regulating the cadastral and land register, corresponding to existing legislation in the country.
2. Creation of a cadastral agency, subordinated to the Council of Ministers, which will be the liaison body between the different ministries and institutions affiliated with the preparation of the cadastral and land register.
3. Resolution of the existing breach and lack of interaction in the strategies and tactics chosen by different ministries concerning the cadastral and land register; the building up of a uniform organization responsible for the cadastral system and land ownership.
4. Delineation of a clear distinction between the regulations concerning the transformation to the new system and the regulations associated with follow-up deals.
5. Differentiated and gradual introduction of the real register system. Simultaneous registration according to the new system across the country is not possible, because the basic units are the parcels themselves (which are too diverse). The peculiarity of transition to this system is determined by the accessibility and quality of the existing information containing data about estates. A successful transition can be achieved by using the appropriate strategies.

Real Estate Property Registers

1. At the Notary Public

Transfer of the title to real estate or the establishment of property rights to it is performed by the regional notary public. The regional registrar judge records, makes changes to and deletes the documents concerning the titles.

The interested person prepares a proposal for the deed in at least two copies. The required size, type and shape of the paper are stipulated by the Justice Minister. The formatting of the text should be neat and legible, numbers should also be spelled out, etc.

The procedure at the notary public is as follows:

- The notary identifies the persons involved by their identity documents;
- The notary identifies the right of ownership of the person who is selling the property by examination of the existing deeds, or other documents;
- The deed or any other document confirming the right of ownership over the piece of property is to be listed in the new deed;
- The notary reads aloud the contents of the deed;
- In the event that the parties agree on the terms, they sign the document in the presence of the notary;
- If the deed has already been signed, the parties should confirm their signatures;
- If the notary is satisfied with everything he issues a title deed for the piece of property regarding which the transaction is being made.

After the act of title transfer, one of the copies of the deed is placed in a special book and is called an “original,” while the other copies are handed over to the parties involved and are called “transcripts.”

2. With the Registrar Judge at the Regional Court

All real estate title transfers are to be registered with the registrar judge having jurisdiction over the area in which the estate is located. In the event of title transfer, the registration is carried out at the official request of the notary who performed the transfer. For this purpose three identical transcripts are presented to the registrar judge. The judge enters a record in the Incoming Register and writes the incoming number on the deed itself, along with the date and the volume and page number of the entry in the Private Property Register.

In the registrar offices where there is software for computer handling of the Private Property Register, the judge writes the number of the private property record on the transcript, as well. After this the judge

hands the deed back to the person in question, or if official registration has been requested by the notary the judge returns the remaining two transcripts with the same notes on them and signs them.

The (real estate) registers kept by the registrar judges are as follows:

- the volume of deeds' transcripts;
- the volumes of deeds with different kind of mortgage;
- the Incoming Register;
- the Private Property Register;
- the Alphabetical Index;
- the Inquiries Register;
- the last four can be kept on computer.

All incoming deeds or other documents subject to registration are entered into the Incoming Register according to the order in which they are received.

The incoming deeds are filed into volumes of 200. At the end of every year they are sealed together under the supervision of the regional registrar judge.

Every person who owns or has owned property in the region has a record in the Private Property Register. The record includes the volume and page number of that person's deeds, as well as information about any changes concerning their property.

The Alphabetical Index contains the names of all of the persons for whom there are records in the Private Property Register. It is ordered according to the persons' first names.

The Inquiries Register contains information about all inquiries made by interested parties. Inquiries can be made in written or oral form. If a notary wants, they can be made over the phone as well. There are three types of inquiries: about a certain person, a certain property or a certain time period.

In order to make an inquiry, one should find the name of the person who owns the estate in the Alphabetical Index and then the record in the Private Property Register. There is a history of that person's property in the region and the volume and page numbers where the deeds are kept.

Comments

The provision that some of the registers can be kept on computer reflects the understanding that computers can handle the better part of the job. On the other hand, as the deeds can only be on paper and signed by hand, they still need to be kept as they are, in volumes. The data in the computerized registers is entered by hand. There are currently a large number of computerized registrars where it is easy to make an inquiry, either by land title or owner's name, and to track the records of a given property. In the rest of the registrars records are kept and inquiries made using the system described above.

PUBLIC PROCUREMENT

The first Bulgarian Law on Government and Municipal Commissions Procurement (LGMCP) was published in the State Gazette's issue of January 31, 1997 and repealed in June of 1999. During those two and a half years the law proved to have some weaknesses, which hampered and/or compromised the procedures outlined in it. For this reason (along with the UDF government's commitment to harmonize Bulgaria's laws with the EC Directives) a new Law on Public Procurement (LPP) was enacted (published in State Gazette on June 22, 1999).

The LPP and the LGMCP, which it replaced, are similar in structure and sense; however, the new one attempts to overcome the ambiguities and weaknesses of the old one. Both laws describe their scope, the entities required to conform with the law, the prospective contractors, the fields of application (along with the exclusions) and the procurement procedures (i.e. the terms of application of the different procedures, the consecutive steps of the procedures, etc.). One advantage of the new Law on Public Procurement is its more detailed description of the issues listed above.

1. The Laws

The old Law on Government and Municipal Commissions Procurement was adopted in a hurry, at the insistence of international institutions. This resulted in insufficient preliminary debates on the law, as well as difficulties in its implementation afterwards. At any rate, it was important to have such a law

because of the significant part that state- and municipality-owned assets constituted as a share of total assets (in 1997 the level was about 70%) and the contracts they awarded each year (see table below).

Public Investment Program (USD, millions)

Year	1998	1999	2000	2001	1998-2001
Total investment	1,673.8	2,420.7	2,687.2	3,051.3	9,832.7
including:					
Public sector	883.2	1,063.0	1,032.6	969.4	3,948.2
of which:					
Financed by the consolidated budget framework	181.0	361.7	387.7	408.2	1,339.0
State sector	702.2	701.3	644.9	561.2	2,609.6

Source: *Midterm Program for Public Investment of Republic of Bulgaria (1998 - 2001)*

Before the LGMCP took effect in 1997, local and government authorities followed various laws, regulations and instructions with respect to the tenders and auctions connected with their activities. These regulations and instructions were issued by the appropriate ministries, agencies or local governments. Some of them are still in effect. For example, the Law on Municipal Property stipulates the adoption by each local government of a special regulation. In cases which fall into that regulation's scope, the application of the LGMCP and the Law on Public Procurement is excluded. Privatization deals are also subject to a separate law.

Thus, the LGMCP and the LPP cannot be intended as an all-encompassing scheme for public procurement. The LGMCP (and, respectively, the LPP) mostly apply to purchases of fuel, office equipment and office supplies, as well as the construction and reconstruction of roads and buildings. However, when planning a construction project the respective public authority has to determine whether the project falls under the scope of the LGMCP (or now the LPP). If so, it should determine which procedure to apply (i.e. tender or direct negotiations) and if the selected procedure is a tender it should follow the procedures outlined in Regulation No 1 on Construction Tenders, issued in 1993 by the Ministry of Regional Development, Housing Policy and Construction.

As already mentioned, the LGMCP earned many critics during the time it was in force. Here are some of the most criticized weak points of the LGMCP, as well as their solutions in the new Law on Public Procurement:

- The scope of the LGMCP offered many opportunities for evading the law. For example, according to Art. 3, § 1, state commissions connected with the security and defense of the country were exempt from the law if carrying out their procurement under the provisions of this law could endanger the country's defense and security. This was a rather elastic wording, allowing different interpretations. In the new law the fields of application are described in more detail, but this exemption remains.
- Another weak point of the LGMCP was the use of terms that are neither defined in the law nor elsewhere in Bulgarian legislation. A good example of this are the so-called "qualified experts" (Art. 13, § 3). There is no authorized institution that could "qualify" these experts;⁴⁰ and there are no clear principles according to which these experts can be identified. Despite this fact, the term "qualified experts" also appears in the new Law on Public Procurement. This results in doubts about the sufficiency of skills and adequacy of qualifications of tender committee members, with the ensuing complications afterwards.
- The thresholds in Art. 2, § 3 of the LGMCP, according to which it is determined whether or not the law should be applied (it is applicable when the value of the awarded contract exceeds the threshold value), were very low when the law was taken effect and steadily rose over the subsequent year and a half. Thus local and government authorities had to work in an often-changing environment, which caused problems and misperceptions in the law's application.

⁴⁰ An exception is the Privatization Agency, which grants licenses to privatization appraisers.

In the Law on Public Procurement the thresholds are defined as absolute sums, but are relatively high (lower than the thresholds in the EC directives but high for Bulgarian standards). For example, a contract for legal consultations in the amount of (new) BGL 2,400 per month is outside the scope of the law.

- Art. 17 of the LGMCP stated that tender committee members could be replaced up until the last day on which offers were accepted. This was very convenient for the contracting entities if they had decided to manipulate the tender. There was a good possibility of rearranging the structure of the committee in order to have it choose the preferred bidder.

The new Law on Public Procurement has not overcome this problem; according to it, the committee isn't even appointed until after the offers have been submitted.

- According to the LGMCP, when a bidder was rejected from participating in the tender for procedural or other reasons the guarantee he had deposited was released only after the tender's end. This meant that the guarantee remained blocked and could not be used by the depositor, even though he could not actually participate in the tender.

In the LPP this point is not even touched upon, and it is unclear how to proceed in such cases.

- If the bidder who won first place declined to sign the contract, according to the LGMCP, the organizer of the tender was obliged to invite the second-ranked bidder to sign it. If he, too, declined to sign, then the third-ranked bidder was to be invited to do so. Very often the winner and the second-runner turned out to be "men of straw." In such cases, the actual winner turned out to be one with a far less favorable offer.

Unfortunately, this pattern cannot be avoided and is not a matter of legal regulations. These texts remain the same in the new LPP.

- The LGMCP allowed the contracting authorities, when conducting a two-stage tender, to alter the tender documentation after holding preliminary talks with the bidders. These talks could be confidential, so the prospective contractors had an opportunity to influence the terms and clauses of the tender.

Such practice is strictly forbidden in the new LPP, which is one of its greatest achievements.

The new Law on Public Procurement definitely has a better chance of working well than the old LGMCP. In it, procedures are itemized and exclude the "legalization" of the contradictory practice (possible in some cases under the LGMCP). One step forward is the LPP's creation of a Public Commissions Register. This will aid better transparency and supervision on the part of the Accounting Chamber, the State Financial Comptroller and all other parties concerned.

Comments

Interesting issues are raised by comparison of the new LPP with the three EC directives that apply for the procurement of public supplies, works and services. With regard to public services, the law does not prescribe the principle of non-discrimination according to nationality. The design contests from the Public Services Directive and the Utilities Directive are also not implemented in the Bulgarian law. The Utilities Directive prescribes two more procedures that did not find place in the Bulgarian Law on Public Procurement:

- Framework agreements: agreements between a contracting entity and one or more suppliers, contractors or service providers, the purpose of which is to establish the terms, particularly with regard to prices, and where appropriate, the quantity envisaged, governing contracts to be awarded during a given period. If contracting entities have awarded a framework agreement in accordance with this directive, they may use a procedure without a prior announcement of competition when they award contracts based on that agreement. They may not misuse framework agreements in order to hinder, limit or distort competition.
- Qualification System: contracting entities may establish and operate a system for the qualification of suppliers, contractors or service providers, which may involve different qualification stages. The implementation of such a system could have solved some of the problems encountered by Bulgarian contracting entities early on in the implementation of the law.

BANKRUPTCY PROCEDURES

Restructuring the enterprise sector is one of the central objectives of current systemic reforms in Central and Eastern European (CEE) countries. Developing a well-functioning private sector includes the use of such important policy tools as privatization, the creation of efficient capital markets and the encouragement of foreign direct investment. A fundamental prerequisite for obtaining tangible results is the existence of a “hard budget constraint”; i.e., a market discipline that rewards efficient enterprises while forcing the less efficient ones to either undergo considerable restructuring or be liquidated. In market economies, this discipline is mainly provided for by bankruptcy and restructuring procedures.

The social costs of bankruptcy, however, may be high, especially in CEE countries, when extensive misallocation of resources in the past means that bankruptcy may threaten a large number of enterprises. In many of these countries, therefore, newly-adopted bankruptcy legislation favors re-organization procedures — which can themselves be quite costly, in terms of time and resources — rather than outright liquidation.

Despite important progress, bankruptcy and liquidation institutions remain weak in CEE countries. Bankruptcies and liquidations were virtually non-existent in Bulgaria until the economic crisis of 1996-97. While progress has been made in this area recently, the remaining weaknesses in these institutions hinder the restructuring process and account for an important part of the above-mentioned hazards to commercial lending.

A recent key reform 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 program has been largely successful and has been associated with a number of important bankruptcies, though it requires the special intervention of the state. Bankruptcies of medium-sized 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 case of bankruptcy due to slow liquidation process. The streamlining and activation of bankruptcy and liquidation procedures, together with 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 the resolution of these problems.

Such resolution involves 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 could have multiple benefits for the development of credit markets, corporate governance and the financial health of the banking system.

Present legislation in Bulgaria provides opportunities for companies’ owners or creditors to initiate liquidation and insolvency procedures. These procedures are borrowed from EU legislation. Implementation is comparatively sluggish; the average duration of insolvency procedures exceeds two years, while liquidation procedures take one year. The main reason for this slow pace is lack of practice and poor interaction between institutions. Another weakness is the fact that the state is the prevailing initiator of insolvency procedures for other subjects. All of the above actually means that the involuntary exit from business of ineffective economic agents is still dependent on the state, while private subjects are not active yet.

In this respect, there has been some improvement in 1999 in the implementation of procedures, which led to an increase in their number. During the first half of this year, 100 insolvency procedures were initiated, and about 1,600 liquidation procedures. In both categories, an acceleration in the execution of procedures can be noted, compared to previous periods. This development is due to changes in regulations, as well as accumulated experience. Some insolvency procedures were commenced in almost every regional court. Considerable progress was evidenced during the second quarter of 1999 by the initiation of declarations of insolvency and liquidation procedures on non-performing state-owned enterprises. In accordance with the IMF Agreement, insolvency procedures were started for not-yet-privatized SOEs from the so-called ‘second list’. (There are some economic activities, protected by the Bulgarian Constitution and/or special laws, that are exempt from being stopped in the event of insolvency procedures. This ‘protection’ is compensated for so far by more strict financial control and monitoring when the satisfaction of creditors’ claims against SOEs is taking place. In order to introduce

hard budget constraints in these SOEs, they were placed on a special list for financial recovery and intense control — the ‘second list’).

Generally, the introduction of insolvency procedures in the country over the last few years has revealed both disadvantages and advantages, in terms of regulating ‘the rules of the game’ and hence promoting economic development. The positive development is the fact that many insolvency procedures have been initiated; part of them are still in process, and some have been concluded. This will enforce discipline on the market. Still negative are the typical behavior and practice in this area, with insufficient experience and inapt implementation.

Just recently, in September of this year, the government adopted a draft law introducing amendments to the Commercial Code, according to which all insolvency procedures in Bulgaria will be conducted by the Sofia City Court. A special department dealing with these procedures is planned to be established. The suggested amendments anticipate the simplification and acceleration of procedures, which should be reached through decreased protection of creditors; i.e., they will have to strictly follow regulations, observe deadlines, etc.

COMMODITIES EXCHANGES AND WHOLESALE MARKETS

The existence of an efficient market-based economy presumes the presence of three basic elements of a market economy: *free producers of goods, market structures and a mechanism for state regulation*. Normal market economy functioning requires the existence of a multitude of competing economic agents: producers and traders. During the transition, there is evidence that economic initiative realigns toward trading, despite the fact that newly-established market networks have questionable effectiveness. Usually, they are overloaded with too many intermediaries positioned between the producer and the consumer. Also, the distribution of goods is performed using primitive technologies, which leads to increases in transaction costs. Stronger competition within the distribution system often brings a contravention in terms of trade. The consequences of these disturbances reflect in two directions: one is unfair competition imposed upon agents who operate according to official regulations, and the second is pressure on consumers.

Commodities Exchanges

The change in political and social systems in Bulgaria after 1990, as well as the dismantling of the centrally-planned economic system, created the necessary preconditions for the resumption of commodities exchange activity. After more than forty years of inactivity,⁴¹ trade on exchanges was reintroduced. Within the first three years of transition to a market economy, 1990-1992, more than 30 new commodities exchanges emerged (see list below). Naturally, their number decreased to three: the Sofia Commodities Exchange, Plovdiv Commodities Exchange and Rousse Commodities Exchange.

Commodities Exchanges in Bulgaria, 1990-1992

Bourgas Regional Commodities Exchange
Varna Construction Commodities Exchange
Varna Commodities Exchange
Varna Fruit & Vegetable Exchange
Vratsa Commodities Exchange
Agrarian Commodities Exchange – Rousse
Plovdiv Commodities Exchange
Razgrad Commodities Exchange
Sofia Commodities Exchange
Commodities Exchange “Oil Metal” – Bourgas
“Exchange – KOO” – Pernik
Gabrovo Regional Exchange
Dobrudzha Commodities Exchange
Western Commodities Exchange

⁴¹ In 1948, the last operating commodity exchange, in Bourgas, was shut down.

Kazanluk Commodities Exchange
Consortium-Commodities Exchange – Stara Zagora
Cooperative Commodities Exchange at the Central Cooperative Union
Kyustendil Commodities Exchange
National Agrarian Cooperative Commodities Exchange “BRAZDI”
Pleven Commodities Exchange
Regional Commodities Exchange “MONTANA-92”
North-West Commodities Exchange – Mihailovgrad
Silistra Commodities Exchange JSCo
Sliven Commodities Exchange
Commodities Exchange – Smolyan
Commodities Exchange “Stroymat”
Commodities Exchange “Hermes %”
Commodities Transport Exchange “TRAKIA” Ltd.
Haskovo Commodities Exchange
Black Sea Commodities Exchange “Oil Metal” Ltd.

The necessity of commercial exchanges arises from the market’s feature of trading mainly basic goods. As in other sectors, the organization of trade appears beforehand in agriculture. This is explained by the fact that agriculture goods are produced in a competitive environment, by comparatively small production units, but are widely distributed. The end-consumers of these agricultural products are distributors and/or consumption centers, remote from the production areas. This holds true for cases when the agriculture producer has insufficient trading and financing knowledge. This is the reason that the producer is unable to wait for the proper moment for the realization of his produce, and is forced to get rid of it fast. Another peculiarity is the inelastic demand and supply of agricultural produce in the short term; decreased prices does not lead to considerable increases in consumption, and price increases cannot expedite market suppliers.

A peculiarity of agricultural production supply is its strong dependence on nature (i.e. climate, natural disasters), while demand depends on economic activity (solvent demand, changes in consumers’ taste, etc.).

Thus, in the event of unregulated competition, such markets are characterized by wide fluctuations in prices and production volumes. These fluctuations can be avoided to a certain extent by amassing stockpiles when agricultural produce prices are low, and realizing production when demand, and thus prices, rise. Such purchases and sales are considered ‘speculative deals’, whose aim is to smooth the effect of the fluctuations.

Basic commodity market behavior is of vital importance, when society depends on a certain good, or it is related to income, employment or salaries. In transitions to market economy, this creates a necessity to develop a mechanism for trading such goods that makes trade transparent for society as a whole. Such transparency is achieved only on commodities exchanges.

Nowadays, commodities exchanges are actually organized markets, where salesmen, buyers and traders (intermediaries, brokers) meet. At commodities exchanges goods that exist in the domestic and foreign trade channels are traded. In other words, *commodities exchanges are open, transparent wholesale markets, accessible for all traders, that are organized, concentrated and have high liquidity.*

Trading at exchanges in Bulgaria is practiced in two ways: trading contacts, and deals with commodities exchange goods. In their initial period of development, commodities exchanges had a general function; at them a variety of goods (from foodstuffs to cars, etc.) were traded. With the evolution of market relationships, purely “commodities exchange goods” were identified. At present, both foodstuffs and non-food produce are traded at commodities exchanges.

The large variety of goods traded at exchanges defines their general character. Compared to other countries, exchange trade in Bulgaria is not very active, even though that sessions are held each week. Spot/cash deals prevail, whereas futures and forward deals are not well represented. During the last two

years, there has been some effort to vitalize futures trading with grain,⁴² although real trade with futures contracts does not yet exist in the country, for the following reasons:

- major grain producers (large individual producers and cooperatives) have no interest in participating in exchange trading;
- the major part of grain trading is connected to the provision of the country's cereals balance, which creates uncertainty on the grain market; and
- frequent changes in trade regimes regarding grain export.

According to the Law on Commodities Exchanges and Wholesales Markets (LCEWM), commodities exchanges and organized wholesale markets in Bulgaria are under a licensing regime. This has enforced changes in the exchanges' organization. They have to register anew, transforming from limited liability companies to non-profit joint-stock companies.

Commodities exchange activity is regulated by a special state body, the State Commission for Commodities Exchanges and Wholesale Markets (SCCEWM). The commission regulates and controls the establishment and activities of commodities exchanges and organized wholesale markets.

The licensing procedure for exchanges is elaborated in the following scheme.

Commodities Exchanges Licensing Procedures:

- In accordance with Art.14, §.2 of the Law on Commodity Exchanges and Wholesale Markets (LCEWM), an application is submitted before the State Commission for Commodity Exchanges and Wholesale Markets (SCCEWM).
- The application is accompanied by forms named in Art.14, §2 of the LCEWM, and Art. 3, §1 of the regulations.
- If a deficiency in the papers is noted, the applicant is notified within 10 days, in accordance with the Civil Adjective Code.
- Within one month after receiving the notification, the applicant must eliminate all of the deficiencies noted, or the SCCEWM denies licensing.
- If no deficiencies are noted, or if they are eliminated in time, the SCCEWM considers the application thoroughly.
- Within a month after submitting the papers, the commission executes the necessary examination to determine trustworthiness and whether all of the legal requirements have been followed.
- If no imperfections are noted, the SCCEWM announces its decision to grant a commodities exchange activity license.
- Based on the license issued, the applicant registers its activity as a commodities exchange in the country.
- The applicant submits to the SCCEWM all of the papers necessary for the certification of a commodities exchange activities license.
- The commission issues a Certificate of License to Perform Commodities Exchange Activities, following a procedure similar to the one for licensing.

Wholesale Commodities Markets' Role in Food Trade

Community arrangement of commerce in foodstuffs in Bulgaria began in the Middle Ages. At that time, fairs were subordinated to the chairman of the city council. This authority was responsible for order and safety at the trading places. The first Law on Organized Markets was adopted in the re-created Bulgarian state on December 5, 1880, later amended in 1883. Administrative, phyto-sanitary and veterinary authorities controlled the wholesale markets.

During the centrally-planned economy, Bulgarian organized markets were replaced by structures like "Bulgarplod" and "Wholesale Trade". These structures bought up foodstuffs from producers at prices defined by the state.

During the transition to market economy, the recreation of wholesale markets as a building block for market structures began. These are markets that mainly trade foodstuffs: fruit, vegetables, livestock and

⁴² Contracts for the following types of grain are traded: flour wheat, fodder wheat, maize, fodder barley, brewing barley.

processed foods. The largest markets arose in large consumption centers: Plovdiv, Varna, Bourgas, Stara Zagora and Rousse.

Along with providing advantages for trading agricultural products at organized markets, the state (and specifically municipalities) should do its best to support the most efficient functioning of the markets. A well-developed material base with an availability of specialized storage, sorting and packing equipment, quality rating, bank branches, marketing institutes (and any other structure relevant to the markets' operation) is of vital importance.

Main Features of Wholesale Commodities Markets

An organized wholesale commodities market is a place where the trader (intermediary) organizing the market provides storage, refrigerating, trading areas and other assets for the free use of producers, importers and wholesalers with available foodstuffs and livestock. This trader provides customers with access to the market place, and creates the necessary conditions for guaranteeing the interests of producers and consumers, by securing the lowest possible transaction costs.

A major goal of the newly-created and evolving organized markets in Bulgaria is to develop a market-based system for trading fruit, vegetables and other food produce. Other important goals are:

- to provide efficient, market-based distribution channels for suppliers of fresh fruit and vegetables;
- to provide transparent trading of foodstuffs;
- to create competitive collective markets where foodstuffs producers and traders meet large consumer centers;
- to encourage private sector traders;
- to ensure consumer supply throughout the year, at competitive prices;
- to limit farmers' losses and support a higher level of quality (consumer interests);
- to increase the general efficiency of the marketing and realization systems, stimulating competitive pricing both for producers and consumers; and
- to provide a base for the expansion of production and export, thus increasing incomes, currency revenues and employment.

Worldwide, the active parties on wholesale markets are the producers of agricultural products. In Bulgaria, the active agent is the trader. This is due to the inadequate organization of Bulgarian farmers. Integrational processes allow organized markets overcome, to a certain extent, the differences in producers' and traders' interests. Producers can start operating on a customary market, while traders have secured for themselves the delivery of production of a defined sort and quality.

Wholesale markets' equipment should be rented exclusively to private agents: wholesalers, suppliers and other related private enterprises, directly or indirectly related to the agricultural sector in the country. This is the way to eliminate state interference in the real purchase and sale of foodstuffs.

Wholesale markets concentrate the demand and supply of food produce. Because they regulate the relations between a multitude of participants and are bound to supply safe and healthy food to consumers, such wholesale markets should be licensed. The purpose of such licensing would be to help raise the material base level, and also to equalize Bulgarian trade culture with that of the EU. Of course, this will take quite some time, although the process could be accelerated by the introduction of competing distribution systems — chains of hyper- and supermarkets.

The importance of organized markets at this stage of the development of Bulgarian trade is evident. Its advantage lies in the attraction of a larger number of traders. Also, they would allow producers and retailers to conclude deals at locations that are well defined and regulated by state and municipality bodies.

At present, such markets could bring strong advantages, because they do not need a large amount of working capital in order to develop their business. This is true regardless of the fact that organized markets will have to deal with competition pressure from supermarkets and wholesalers, such as the METRO chain, etc.

Conclusions

1. In Bulgaria, commodities exchanges mainly function as contract auctions.

2. Commodities exchanges have general functions, they are not specialized.
3. Hastening trading on exchanges will be possible only after the differentiation/identification of active agro-producers who have a clear vision of the advantages of such trading.
4. A licensing regime in the case of organized markets presumes a clear distinction between wholesale markets and collective markets. The majority of auctions in Bulgaria do not conform with the requirements for an auction. In practice, they are organized producers' markets.

PART NINE

WHERE THE PROSPERITY COMES FROM? THE MARSHALL PLAN AND THE STABILITY PACT

by Krassen Stanchev (IME),
Dessislava Kocheva (AUBG)

Security, democracy and prosperity are the three pillars embraced by the signatories of the Stability pact. Prosperity is claimed to be the key element: without it low living standards would sustain animosities in South East Europe. For its accent on prosperity, an analogy is often being drawn between the post-Kosovo developments on the Balkans and those in Europe after the World War II.

It is obvious that the Stability Pact for the Balkans is different from the real Marshall Plan. But it is also obvious that political leaders do not pay proper attention to this fact. The best the Pact can do is to set up a round table, at which to negotiate constitutional and financial reforms of the region. Although it is called a "pact", the Pact is not an agreement, but a process of agreeing on the international security and economic exchange in South Eastern Europe.

The longest economic growth period

Perhaps, the longest period of more or less steady economic growth and expansion in European history is attributed to the years after the Marshall Plan. In fact, success came from creating its own pattern of institutionalized, international economic interdependence. This is neither the pattern of a monetary system, nor the emergence of harmony between Western Europe and the United States. In much of the 'Atlanticist' literature, this harmony is depicted as a result of the postwar development. Nowadays, similar harmony is attributed to the future relations between the Balkans and the European Union by the same leanings. However, it seems a bit premature.

Contrary to the common opinion, when the Plan started (1948), no symptoms for an economic crisis

were observed. The years after 1947 were years of growth and prosperity. The proportion of Western Europe's food imports originating in the dollar zone increases up to three times in importing various goods (such as maize, barley, and fats and oils) in the period of 1949-51 compared to 1934-38. In the second quarter of 1947, the level of industrial production (excluding Germany as the most defeated after the war) reaches 100% of the 1938 level. At the same time, gross and net domestic capital formation as a percentage of the national income are higher than in 1938. The only exception from this picture is the fall in gold and foreign exchange currencies in some countries associated with balance of payment difficulties. These difficulties resulted from the high output and employment rate in the years prior to the Plan. Payment balances suffer from dollar deficit on trade with the US. Trade deficit and low interest rates in Europe result from imports of capital goods by European countries, as part of their plan for a fast recovery after the end of the war. They did not manage to/could not finance their trade deficit with US through invisible earnings from the interest rates of foreign investment or foreign tourists.⁴³

The trade and exchange crisis came from increased demand by Western Europe on a relatively constant supply of dollars and the high rate of flow of gold back into the US. The effects of outward movement of gold from America during the war have been annulled by the end of 1947.

The policy of the US

The US tried to meet three main objectives:

1. return to the pre-war view of strategic self-interest, where the main threat to US and Western Europe comes from the Soviet Union;
2. prevent the breakdown in international trade and in payments mechanisms;
3. partly solve the problems in Germany, without the reconstruction of which, the recovery of Western Europe seems impossible⁴⁴.

Germany is included in the recovery plan. Only through its reconstruction, Europe is also recovered. Germany, as a part of Western Europe, resolves the problem with the world trade equilibrium: without Germany, it is impossible neither to preserve the international trade, nor to form the payments mechanisms. The last two also regain equality of economic rights of Europe in the world. That is the essence of the European Recovery Program (ERP), i.e. the "Marshall Plan". The Plan actually pays for sustaining expansion economic and social policies in WE countries in order to prop up American interests against communists and the Soviet Union.

Is there a foundation for economic growth in South Eastern Europe?

The Balkans are geographic and a political, but not an economic notion. They do not constitute a market. The Croatian, Romanian, and Greek governments have their right to deny being Balkan states. The first two as located at the periphery, while Greece is the only Balkan member of EU and NATO. But most of the countries are not on the Balkans in terms of trade, and those who can separate its image from this "boiling spot of Europe" are trying not to be a political part of the Balkans as well.

Take, for example, Bulgaria's major trade partners. Table below shows a positive trade balance with Balkan countries, and increasing share of non-Balkan partners in Bulgaria's foreign trade. As IME discussion paper *In Search For Growth: Bulgaria's Lessons and Policy Options*, points out, in the last three and a half years Balkan countries decreased their share in Bulgarian trade to less than 5% (in the first half of 1999). Balkans have no market sense per se for Bulgaria.

But the trade picture of the region viewed from other Balkan countries is similar to that from Bulgaria. According to UN ECE⁴⁵ respective South East Europe share for different countries was in 1997 as follows: for Albania 7.13% of the exports and 5.6% of the imports; for Bosnia and Herzegovina 60.2% of the exports (Croatia's share is 57%) and 20.1% of the imports; for Croatia 18.6% of the exports and 2.6% of the imports; and for Macedonia 16.3% of the exports and 22.4% of the imports (half of this trade is with Yugoslavia).

These figures suggest that geographic and background factors still play a key role in the

⁴³ Data in the paragraph above is borrowed from: Alan S. Milward, *The Reconstruction of Western Europe: 1945-1951*, London, Methuen & Co. Ltd., 1984.

⁴⁴ Milward, Alan S., *The Reconstruction of Western Europe 1945-51*, Methuen & Co. Ltd, p.53.

⁴⁵ *Economic Survey of Europe*, 1999, No 2, p.15.

commercial exchange within the South corner of Europe. This means that the countries (or governments) have more incentive to seek rents from transit fee rather trading with one another. All countries have relatively liberal FDI frameworks. But they lag far behind other European transition economies, in terms of foreign investment. One of the reasons is to be found high economic and political instability. Equally important, however, is the fact that these economies are small individual markets with low rates of return. Their individual share in the global trade is declining. Fragmentation and diverse framework of doing business impedes expansion into neighbor's yard. Hence, they constitute no significant destination for investment abroad. On its turn, domestic investment is hampered by a constellation of factors, acting national and regional level:⁴⁶

at country level:

- company survival strategies;
- weak and/or unsophisticated demand;
- underdeveloped clusters;
- over-reliance on factor conditions;

and on regional level:

- poor trade and cooperation;
- diverse frameworks for doing business;
- underdeveloped information for economic policy and decision making;
- economic structures based on low value added and unskilled labor;
- lack of shared vision on growth and prosperity.

Thus, we have two major sources of growth - investment and exports - hampered and dependent on previous development paths or on stickiness of institutions and traditions.

Stability Pact Preconditions

Marshal Plan had as an economic policy motivation an attempt to avoid then perceived dangers of It is impossible to have common trade disequilibrium (even at a complete absence of the Balkan transition economies from the European or world market). It is unlikely to expect a common, commercially or economically motivated, action to "rescue" Balkans. In normal conditions, these economies exchange 3 to 4 times more with EU, EFTA, and CEFTA than among themselves. The level of their GDP, with the exception of Slovenia, is far below those of the years before the reforms have started. Expected 1999 joint economic performance of the Balkan countries' (excluding Yugoslavia) would be marked by overall GDP of 8%. Only Bulgaria and Croatia from the neighbor countries can mark a small-scale increase in GDP. No country from the region has regained completely the level of investments from 10 years ago; it is two times lower in Bulgaria. The aggregate level of investment as percentage of GDP in the Balkan transition economies is at average 5-6% lower than the same index in the emerging Central European markets.

Level of GDP (1989=100%)	Albania	Bulgaria	Croatia	Macedonia	Romani a	Slovenia
1997	80	63	76	56	82	99
1998	86	65	78	58	76	103
1999*	91	66	79	60	74	107
FDI-inflows as a % of GDP						
1997	1.9	4.8	1.0	0.9	3.5	1.6
1998	1.5	2.8	2.9	3.7	4.7	0.8

Source: Transition report update. 1999 EBRD. *Projected level

Yugoslavia, obviously, is a different case. According to the estimations of the Belgrade-based group of

⁴⁶ The following two set of factors have been identified by a research, sponsored by the Worldbank Institute in five countries (Albania, Bosnia and Herzegovina, Bulgaria, Macedonia and Romania) on Competitive Advantage of Regions: Creating Competitive Clusters (the results were presented at a Senior Policy Makers Forum on September 15, 1999 in Vienna, Austria.

non-government economists, G-17, the gross domestic product of the Federal Yugoslavia (excluding Kosovo) in 1998 represented about 60% from the 1989 level, and the level in 1999 will be 40% lower than last year. Although the condition of Yugoslavia is important to the neighbor countries, (mostly to Macedonia, but also Kosovo - because of the interdependence in water supply and electrification), the FRY - contrary to Germany right after the war - is not a part of recovery plans for the time being. The neighbor countries will have to pay for this decision and will get some compensations and credits.

The value of Marshall Aid

The Marshall Plan allows Western Europe to continue maintain a high level of investment, avoid the deflation raised by the further increase in trade controls as the only possible response to the crisis, and to maintain flow of dollar imports. The Economic Cooperation Administration (the body which administered Marshall Aid) never has had the objective to produce such deflationary policies in Europe⁴⁷. It is essential, that the Plan finances increase in capital goods imports from the US. It raises alarm and makes Western Europe continue restrictive trade policies and seek a commonly accepted way to remain a self-dependent part of the international payments system.

Marshall Aid is directly of much more value to certain industries which are unable to attract private long-term capital investment for reconstruction or to finance their own investment policies (electricity, gas, coal-mining, steel industry)⁴⁸. In its first year ERP means a large increase in national income for the majority of recipients and allows governments to widen the scope and forms of the advanced recovery process.

Marshall Aid, however, is not so great a political leverage as it is meant to. The limitations to the exercise of American power and influence through ERP are subtle, complicated, but always present and often narrow. The main issue limiting conferred by ERP power is the unwillingness of the European countries to offer most-favored-nation treatment to Germany, upon which the US insists. Another barrier is the demand the signatories to register and discuss any projected change in the exchange rate of their currency with the IMF prior to making the change. The program rests on the assumption, that productivity growth leads to decline in the political argument, and that investment is needed for productivity increase, which then results in economic growth, and hence political stability. Although the ideology of the ERP is basically acceptable and the growth of productivity of labor and capital of Europe to the levels of US is economically desirable, the program has not been committed because of trying to impose a set of particular human and economic values on European societies. The US sought extra political gain next to the economic ones in return for Marshall Aid. At the same time, gains achieved by the European countries are not as large as to shape the politico-economic future of Western Europe. The gains for the US can only be judged related to specific issues and specific countries.

The Marshall Plan and international security

Marshall Aid resolves the crisis between Western Europe and North America, but by openly inviting European countries to go into the direction of an expansionist economic policy might drive them to a crisis among themselves. Naturally, when the countries are aiming at high productivity, output and expanding exports, they need to cooperate. The cooperation is to be coordinated by the OEEC (Organization for European Economic Cooperation). This attempt has failed, however, because the OEEC could not function effectively both politically and economically. OEEC is an example of the way in which the gap between ambition and feasibility has deprived American policy of all effectiveness in the period.

The reason the Western European countries to refuse the political implications of the American economic conception, is that it is based on imposing a risk against a set of political and economic ideas, they personally do not share. There are various barriers to this. The so-called Great Powers, often change their roles and make no decisions as in the period before the First World War. When it comes to a cooperative action, the different national interests of the European countries are emphasized. These are assumed too great to be resolved in an international organization. Another barrier to the American policy implementation is the high capacity of the two dominant states (UK and France) to ally against and resist it. At the same time, the chances of the US forming sufficiently strong and stable alliances

⁴⁷ Milward, Alan S., op.cit., p.99.

⁴⁸ The data which follows on this page are from: Alan S. Milward, Op. Cit., p.108, 114, 125, 195, 210.

with the smaller states to push through any parts of its policy are negligible. The US do not have the economic or political leverage to achieve such ambitions.

Comparing the period after the Second World War to the one of the 1990s on the Balkans outlines a few differences. The recovery of Western Europe after the World War II includes definite states, participating in the process of integration. This process on the Balkans includes states disintegrating into new nation states (Bosnia and Herzegovina, Slovenia, and Croatia in the first half of the 90s, and Kosovo and Sandjak in the second half of the 90s). The different neighbor countries have claims on different state of circumstances in the countries – Greece has claims on the name and national symbols of Macedonia, Hungary on the status of Vojvodina and the human rights in former Yugoslavia. Along with this, there are inner claims such as the one on cultural autonomy of the Albanians in Macedonia and the Hungarians in Yugoslavia. There is no homogeneity of the issues such as to define one common direction to integration.

America exaggerates the weakness of European economies. It also overestimates the scope of political and economic action needed as well as the capacity of power and influence of the Marshall Aid. Actually, later only solves the technical problem of the crisis (the deficit with the dollar zone), but does not interfere with the expansion of these economies. The success of Marshall Aid itself is a major obstacle to the implementation of American policy⁷. The declared aim of the Aid is the recovery of the European economy. In such a case, the share of the American economy on the world market will decrease. If the US wants to conquer the European markets, the ‘subsidies’ must not be successful. American attempts at integrating Europe by Marshall Aid and the OEEC ultimately produce not only a different path of European integration as a defense against America, but also strengthen the European motion of anti-Americanism. Such a reaction against American policy were the European Payments Union (EPU) and the European Coal and Steel Community (ECSC). Intra-Western European trade, the larger less restricted markets, as well as the decay of protectionism, the political objective of WE integration enabled Western Europe to survive in a worldwide multilateral trade and payments system without the need of dollar aid from the US⁴⁹. Foreign trade is basis for further economic development and integration.

Foreign trade is the foundation of the integration after the Second World War, but it’s not the case on the Balkans, where there are no such prerequisites. The Balkan economies potential has seldom been discussed. Whatever the American interest in the region, it is most unlikely that it is lead by economic motives. There are no symptoms of economic motives being leading for the EU’ attitude to the Balkans too. The situation is characterized by the fact that the ideas for resolution are once again coming from ‘outside’. In contrast to the period after the Second World War, there is no inner integration process in the region. In regional economies production with low added value prevails and the services are almost absent. The economic, monetary, and political instability in the few past years result in exports to the hard currency zone, and not into the region.

The collapse of the OEEC resulted positively in September 1949. For the commitment of the integration of the European economies, there is raised the need for other institutions to participate in the process. Ideas of a payments union are introduced, that later result in the European Monetary System and the Euro. Through removal of restrictions on foreign trade, the ECA tries to achieve these goals for the OEEC. The agreement on the EPU, however, signifies the defeat of all these future American hopes⁵⁰.

After it has been severely affected by the American recession in 1950, Britain threatens to withdraw completely into the sterling area payments mechanisms, and thus to divide the world into two payments systems. For this reason, there is a drastic change in American policy by abandoning goals of integrating UK into a united Western Europe and the acceptance of the existence of the sterling area and of the UK as its pivot in the post-war world¹⁰. The US accept that its real interests are more affected by the world-wide ramifications of British and sterling area trade than by Britain’s role on Europe.

⁴⁹ Alan S. Milward, p.216.

⁵⁰ Ibidem, p.473.

¹⁰ Ibidem, p.474.

South Eastern Europe is characterized by the process of currency substitution and by referent currency represented by the German mark. The process resembles the drawing of Britain in the sterling mechanism in so far as local currencies are not self-dependent and are not free-traded outside the respective countries. The difference from the development of the British sterling is that the currencies are substituted with the German mark and tend to be substituted with the Euro. That is why ideas for rational and freely chosen rejection of national currencies emerge naturally.

In this situation no durable reconstruction could have been possible unless the future terms of coexistence of the sterling area, Western Europe, and the dollar trading zone have been defined¹⁰. The last is done by the EPU which creates a pattern of institutionalized interdependence; it is a multilateral payments network imposing certain restrictions on national policy choices to make it work. The success of this institutionalization of interdependence free from pressure towards integration is immediately seen in the way the EPU have coped with the very problem, which had proved most disastrous for the OEEC, the economic recovery of Germany.

In fact, Britain limits its participation in the process of European integration. The imports of West Germany increase. Germany appears to be a potential leader of any Little European economic association, which makes France to take its own initiative. The most dynamic sector of the French economy in 1949 is foreign trade and that is why ideas turn towards a more liberal framework for an integrated Little Europe as a solution to the problem of national security. Little European payments union is unacceptable, however, to the Dutch without the German participation, and the French government is not prepared to face the West German economy in so liberal a framework.¹¹ After January 1950 the only practically acceptable framework is to return to the concept of a regulated market.

The first step in this direction was the establishment of the European Coal and Steel Community (ECSC) as a result from the idea that any policy for harmonizing French and German reconstruction has to deal directly with the central question of coal and steel resources. As far as the customs union is defined as a common market, confined at first to those strategic commodities, no common market in those products could be created without the most complex agreements on its regulation. Here the Schuman Plan negotiations began on cooperation of Germany and France in Ruhr. As a result, the ECSC is founded, which contains large modifications to accommodate not only France and Germany, but also European countries and the US. These modifications, however, join together more strongly and intricately the framework of economic interdependence and political alliance on which the rest of the economic peace settlement is later erected. From the Schuman Plan, negotiations emerge an altogether more pragmatic process of integration which resolves the central political problem of Western Europe and becomes the pattern for the European Economic Community (EEC)¹².

Instead of a liberal unified Europe comes a closely regulated Little European common market. It provides simultaneously for French national security by containing West Germany and permits its members to continue to pursue a very limited range of common economic policies in a few specific sectors of economy, which would otherwise have become impossible. Parallel with this development, the whole of Western Europe by rejecting the economic framework for interdependence which the US seek to impose on it, is able to build an alternative framework. Although it may not have withstood the challenges of that time, it is certainly better founded than anything devised in the inter-war period¹³.

Western Europe creates an alternative pattern of reconstruction by a restricted institutional framework for economic interdependence, which has proved to be more effective than any previous peace settlement and in the end the best solution for the United States too.

The creation of institutions after the pattern of the experience and mistakes from the late 40s and early 50s in Europe seems impossible on the Balkans. What is possible, is the adoption of patterns of institutions and laws already created in EU or the international community (UN, NATO, IFIs, and G-8). This raises the basic problem of the natural origin of the legal and constitutional changes, which might emerge on the Balkans. As a consequence again arises the problem of security.

¹¹ Alan S. Milward, Alan S., p.475.

¹² Ibidem, p.475.

¹³ Ibidem, p.476.

Institutions and Ideas

Institutions which emerged as a result to the Marshall Plan	Ideas of the Stability Pact
16 July 1947 CEEC Committee for European Economic Cooperation	June 1999 – Adoption of the Stability Pact for South Eastern Europe and drawing up of the draft for it.
5 June 1947 ERP European Recovery Program	Regional table for South Eastern Europe which will coordinate the three working tables: (1) on democratization and human rights; (2) on economic reconstruction and reform; (3) on security
April 1948 ECA Economic Cooperation Administration	The Special Coordinator, appointed by the EU and responsible for the process of implementation of the Pact within and between the individual countries, will be supported by appropriate structures tailored to need
16 April 1948 OEEC Organization for European Economic Cooperation	The Southeastern Europe Cooperative Initiative for economic and infrastructure related regional cooperation will attract private investments to the region.
7 July 1950 EPU European Payments Union	The process of establishing a framework for cooperation in the region in Royaumont will play a key role concerning civil society issues in the framework of the first Working Table of the Stability Pact.
18 April 1951 ECSC European Coal and Steel Community	The Conference on the Adriatic and Ionian Sea region proposed by the South Eastern European Defense Ministers (SEDM) group will contribute to the security of the region.
25 March 1957 EEC European Economic Cooperation	A donor/reconstruction conference for Southeastern Europe in order to launch a comprehensive and coherent economic development plan for the region.

Source: History of the Marshall Plan is reflected after Wexler, Imanuel. *The Marshall Plan Revisited. The European Recovery Program in Economic Perspective*. Greenwood Press. London 1983.