CENTRE FOR CO-OPERATION WITH THE ECONOMIES IN TRANSITION

OECD ECONOMIC SURVEYS

BULGARIA

1997

SPECIAL FEATURES

FINANCIAL INSTABILITY
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CCET

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Publié également en français.

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BASIC STATISTICS OF BULGARIA

1995 unless otherwise noted

THE LAND	Area (sq. km)	110 994
	Agricultural area (percentage of total)	55.5
THE PEOPLE	Population (thousands, end-year)	8 385
	Inhabitants per sq. km (end-year)	76
	Average annual population growth (percentage, 1991-1995)	–0.7
	Inhabitants in major cities (thousands, end-1994)	
	Sofia	1 116
	Plovdiv	346
	Varna	304
	Bourgas	200
	Registered employment (total, thousands)	3 311
	Labour force survey unemployment (percentage of labour force)	14.7
THE PARLIAMENT	National Assembly (unicameral)	240 seats
	Political parties (number of seats on 1st January 1995):	
	Bulgarian Socialist Party	125
	Union of Democratic Forces	69
	People’s Union	18
	Movement for Rights and Freedoms	15
	Bulgarian Business Bloc	12
	Independent	1
PRODUCTION	GDP (US$ billion)	13.0
	GDP per capita (US$)	1 546.9
	Structure of GDP (per cent):	
	Agriculture	12.7
	Industry and construction	31.3
	Services	46.0
	Other	9.9
	Gross fixed capital formation (percentage of GDP)	15
PUBLIC FINANCE	(percentage of GDP)	
	Consolidated budget revenue	36.1
	Consolidated budget expenditure	41.8
	Domestic debt	39.7
FOREIGN TRADE AND FINANCE	(US$ billion)	
	Exports of goods and services	6.8
	Imports of goods and services	6.5
	Foreign currency reserves	1.2
	Official foreign debt	9.4
THE CURRENCY	Monetary unit: lev	
	Currency units per US$:	
	end-December 1995	70.7
	end-December 1996	483.0

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An Economic Assessment was carried out in 1992; this is the first full OECD Economic Survey devoted to Bulgaria.

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This Survey is published under the responsibility of the Secretary-General of the OECD.

Assessment and recommendations

Assessment

Bulgaria is in the midst of a major economic crisis

At the time of the previous OECD Economic Assessment of Bulgaria in 1992, the government had just embarked on a bold and ambitious ''shock therapeutic'' reform programme, including the abolition of central planning, the liberalisation of the vast majority of prices, and the removal of most barriers to foreign trade. Despite the very difficult situation in the country at that time, the introduction of the 1992 Assessment concluded that, ''much has been achieved in extremely difficult circumstances; but the most difficult part of the road may still be ahead''.[1] Four years and several governments later, while a certain degree of macroeconomic stability and growth are taking hold in much of Central and Eastern Europe, Bulgaria finds itself in the midst of a major economic crisis, including the virtual collapse of the banking system, a significant decline in GDP, the rapid devaluation of the lev, double-digit monthly inflation, an escalating budgetary crisis, and a general loss of confidence and credibility in economic policy. A major goal of this survey is the identification of problems in the Bulgarian economy that have hindered the achievement of both macroeconomic stability and robust economic expansion at a time when many other central and eastern European countries in transition appear to have been more successful.

Unfavourable initial conditions and lags in structural reform underlie the crisis

All of the transition economies have suffered, to one degree or another, from inherited conditions associated with low competitiveness, the lack of developed financial and fiscal institutions, low confidence in economic policy, and the accumulation of bad debt. Initial conditions in Bulgaria were more unfavourable than average in all of these areas. The fact that Bulgaria now lags behind most central and eastern European countries in stabilisation and structural reform reflects, to some degree, these relatively adverse initial conditions. At the same time, the lag in structural reform has added serious complications to an already fragile economic environment. The financial crisis of 1996 has had unfortunate negative consequences on the Bulgarian economy from many perspectives. The hope is that the crisis may at last provide a context to realise painful but necessary decisive measures to deal with loss-making banks and enterprises, accelerate privatisation, and improve the overall environment for domestic and foreign businesses.

The revival of moderate growth in 1994 and 1995 in part reflected an adjustment to market conditions...

The period of 1994 and 1995 witnessed a revival of moderate economic growth and a strengthening of the current account, deriving from both higher industrial exports and the rapid expansion of the private sector. This growth has been interrupted by a fall in GDP in 1996 of about 10 per cent. An important question concerns the degree to which the growth of 1994-1995 was soundly based, representing forces that could be expected to sustain growth in years to come, albeit with an interruption due to the current financial crisis. Despite some evidence of genuine restructuring among industrial exporters, it is nevertheless concluded that the medium-term sustainability for the current export structure, which favours energy-intensive branches such as ferrous metallurgy and chemicals, is highly unlikely. On the positive side, the primary industrial exporters in 1994 and 1995 exhibited higher profitability than the average in their industrial branches. Furthermore, gross profitability (before tax) of the main exporters from several branches was positive. The expansion of the private sector in areas such as trade, services, transportation, and construction has also made an unquestionable contribution to the revival of the Bulgarian economy, and this contribution should continue. On the other hand, both industrial exporters and private firms were benefiting from an undervalued currency, energy subsidies, payment arrears and loose bank credit. Problems in stabilisation have depreciated the lev to an extent that could not possibly be maintained in a robust economic recovery. An overall assessment of the private sector is also complicated due to the presence of various arbitrage opportunities for access to resources of the state.

... but the sustainability of the current export structure is highly unlikely

Progress in slowing the growth of money supply and reducing the budget deficit did not translate into stabilisation

Bulgaria has made important progress in developing the basic tools of monetary and fiscal policy. Until the crisis of 1996, under quite difficult conditions, the National Bank and the government managed to slow the growth of money supply and reduce the budget deficit, though at the expense of austerity in the area of social policy. But this did not translate into economic stabilisation. While a few mistakes in the conduct of monetary policy appear to have contributed to the instability, the scope and efficiency of stabilisation policies have also been severely limited by structural problems. These problems have been reflected in a rapidly-deteriorating situation in the banking sector and an alarming accumulation of government debt. Stabilisation efforts have also been hindered by problems in the implementation of key economic laws and regulations, particularly in the areas of taxation, foreign exchange transactions, and prudential regulations for banks.

Recurring bursts of high inflation and currency depreciation have been associated with a highly unstable demand for money...

Bulgaria continues to experience high instability, associated with recurring bursts of high inflation and currency depreciation. Most recently, after monthly inflation had fallen to under 3 per cent for almost every month between April 1995 and April 1996, it quickly accelerated to over 20 per cent in June 1996, leading to double-digit average monthly inflation for the second half of the year. Adverse expectations, associated with growing losses in the economy and the decapitalisation of the banking sector, poor enforcement of regulations on the foreign exchange market, and substantial foreign debt service requirements, have contributed to a highly unstable demand for money. As was the case for a similar crisis in 1994, the initial instability that surfaced in 1995, leading into the financial crisis of the following year, was primarily demand-driven, corresponding to a rapid portfolio shift away from lev-denominated assets. In both cases, this shift followed decisions of the National Bank to decrease its basic interest rate to bring it in line with lower expected inflation. Also, in both cases, once expectations had become destabilised, subsequent increases in the basic interest rate did not succeed in restoring stable money demand. Sharp currency depreciation, followed by high inflation, occurred after monetary authorities had essentially exhausted their supply of foreign currency reserves for defending the value of the lev.

... and structural problems have severely limited the freedom to manoeuvre in monetary policy

The freedom to manoeuvre in macroeconomic policy has been limited by structural problems. The enforcement of control over money supply and prudential regulations for banks has been difficult due to the prospect of mass insolvency in the banking sector. Moreover, until recently, the National Bank had few means of compelling banks to follow regulations. Interest rate policy has also been complicated; high interest rates place a very heavy demand on government debt service and lead to greater financial distress among firms and banks, while lower interest rates can have an implosive effect on money demand. A weak foreign exchange position, due to a weak current account, high external debt service, and low external financing has continued to compromise the credibility of intervention by authorities on the foreign exchange market to defend the value of the lev.

The fiscal situation is becoming increasingly critical due to rapidly growing interest payments and falling tax revenue

Despite a reduction of the consolidated budget deficit from 11 per cent of GDP in 1993 to less than 6 per cent in 1994 and 1995, the fiscal situation in Bulgaria is becoming increasingly critical. The share of tax revenue in GDP, which has generally been low in comparison to most countries in transition (25.5 per cent of GDP in 1996), continues to decline, while the enormous burden of domestic debt service continues to grow. Interest payments on the government debt in 1996 reached 20 per cent of GDP. Interest on the domestic debt alone accounted for 17 per cent of GDP. As of mid-1996, over half of all domestic debt consisted of various special bond issues for assuming the non-performing assets and liabilities of distressed commercial banks. Despite an erosion of part of the principal of this debt during the rapid inflation of 1996, the crisis, on balance, is having a very negative impact on the budget. This is due partly to the unfortunate circumstance that a large share of domestic debt is denominated in foreign currency, the burden of which has increased with the depreciation of the lev. Second, the emergency measures to stabilise the economy in 1996 included substantial increases in the basic interest rate of the National Bank that, for some of the time, even outstripped the rate of inflation. Government debt service is indexed to this rate. Third, the provision of state deposit insurance for failing banks has led to a new wave of state bond issues, which joins additional new state securities associated with greater needs in deficit finance. This comes at a time when substantial falls in profitability and output have further accentuated declines in tax revenue.

The growing fiscal imbalance provided the context for the government decision in late 1996 to approve a new ''emergency privatisation list'' of 18 of the most valuable state firms.

Growing austerity in social policy conflicts with increasing needs in social assistance

The growing budgetary crisis comes at a time when needs in social assistance appear to be growing. In the process of generating large primary budgetary surpluses in the last few years, the government reduced social expenditures on wages, salaries, pensions and direct subsidies to below 14 per cent of GDP by 1996. In addition to a deteriorating social infrastructure, difficulties in the labour market have encouraged high exit rates and early retirement, causing the dependency ratio (the ratio of pensioners to contributors to the pension fund) to escalate from an estimated 55 per cent in 1990 to 89 per cent in 1995. This, as well as the evasion of social security taxes, has placed increasing strain on the pension fund, the deficit of which was approximately 3 per cent of GDP in 1996. While a rather high degree of austerity in social policy has so far been maintained in Bulgaria, the extent to which current trends in this area are politically or economically sustainable is unclear.

Problems in the banking sector are central to the current crisis

Problems in the banking sector are central to the current crisis in the Bulgarian economy, and receive special attention in this survey. Despite serious efforts by the government, under difficult circumstances, to adapt a legal and regulatory framework for the banking sector largely according to Western practice and recommendations, a spiral of bad loans and refinancing has taken an enormous toll on the Bulgarian economy in recent years, and underlies the current financial crisis. The state of the banking sector continued to deteriorate at an alarming rate during the ephemeral economic recovery of 1994-1995. By December 1995, excepting one large bank, the aggregate capital base of the banking sector had turned negative, over 70 per cent of all commercial loans were classified as problematic, and losses were rapidly accumulating. Despite these trends, the expansion of new bad credit to the non-financial sector continued. At the end of 1995, credit to the non-financial sector amounted to 41 per cent of GDP. Moreover, this credit consists almost entirely of new loans contracted after 1990, as the liabilities of non-performing loans contracted before 1991 were assumed by the government between 1991 and 1993 through special state bond issues. Bulgaria is unique among transition countries in maintaining such a high ratio of new (post-transition) credit to GDP. While the issue of bonds to assume non-performing pre-transition loans was large enough to have a crippling effect on the state budget, it was not large enough for an effective recapitalisation of the banking sector at the time.

Commercial banks have been operating under distorted incentives

It appears that the commercial banking system has been used, to some degree, as an implicit means of subsidising many loss-making state-owned enterprises. But problems in the behaviour of commercial banks go far beyond this implicit subsidisation. In recent years, more than half of all new credit has gone to the private sector, which, on aggregate, has no better a record of debt service than the state sector. Furthermore, credit to the private sector has been extraordinarily concentrated in a very small number of big loans. This is one clear indicator that commercial banks have operated under distorted incentives, and have, themselves, played a very active role in the expansion of bad credit in recent years. Reasons for distorted incentives include low capitalisation, an overhang of bad debt, problems in the feasibility and credibility of policies, and an insufficient ability of the National Bank to enforce regulations. Problems in the banking sector culminated in massive bank runs in 1996, during which roughly one third of all Bulgarian banks were put under ‘‘conservatorship’’, corresponding to the virtual cessation of all banking operations and possible pending bankruptcy.

The privatisation process has stalled for several years, but has reportedly picked up again in the latter half of 1996

Bulgaria has been making slower progress in privatisation than most other central and eastern European countries. Significant progress was made in the early years of transition in the restitution of urban property, as well as in the drafting of ambitious legislation to facilitate medium and large-scale privatisation. But the privatisation process subsequently stalled, reflecting both political controversies and low incentives on the part of insiders. The second half of 1996, however, appears to have been a turning point in re-establishing momentum, with a significant acceleration in cash sales and the final launching of voucher-based mass privatisation, even if the actual receipts of the government have so far been small.

Bulgaria has been lagging behind other transition countries in attracting foreign investment

Bulgaria also remains well behind most central and eastern European countries in its ability to attract foreign investment, despite rather liberal laws in this area and an expressed high potential interest by foreign investors in the relatively cheap and skilled Bulgarian labour force. Foreign investors continue to rank the business environment in Bulgaria as one of the least hospitable among transition countries. Other than problems due to high and variable inflation and taxation, foreign investors complain in particular of unstable laws, regulations, and contractual conditions, as well as numerous cumbersome and time-consuming bureaucratic procedures. While business practice in Bulgaria often involves circumventing a number of laws and regulations as well as, perhaps, establishing close relationships with various government officials, Western businesses are generally less willing to engage in such practices.

Recommendations

A comprehensive approach to macroeconomic and structural reform is needed

The current crisis in Bulgaria, which includes an overall loss of credibility and confidence in economic policy and domestic financial institutions, offers no easy solutions. The nature of the crisis necessitates a comprehensive programme of macroeconomic and structural reform. As the macroeconomic instability in Bulgaria has structural roots, any programme aimed at macroeconomic stabilisation that does not involve simultaneous measures to deal with loss-making firms and insolvent or undercapitalised commercial banks is bound for failure. Another essential condition for successful stabilisation is a restoration of credibility in economic policy. The government should, therefore, aim at a medium-term strategy designed to restore and solidify confidence and credibility through a process of making and enforcing a series of policy commitments aimed at improving the economic environment.

Stabilisation in the near future may require external assistance and an explicit exchange rate anchor

The specific macroeconomic policy response to the unfolding crisis is, of course, very complicated. Given the current circumstances, the stabilisation of expectations that underlie the demand for the lev can most likely be achieved only through a policy that explicitly uses the exchange rate as an anchor. While Bulgarian monetary authorities did implicitly attempt to use the exchange rate as a stabilisation anchor in recent years, the explicit pre-announcement of targets can help to reduce uncertainty and promote enforcement. At the same time, under present conditions, Bulgarian authorities face the dilemma that a mere announcement of an exchange rate target may have little effect on expectations, and could even backfire by further reducing the credibility of macroeconomic policy. For this reason, a programme involving both domestic policies and external assistance might very well be a necessary condition for a genuine stabilisation of the economy in the near future.

Extensive negotiations with the IMF have focused on the introduction of a currency board...

Extensive negotiations with the IMF since November 1996 have focused on the possibility of creating a currency board, under which a commitment to a fixed exchange rate, or strict monetary rule, would be enforced through backing up the value of domestic currency 100 per cent with foreign currency reserves. This idea, which was originally the source of some controversy within Bulgarian political circles, appeared to have obtained the general backing of the main political forces by the end of the year. While a currency board may hold the best promise for stabilisation and the restoration of confidence in economic policy, its successful implementation implies strong simultaneous measures to address problems in the banking sector, enterprise restructuring, and fiscal imbalances. Such an ambitious reform package requires both a strong political commitment by Bulgarian authorities and external financial support that goes beyond reserve funds needed to back up the currency.

... but supporting policies are needed to recapitalise and monitor commercial banks...

As commercial banks would essentially lose access to refinancing under a currency board arrangement, the restoration of confidence in the banking sector promises to be a difficult task. Those banks that are allowed to continue operations in this environment should be well-capitalised, sufficiently liquid, and closely monitored. This most likely requires a combination of measures to limit the number of operating banks, recapitalise these banks, and step up the monitoring of their activities. Unless banks are well-capitalised and properly monitored, they will continue to operate under distorted incentives, and may pursue excessively risky or myopic loan policies. This could cause serious problems for the future rebuilding of the banking sector, and jeopardise the success of a currency board arrangement in general. On the other hand, if the presence of a currency board succeeds in bringing down interest rates, this will be helpful to many banks, allowing them to attract deposits at lower interest rates and collect a larger share of outstanding loans. Nevertheless, under current circumstances, confidence in the banking sector can be restored only with time.

... ensure financial discipline in the enterprise sector...

Reforms in the enterprise sector are also critical to the success of a currency board arrangement. Low competitiveness in much of the Bulgarian economy, together with highly restricted future access to subsidies and credit, imply difficult times for many Bulgarian firms. In addition to cutting off some firms from a former source of implicit subsidies, the dearth of commercial credit in the aftermath of the banking crisis will cause general problems in liquidity in the non-financial sector. In this context, however, it is important that the government continues to isolate and shut down many of the most problematic loss-making enterprises. As the general experience of economic transition indicates, unless the threat of insolvency can be made credible, interenterprise arrears will rise to fill the gaps created by the removal of monetary subsidies, thus threatening to entangle virtually all firms in a complicated web of debt. Rising interenterprise debt is already a major problem in Bulgaria, and only under a genuine threat of bankruptcy in the economy will enterprises become sufficiently concerned about the solvency of those firms whose debt they are accepting. Assistance from international financial institutions was discussed in the 1996 negotiations for the purpose of supporting unemployment benefits and retraining for former employees of enterprises that have been shut down.

... and correct severe fiscal imbalances

Another set of simultaneous policies must address the fiscal crisis. The financial crisis has pushed Bulgaria into a genuine debt trap, which is inconsistent with the successful operation of a currency board. Under a currency board, the government would no longer have access to its current sources of deficit finance. Direct loans from the National Bank, such as occurred in 1996, would no longer be possible. In addition, commercial banks and other domestic institutions would initially be in no position to absorb large issues of state securities. In the early period of operation of a currency board, therefore, the budget deficit would most likely need to be financed almost exclusively from external sources or revenue from privatisation. Specific policies to repurchase or restructure a part of government debt may also be necessary. To the degree that the establishment of a currency board can restore confidence in the lev in the near future, these fiscal problems can be somewhat alleviated. Lower interest rates will decrease the burden of debt service and possibilities for placing state securities with private foreign and domestic investors will grow.

Such a comprehensive programme demands a major commitment, both from the Bulgarians and the international community

As should be clear from the preceding paragraphs, a comprehensive reform programme, involving a currency board and critical supporting measures in fiscal and structural policy, demands a major commitment from both the Bulgarian government and the international community. But the seriousness of the economic crisis in Bulgaria today requires such a comprehensive programme in order to avert years of continuing economic instability and decline. For the international community, the task is not only to supply financial resources to underpin the currency board and other reforms, but also to provide technical assistance and monitor implementation. Clearly, support on the required scale can only materialise if the political commitment by the Bulgarian authorities to undertake and carry through the needed reforms is clearly and credibly manifested. For example, strong social and political pressures will need to be resisted in order to maintain financial discipline and control. This particularly concerns possible pressures to loosen controls on commercial banks in the face of severe liquidity problems in the non-financial sector. Tight controls on commercial banks are essential for the rebuilding of the banking sector on sound principles, and will be inconsistent with a ‘‘normal’’ expansion of commercial credit in the near future. As the institutional framework needed to support genuine profitable loan portfolios for commercial banks begins to develop, commercial credit will gradually expand. This institutional development can be facilitated by a strong effort of the government to implement legislation to protect the rights of lenders in the event of default, allowing them easy-to-implement options of either seizing collateral, initiating bankruptcy, or taking effective control of the respective enterprises for the replacement of management.

Expanded activities of foreign banks in Bulgaria should be promoted

Under the present circumstances, the Bulgarian government should promote the expansion of the activities of foreign banks in Bulgaria. This could have several beneficial effects on the state of the Bulgarian economy under a comprehensive stabilisation and reform programme. First, foreign banks can promote the recovery and development of commercial banking in Bulgaria, not only by providing important human capital, but also by supplying at least some liquidity on the interbank loans market to ease the strain from extremely limited central bank refinancing. Second, these banks would be in an advantageous position to provide at least some commercial credit to firms, alleviating somewhat the severe liquidity problems in the non-financial sector. Third, foreign banks also possess the liquidity to absorb some state securities used to finance the deficit. Thus, an enhanced presence of foreign banks in the Bulgarian economy in the near future can serve to alleviate problems in all three above-mentioned categories of fiscal and structural policies, which are vital for the success of stabilisation through a currency board.

Tax reform should concentrate on greater stability and enforcement of somewhat lower, uniformly-applicable rates

Given the need to strengthen incentives in the economy, the possibilities for increasing taxes in the short run appear to be quite limited. A major deterrent to foreign as well as domestic business in Bulgaria remains high and unstable taxation. For the medium term, while budgetary problems in Bulgaria will continue to make a substantial tax burden on businesses inevitable, incentives and state revenue can simultaneously be improved through a reform strategy that includes: *a)* the reduction, to some degree, of the explicit tax burden; *b)* a greater stability in the rules and laws that determine taxes; and *c)* a greater effort in enforcement. For the improvement of incentives for both tax compliance and investment in the economy, it is particularly critical to combat the expectation that changing conditions will lead to numerous changes in tax laws and regulations in the future. In addition, given the inability of authorities to control flows of resources between state and private firms, the recent measures to equalise the tax treatment of these two categories of firms make good sense. By the same token, recent amendments to the Profit Tax Law that create special tax holidays for privatised firms may seriously complicate tax collection for Bulgarian authorities.

Future strong pressures for the real appreciation of the lev should be expected

Even before the current financial crisis, according to measures such as purchasing-power parity, the lev was highly undervalued relative to the currencies of other central and eastern European countries. In 1996, the exchange rate moved from 74 to roughly 500 leva to the dollar between January and December. Under these circumstances, authorities must expect that the process of economic recovery will be accompanied by the steady and substantial real appreciation of the currency. In the presence of a currency board and a corresponding rigid nominal exchange rate, this real appreciation will take the form of increases in domestic prices and wages, which may be associated with increasing difficulties for many exporters. But efforts to counteract this effect could jeopardise current stabilisation efforts, make imports of important investment goods too costly, and, for the medium-term, distort investment decisions that are based on an erroneous assessment of comparative advantage.

State subsidies to enterprises should no longer be channelled through commercial banks

One important key to the creation of sound incentives in the banking sector is that state subsidies to enterprises, to the degree that they are maintained, should no longer be channelled through commercial banks. If the portfolios of commercial banks remain saddled with non-performing loans representing implicit subsidies, these banks will continue to link their solvency with that of the loss-making firms that they are being pressed to support, implying a fundamental distortion in incentives. The idea that subsidies channelled through commercial banks are less costly to the state than direct subsidies is an illusion. The opposite is true, as the former implies a distortion in bank incentives along with the cost of the subsidy. The elimination of implicit subsidisation through commercial credit is also an essential condition of a currency board arrangement.

It is important to improve the climate for foreign investment...

The crisis of 1996 has made the attraction of foreign investment an even more critical objective for the recovery and development of the Bulgarian economy. The virtual collapse of the domestic capital market greatly increases the relative value of foreign capital. Furthermore, foreign investors and financial institutions can promote the development of corporate governance, which is vital to successful restructuring and the future development of capital markets in Bulgaria. Bulgaria already possesses quite liberal laws associated with foreign investment. But much needs to be done to improve the actual environment for foreign investors. The Bulgarian government should work hard both to streamline the current procedures that foreign investors must confront, and, most importantly, to develop a strong reputation for upholding the spirit and content of previous implicit or explicit contractual agreements. Changing circumstances may often appear to favour unilateral changes in existing contractual conditions and the regulatory environment. But this practice can have a very damaging effect on the incentives for investment, as appears to have been the case in recent years in Bulgaria.

... and continue the acceleration of the privatisation process

Opportunities for increasing foreign investment lie with the continued acceleration of the privatisation process. Sales to foreign investors can not only provide much needed short-term financial relief for the government, but can play a vital role in the further restructuring and development of the Bulgarian economy. Together with this, privatisation to domestic owners can aid the depoliticisation of subsidy policies and directly enhance economic incentives.

Agricultural markets should be liberalised and the land restitution process should be completed

Agriculture has suffered greatly from severe price and export regulations. These policies, together with the difficult and costly process of obtaining titles for restituted land, have depressed incentives, decreased output, and slowed the development of land markets. Particularly in the light of the fragmentation and dispersion in ownership that is resulting from the restitution process, the development of markets for the sale and leasing of land are critical to the revival of agriculture. Along with a relaxation of price and trade regulations and easier access to land titles, the process of land restitution should be completed as soon as possible in order to create and defend well-defined property rights in agriculture.

In summary, Bulgaria’s policies in the 1990s have lacked consistency and continuity, and the present crisis necessitates profound efforts in stabilisation and reform. The proposed currency board arrangement is in no sense a quick fix; it is an approach that will have to be persevered with in the face of possibly heavy adjustment costs. But, in present circumstances, it is an approach that not only offers the prospect of stabilisation, but also provides a framework to pursue the comprehensive programme of fiscal and structural policy reform needed to underpin Bulgaria's economic future. Such a programme requires support from the international financial community, but more important, it calls for a strong consensus for reform and a commitment to pursue it on behalf of Bulgaria itself.

I. The Bulgarian economy: a macroeconomic overview

Introduction

Even relative to most other eastern European countries, Bulgaria began its economic transition to a market economy under a very difficult set of circumstances. When market reforms were already beginning to transform some countries such as Poland and Hungary, the Bulgarian economy continued to operate largely on the basis of an administrative allocation of resources and state ownership of economic organisations. In addition, more than any other country, Bulgaria was oriented toward the CMEA market, the ratio of imports and exports on this market to GDP being over 60 per cent on the eve of the collapse of COMECON. Consequently, the collapse of this market had a devastating impact on Bulgaria, contributing to large initial declines in GDP and increases in unemployment. The former orientation toward the CMEA market necessitates a fundamental restructuring of production at a time when domestic capital is exceedingly scarce, and foreign capital difficult to attract. During the economic downturn of 1990, Bulgaria suspended the servicing of its foreign debt, at the time comprising well over 100 per cent of GDP, which had accumulated through years of trade deficits and borrowing from the West, mostly during the economic stagnation of the 1980s.

After a series of bold measures toward liberalisation in the early 1990s, documented in the first OECD Economic Assessment of 1992, the Bulgarian Economy has undergone important institutional and economic changes. Significant strides have been made toward building a market economy, based upon legislation largely consistent with Western practices and featuring a high volume of trade with OECD countries. The private sector, comprised primarily of new firms that emerged in the 1990s, is now responsible for close to 50 per cent of value added.

But the transition process in Bulgaria has witnessed a high degree of instability and lack of decisiveness in economic policy. No less than seven successive governments have ruled the country between the fall of former Communist Party leader Todor Zhivkov in 1989 and 1996. While every government has retained a general commitment to economic transition, important controversies surrounding such issues as privatisation, subsidies, co-operation with IFIs, and foreign investment, have been reflected in rapidly changing economic regulations and policy priorities. Partly as a result of this, decisive measures to deal with loss-making enterprises and banks, the privatisation of state assets, and the attraction of foreign investment have been delayed. As of mid-1996, little progress had still been made in any of those areas. The cost of these delays, together with pressure from the social sphere associated with substantial declines in income, high unemployment, and high rates of exit from the labour force, have exerted enormous pressure on limited state resources.

In this context, the goal of macroeconomic stabilisation has proved elusive. Growing financial losses in Bulgarian firms and the banking sector have been echoed in rapidly-accumulating domestic debt, payment arrears, and the continual refinancing of distressed commercial banks. The unsustainability of these trends has contributed to the destabilisation of expectations, giving rise to a highly volatile demand for money and several speculative attacks on the currency. The ability of the Bulgarian National Bank to defend the currency has been limited by a weak current account position, low external funding, and substantial requirements in foreign debt service. This has created an unstable macroeconomic environment, where periods of apparent progress towards lower inflation have been interrupted by bursts of very rapid inflation and currency depreciation. Beginning in late 1995, additional instability emerged from a loss of confidence by the population in increasingly-distressed commercial banks. This escalated into massive bank runs, precipitating an overall financial crisis in 1996.

GDP and output growth

Along with the collapse of CMEA trade and the initial shock of transition, Bulgarian GDP contracted by roughly 25 per cent between 1989 and 1992. Declines in industry were the highest. While a few sectors began to show signs of

Table 1. **Overviews and projections**

	1993	1994[1]	1995	1996[2]	1997[3]
GDP (growth in %)	–1.5	1.8	2.1	–9.0	–6
Consumption (growth in %)	–3.6	–4.5	–2.9	–3.6	–3
Fixed capital investment (growth in %)	–17.5	1.1	8.8	–27	–7
Inflation (CPI Dec./Dec. in %)	64	122	33	311	2 000
Registered unemployment (%)	16.4	12.8	10.8	12.5	14
Consolidated government budget (in % of GDP)					
Revenues	37	40	36	31	31
Expenditures	48	46	42	42	39
of which:					
Non-interest	39	32	28	22	22
Interest	9	14	14	20	17
Balance	–11	–6	–6	–11	–8
Trade balance (US$ million)[4]	–885	–17	121	180	280
Current account balance (US$ million)	–1 098	–32	–26	0	100

1. As the NSI began excluding holding gains from GDP figures only in 1994, the figures from 1994 are not exactly comparable to 1993 figures. If holding gains are included in 1994 GDP estimates, the budget revenue share becomes 38 per cent and the expenditure share 44 per cent, generating a 6 per cent deficit.
2. Preliminary.
3. Projections; the outcomes, especially those for inflation and the government budget, depend greatly on if and when a currency board will be introduced in 1997.
4. Reported on a fob-fob basis.

Source: National Statistical Institute (NSI); Ministry of Finance; Bulgarian National Bank (BNB).

recovery in output in 1993, a severe drought contributed to a 20 per cent decline in agriculture in that year, such that overall GDP continued to contract. 1994 and 1995 witnessed a modest revival of GDP growth, along with a notable strengthening of the current account. But substantial economic decline appears to have resumed during the financial crisis of 1996. Reported moderate growth in 1994 and 1995 came from two primary sources: *a)* large export-oriented firms, predominantly in the state sector; and *b)* a growing private sector that is concentrated mostly in services, trade, agriculture, and construction.

As indicated in Table 3 aggregate consumption has followed a steady decline of 3-4.5 per cent a year between 1992 and 1996. During the years of sharp output decline, consumption appears to have been buffered somewhat by a drop in the share of investment in GDP. By national accounts data, an important part of the 2.1 per cent GDP growth in 1995 comes from a renewal in fixed capital investment (8.8 per cent annual growth).[2] This came after a dramatic fall in investment before 1994. As can be seen in Table 4, important sources of the revival of growth in 1994 and 1995 include export-oriented industrial branches,

Table 2. **Components of gross value-added**

In percentage, current prices

	1992	1993	1994[1]	1995[1]
Total GDP	100.0	100.0	100.0	100.0
Agriculture	12.0	10.6	12.4	13.9
Industry	34.4	29.2	27.3	28.4
Construction	6.1	5.8	5.2	5.2
Services	47.5	54.4	55.1	52.5

1. Excluding holding gains.
Source: NSI.

Table 3. **GDP growth by final expenditure categories**

In percentage

	1992	1993	1994	1995
Final consumption	–3.1	–3.6	–4.5	–2.9
Individual consumption	–2.4	–2.9	–4.4	–2.9
Households	1.0	–0.7	–2.6	–1.8
Non-profit institutions	9.2	–15.9	11.6	39.3
Government	–18.6	–15.0	–16.9	–13.8
Collective consumption	–9.3	–9.3	–5.6	–2.1
Fixed capital investment	–7.3	–17.5	1.1	8.8
Changes in inventories	–26.0	–32.5	–72.4	–88.7
Net exports and discrepancy	–58.6	–96.2	–98.5	18.8
Total GDP	–7.3	–1.5	1.8	2.1

Source: NSI; OECD.

such as chemicals and metallurgy, as well as branches where the private sector is becoming dominant. Growth in agriculture in both 1994 and 1995 represents mostly a recovery from the disastrous year of 1993, with output in 1995 only recovering to roughly 1992 levels.

A central question concerns the degree to which the pattern and sources of renewed growth in 1994 and 1995 could be seen as the emergence of forces that could sustain continued, or accelerating, growth in years to come, albeit with an interruption due to the financial turmoil of 1996; or whether, on the contrary, the 1994-1995 recovery was itself not soundly based, and set the stage for the instability that followed. The evidence on this point, which is reviewed in

Table 4. **Growth of gross output by sector**

	Real indices of output				Branch output as share of total output
	1992	1993	1994	1995	1995
	Previous year = 100				%
Industry – Total	83.0	88.2	107.8	109.8	41.2
Electrical and thermal power	82.3	88.4	96.9	105.7	3.1
Coal	95.9	99.3	96.6	108.2	0.7
Oil and gas extraction	98.9	151.1	110.2	155.0	0.1
Ferrous metallurgy, incl. ore extraction	56.3	128.8	124.9	116.0	2.7
Non-ferrous metallurgy, incl. ore extraction	98.5	113.9	111.0	104.0	2.4
Mechanical engineering and metal processing	78.3	79.9	96.3	114.4	4.4
Electrical and electronics	67.7	94.5	95.6	113.2	2.1
Chemical and oil processing, incl. rubber	83.4	88.6	137.1	121.7	9.9
Building materials	80.6	100.1	115.5	107.4	1.1
Timber and wood processing	88.1	91.5	111.4	100.4	1.3
Pulp and paper	90.4	89.4	112.4	120.0	0.8
Glass, china and earthenware	82.5	95.9	123.1	107.7	0.6
Textile and knitwear	87.7	82.9	102.9	99.7	1.5
Clothing	89.3	91.3	112.6	87.5	0.7
Leather, fur and footwear	90.2	85.2	102.7	90.2	0.6
Printing and publishing	83.1	126.5	112.9	85.3	0.6
Food	88.8	73.4	98.8	104.3	8.1
Other industrial branches	129.9	113.9	61.4	80.5	0.5
Construction	103.0	91.3	93.3	104.4	5.3
Agriculture	93.7	80.6	107.1	116.0	12.7
Crops	100.2	73.7	121.7	121.9	5.8
Livestock	97.3	92.0	93.5	110.7	6.1
Agricultural services	73.4	80.6	121.5	119.2	0.6
Other	46.3	45.2	86.4	100.3	0.2
Forestry	110.3	94.6	93.0	114.8	0.2
Transport	105.6	103.6	106.2	117.1	6.2
Communication	100.0	105.2	101.0	132.4	1.1
Trade	94.4	99.5	105.0	105.1	8.7
Business services	87.8	194.7	109.8	100.4	1.9
Unincorporated activities	120.9	97.9	103.6	100.0	2.6
Material sphere	89.1	91.0	105.9	110.3	**79.9**
Housing, public utilities and amenities	93.0	101.1	100.4	100.3	7.6
Imputed rents of owner-occupied dwellings	99.2	100.0	95.0	102.3	5.4
Housing, excl. imputed rents	78.3	104.2	116.7	95.8	2.2
Science	81.4	70.8	71.5	74.9	0.3
Education	97.5	92.3	82.0	88.7	1.8
Culture and arts	103.3	96.6	89.8	96.3	0.4
Health, social welfare [1]	96.7	87.6	85.5	89.7	2.2
Finance, credit and insurance	34.3	83.4	130.8	87.8	4.0
Government	97.9	93.7	97.5	108.7	3.7
Other non-material branches	110.5	83.9	91.8	125.2	0.1
Non-material sphere	72.8	91.7	99.7	96.1	**20.1**
Total branches	86.2	91.1	104.6	107.3	**100.0**

1. Including physical culture, sports and tourism.
Source: NSI.

Chapter IV, is somewhat mixed. While the analysis of that chapter is consistent with at least some successful restructuring among leading export-oriented industrial firms, it is also true that exporters have operated under conditions of an undervalued currency, loose credit, payment arrears, and energy subsidies. At a minimum, it is concluded that the medium-term sustainability of the present export structure, with its high dependence on energy-intensive sectors such as chemicals and steel, is highly unlikely. New private firms have undoubtedly filled many important gaps in the economy in services and trade, while expanding their activities in industry as well. But the continuing ability of many of these firms to exploit various arbitrage opportunities at the expense of the state makes an analysis of their contribution to potentially sustainable growth very difficult.

Foreign trade and the current account

The Bulgarian economy continues to be oriented toward a high volume of foreign trade. Despite the impact of the collapse of COMECON on trade volume in the early 1990s, foreign trade turnover has climbed back to roughly 80 per cent of GDP in 1995.[3] Increases in exports played a key role in the revival of moderate output growth in 1994 and 1995.[4] They have also been associated with an important strengthening of the current account, which had become quite weak by 1993, as shown in Table 5.

The dramatic devaluation of the lev in March 1994 provided an important spark for export-led growth. Along with other favourable changes for exporters, this devaluation contributed to an approximate 20 per cent decrease in the dollar value of average wages (in the state sector)[5] in the first half of 1994. As indicated in Figure 1, the decline in dollar wages in 1994 improved Bulgaria's competitiveness relative to most other central and eastern European countries:

After a 5.8 per cent decline in 1993 relative to 1992, the dollar value of Bulgarian exports grew by an estimated 43.4 per cent in the two-year period of 1994-1995, while imports grew by 13.2 per cent in the same period. This moved a trade balance of US$–885 million in 1993, to –17 million in 1994, and +121 million in 1995.[6] A marginally positive trade balance was apparently maintained under conditions of a falling trade turnover in 1996. Due primarily to the demands of foreign debt service, which resumed in 1994 under a major rescheduling agreement,[7] the current account has remained marginally negative, despite the positive trade balance.

Table 5. **Current account**

Million US$

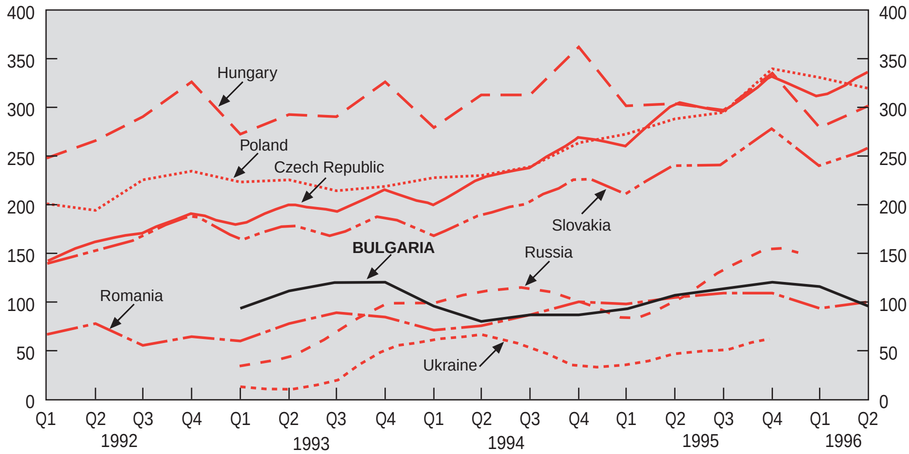
	1991	1992	1993	1994	1995	Jan-Sept. 1996[1]
Current account	–77.0	–360.5	–1 097.9	–31.9	–25.6	–33.7
Goods, services and income, net	–146.1	–403.3	–1 134.8	–198.6	–157.6	–128.2
Credit	4 192.4	5 151.3	4 990.6	5 276.5	6 926.2	4 447.3
Debit	–4 338.5	–5 554.7	–6 125.4	–5 475.1	–7 083.8	–4 575.5
Goods, net[2]	–32.0	–212.4	–885.4	–16.9	121.0	131.8
Exports[3, 4]	3 737.0	3 956.4	3 726.4	3 935.1	5 345.0	3 337.2
Imports[3]	–3 769.0	–4 168.8	–4 611.9	–3 952.0	–5 224.0	–3 205.4
Services, net	–85.9	–95.4	–57.1	10.8	153.4	122.0
Credit	399.9	1 069.8	1 171.5	1 256.8	1 431.5	993.2
Debit	–485.8	–1 165.2	–1 228.7	–1 246.0	–1 278.0	–871.2
Income, net	–28.1	–95.6	–192.3	–192.5	–432.0	–382.0
Credit[5]	55.6	125.1	92.6	84.6	149.8	116.8
Debit[5]	–83.7	–220.7	–284.9	–277.2	–581.8	498.9
Current transfers, net	69.1	42.9	36.9	166.7	132.0	94.5
Credit[6]	123.4	114.1	285.9	357.1	256.9	183.5
Debit[6]	–54.3	–71.2	–249.0	–190.4	–124.9	–89.0

N.B.: In accordance with the IMF 5th edition of the ''Balance of Payments Manual''.
1. Preliminary.
2. Customs data supplied by NSI; revised 1995 and 1996 figures supplied by the Ministry of Finance Computing Centre and adjusted by BNB; exports and imports f.o.b.
3. Includes transportation estimated by BNB.
4. Includes tourist data provided by NSI and estimated by BNB.
5. Data on a cash basis; since 1995, interest payments are on a due basis.
6. Based on data provided by the Foreign Investment Agency.

Source: BNB, Economic and Monetary Research Department, Balance of Payments and External Debt Division.

Fairly liberal legislation has promoted the growth of foreign trade. Import duties have had a maximum rate of 40 per cent and an average rate of 17 per cent since 1992. Although export quotas have been used from time to time, relatively few industrial goods are subject to such restrictions. Restrictions on agricultural goods have been more substantial. During 1994-1995, export quotas and bans were imposed at certain times on wheat, barely, and sunflower.[8] Quotas on tariff-exempt exports for ferrous metals, meat, and textiles to the European Union (EU) do not appear to have been binding constraints. Under the 1993 Association Agreement with the EU, Bulgaria has duty-free access to the EU for exports of industrial goods, but still suffers from restrictions on agricultural products. Except for limited cases (19 products in 1995),[9] no special licenses are required for firms to engage in transactions with foreign partners. Bulgaria achieved

Figure 1. **NOMINAL DOLLAR WAGES[1] IN SELECTED TRANSITION COUNTRIES**



1. Total monthly wages, except Bulgaria (public-sector wages).
Source: Polish Central Statistical Office; NSI; OECD.

current account convertibility (IMF Article 14) rather quickly, and Bulgarian firms are not subject to any regulations regarding the surrender of foreign exchange. Nevertheless, Bulgarian exporters continue to stress the instability of foreign trade regulations with respect to various export taxes, licenses, and quotas as a major impediment to the expansion of their activities.[10]

A growing share of Bulgarian trade has been oriented to OECD countries, which now account for roughly half of all imports and exports. Russia remains Bulgaria's single largest trading partner and primary supplier of important energy imports. In recent years, CIS countries (mostly Russia) have accounted for roughly 80 per cent of the share of imports and 50 per cent of the share of exports to central and eastern European countries, as reported in Table 6.[11] The change in trade orientation has been accompanied by a large shift in the composition of exports, with sharp falls in exports from machine-building and electronic equipment being compensated by growth in branches such as chemicals and metallurgy (see Table 7). This reflects the continued low competitiveness of Bulgarian manufacturing.

Table 6. **Foreign trade partners: exports and imports**

Percentage

	1990	1991	1992	1993	1994	1995[1]
Exports to						
OECD countries	9.0	26.3	42.4	43.2	47.6	51.2
Central and East European countries	80.2	57.7	39.2	35.1	35.6	33.1
Other countries	10.8	16.0	18.4	21.7	16.8	15.7
Total	100.0	100.0	100.0	100.0	100.0	100.0
Imports from						
OECD countries	14.9	32.8	43.8	44.8	46.6	46.9
Central and East European countries	75.9	48.4	36.3	36.6	41.2	42.6
Other countries	9.2	18.8	19.9	18.6	12.2	10.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

1. Preliminary.

Source: BNB, *Annual Reports*, 1994, 1995.

Table 7. **The composition of exports**

Percentage

	1990	1991	1992	1993	1994	1995
Total	100.0	100.0	100.0	100.0	100.0	100.0
Industry	93.2	95.1	92.9	96.9	95.3	94.5
Electricity, steam and hot water production	1.5	2.6	0.1	0.5	0.3	0.5
Coal mining	. .	. .	0.0	0.0	0.0	0.0
Ferrous metallurgy[1]	1.6	3.5	7.6	10.2	11.7	10.9
Machine building and metal working	31.5	17.8	13.6	13.0	13.1	11.5
Electrical and electronics	26.3	12.7	6.9	5.7	5.2	3.9
Chemicals and plastics manufacture	10.1	27.9	22.4	26.3	26.3	25.9
Building materials	0.5	0.7	1.5	1.4	1.7	1.7
Logging, wood and wood products manuf.	0.8	1.6	2.7	3.2	3.1	2.6
Cellulose, paper and paper products manuf.	0.2	0.4	0.7	0.8	1.1	1.3
Glass and glass products, china and earthenware manuf.	0.2	0.5	0.7	0.7	0.9	1.1
Textiles and knitwear	1.4	3.0	3.3	3.4	3.7	3.3
Wearing apparel manufacture	1.6	1.1	3.3	3.3	3.0	3.2
Leather, fur and footwear	0.8	0.9	2.6	3.0	2.9	2.5
Printing	0.1	0.1	0.1	0.0	0.1	0.1
Food, beverages and tobacco	12.4	18.4	18.6	17.3	17.4	16.9
Other (incl. fuels and non-ferrous metallurgy)[2]	4.2	3.9	8.8	8.1	4.8	9.1
Agriculture	2.7	3.5	7.1	3.1	4.7	4.9
Crops	2.2	2.5	4.3	1.8	3.2	4.3
Livestock	0.5	1.0	2.8	1.3	1.5	0.6
Other	4.1	1.4	0.0	0.0	0.0	0.6

1. Includes ore mining.
2. Not reported separately by the NSI.

Source: NSI, *Statistical Yearbook 1995,* p. 308; *Statisticheski Spravochnik 1996;* OECD.

The embargo against the Federal Republic of Yugoslavia may have had an important impact on Bulgarian foreign trade. Its disruptive effect could have contributed to the substantial weakening of the trade balance in 1993. The Bulgarian government estimates the ‘‘minimum losses’’ for Bulgaria between July 1992 and July 1995 from the embargo to be US$8.5 billion. But the assessment of actual losses is quite complicated. By 1994, the Republic of Macedonia had officially become one of Bulgaria’s largest trading partners. It could even be argued that, in certain cases, the embargo might have helped provide some Bulgarian exporters with exclusive markets.[12] Nevertheless, it is quite likely that the impact of the embargo, including the costs of adjustment, has been negative on Bulgarian trade overall.

Inflation and financial instability: the crises of 1994 and 1996

While most other transition economies in Central and Eastern Europe have exhibited steady progress in stabilisation, Bulgaria continues to experience substantial instability and bursts of high inflation (see Table 8). After being reduced to under 5 per cent between June 1993 and February 1994, monthly inflation in March and April 1994 jumped to 7.5 and 21.7 per cent, respectively. After some additional turbulence in 1994, inflation slowed considerably in 1995, with monthly rates falling under 3 per cent for almost every month between April 1995 and April 1996.[13] But inflation rapidly accelerated to 12.5 per cent in May and over 20 per cent in each of June and July, remaining in double digits for almost every remaining month of 1996, driving December/December yearly inflation to 311 per cent. Such an atmosphere of high and variable inflation is, of course, very damaging to the Bulgarian business environment, making effective long-term contracting excessively difficult, costly, and risky.

The causes of these recurring bursts of high inflation in Bulgaria are complex. Difficult initial conditions and problems in structural reform, mirrored in escalating domestic debt and an accumulation of financial losses in the banking sector, have undermined confidence in the economy and, together with difficulties in imposing controls on capital flows and foreign exchange transactions, contributed to a fundamental instability in the demand for money. As discussed in more detail in Chapter II, the initial signs of instability in the latter months of 1993 and 1995, which led into the financial crises of the following years, did

Table 8. **Consumer price inflation in selected transition countries**

December-on-December percentage increase

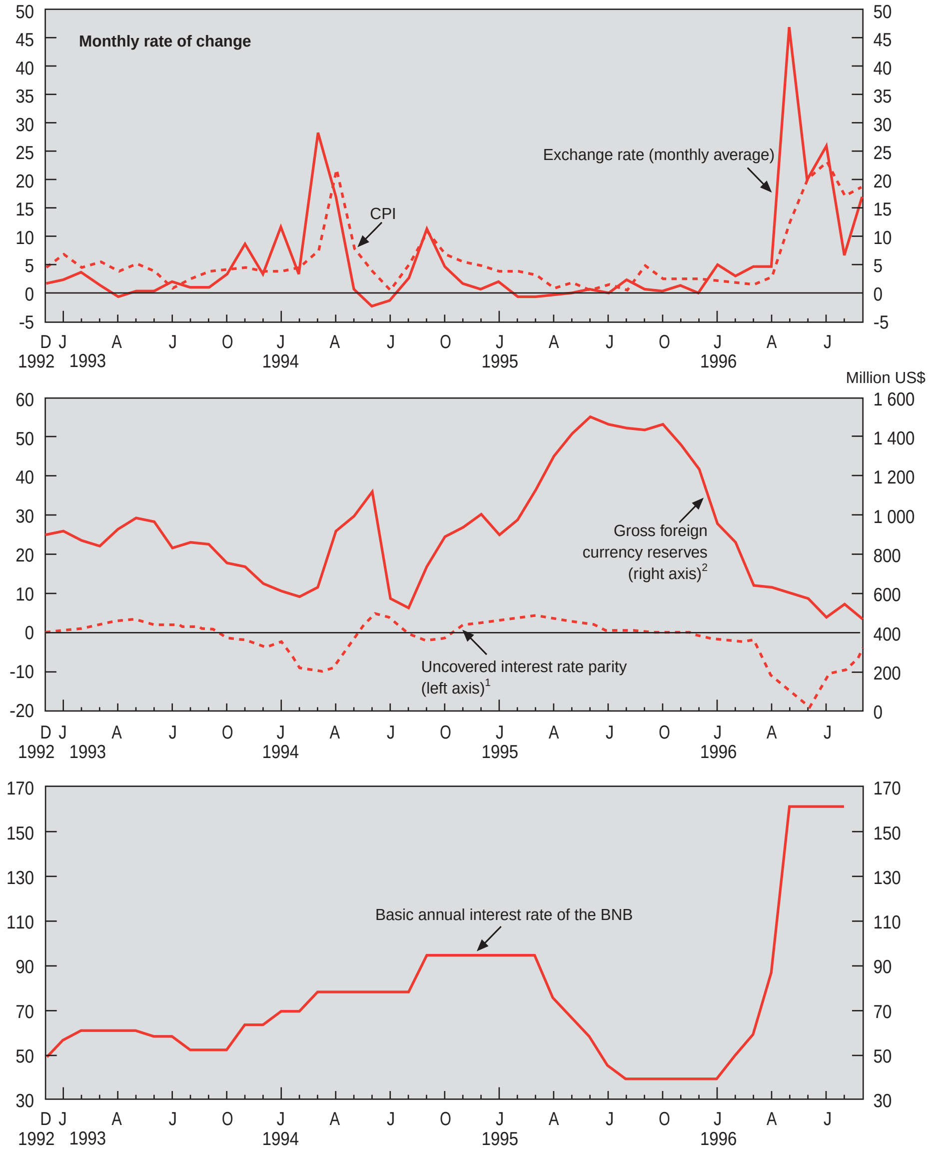
	1990	1991	1992	1993	1994	1995	1996[1]
Bulgaria		**473.7**	**79.5**	**63.9**	**121.9**	**32.9**	**311**
Czech Republic			12.5	20.8	10.0	9.1	9
Hungary	33.4	32.2	25.0	21.1	21.2	28.3	20
Poland		60.3	44.4	37.7	29.5	21.6	19
Romania		222.8	199.2	295.0	62.0	28.0	45
Slovakia		58.3	9.1	25.1	11.7	7.2	5
Slovenia	100.2	241.1	94.5	22.8	19.5	9.0	10

1. Preliminary and projections.
Source: NSI; OECD.

not derive from an acceleration in the growth of money supply. Ironically, in both cases, instability followed decisions by authorities to reduce the basic (central) interest rate in order to bring it in line with *lower* expected inflation and monetary growth. While some subsequent monetary growth did play a role in both crises, this role was secondary to shifts in money demand. In fact, much of the anatomy of both crises can be grasped through the examination of Figure 2, which plots the joint evolution of CPI inflation, the monthly change in the exchange rate, the foreign exchange reserves of monetary authorities, the basic interest rate of the Bulgarian National Bank (BNB), and an estimate of uncovered interest parity, shown as the *ex post* US$ return on BGL time deposits. Institutional arrangements are such that virtually all financial contracts in Bulgaria are indexed to the basic interest rate of the BNB.

As monthly inflation slowed in the first half of 1993 under an average effective basic annual interest rate of 60 per cent, the relative return on lev-denominated assets began to grow.[14] Authorities responded to lower inflation by decreasing the basic rate on two occasions between August and October, bringing it down to 52 per cent. At the same time, monthly inflation steadily picked up from 1 per cent in July to 4.2 per cent in October, due in part to seasonal factors. The implied reduction in the expected return to lev-denominated assets appears to have triggered a portfolio shift of the population and investors. This is illustrated in Figure 2 by the decline in foreign exchange reserves, which were used by monetary authorities to support the value of the lev. As this process continued, authorities eventually became alarmed and raised the basic rate, first to 63 per cent in November and then to 69 per cent in January 1994. They also allowed

Figure 2. **MACROECONOMIC INSTABILITY**
In percentage



1. The *ex post* monthly US$ return on BGL-denominated time deposits; 3-month moving average.
2. Gross foreign currency reserves include BNB foreign currency assets on current accounts and deposits with banks abroad, holdings in SDRs and Bulgaria's reserve position with the IMF.

Source: BNB, *Monthly Bulletins* 1993-1996; OECD.

some limited depreciation of the currency. But, given the magnitude of the depletion of reserves and the knowledge that authorities could not prop up the value of the lev much longer, expectations had apparently already become too destabilised for the decline in money demand to be reversed. Adding fuel to this fire was the pending debt-rescheduling agreement that was to require an up-front payment of over US$700 million. The BNB finally gave up defending the lev in March, leading to an immediate devaluation of the currency by almost 30 per cent in that month, and another devaluation of 17 per cent in April. This was followed by rapid inflation and continual instability until the latter months of the year.

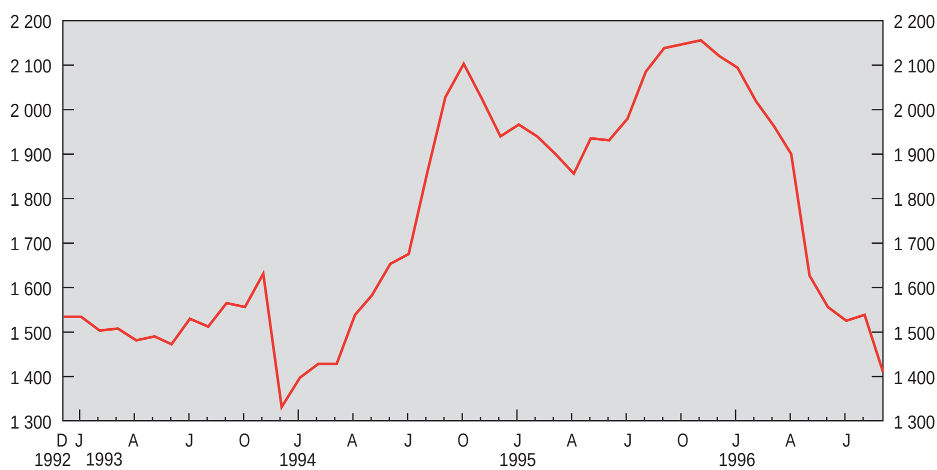
As highlighted below, the crisis of 1996 was distinguished from 1994 in featuring a simultaneous loss of confidence in commercial banks, along with the lev. Under these circumstances, an acceleration in the refinance of distressed banks also exerted considerable downward pressure on the lev from the supply side. But the sequence of events on the foreign exchange market, leading into the crisis of 1996, still bears a striking resemblance to that of 1994, only in magnified proportions. In early 1995, with the basic rate fixed at 98 per cent and unexpectedly low monthly inflation of below 4 per cent, the expected premium on lev-denominated assets became very high. Under these conditions, a dramatic increase in demand for the lev was reflected in its real appreciation against the dollar, and in the very rapid accumulation of foreign exchange reserves, shown in Figure 2. This led to new attempts by authorities to bring the interest rate down quickly in line with inflation. Much of the pressure for this move came from a growing fiscal deficit due to low revenue, associated with lower-than-expected inflation, and domestic debt service, indexed to the basic rate, which was increasingly dominating expenditures. In a series of successive moves, authorities decreased the basic rate from 98 per cent in March 1995 all the way to 39 per cent by August.

As seen in Figure 2, this unprecedented decrease in the basic rate essentially brought an end to uncovered interest parity that favoured the lev. A strong portfolio shift away from the lev, associated with the big drop in foreign exchange reserves shown in Figure 2, began as early as October 1995. Perhaps confident, due to monthly inflation below 3 per cent, the revival of moderate GDP growth, an improvement in the current account, and an initial high level of reserves, authorities did not attempt to counter this trend with an increase in the basic rate until February 1996.[15] By this time, foreign exchange reserves had declined to levels comparable to the crisis of 1994. The absence of a successful agreement to renew financial support from the IMF in the fall of 1995, together with the prospect of more than US$1 billion in external debt service due in 1996, probably also contributed to the destabilisation of expectations. As in the dress rehearsal of 1994, despite even more valiant attempts to boost money demand by increasing the basic rate, expectations that the BNB could not hold on much longer in the foreign exchange market became self-fulfilling, ending in the sharp depreciation of May 1996, and subsequent inflation that exceeded 20 per cent a month.[16]

Not only was the magnitude of the instability greater in 1996 than in 1994, but the crisis of 1996 also took on a new qualitative dimension. Simultaneous with a loss of confidence in the lev in 1996 came a loss of confidence in commercial banks. This difference between 1994 and 1996 is highlighted dramatically in Figure 3. The portfolio shift away from the lev in 1994 actually featured the rapid accumulation of hard currency deposits in commercial banks, whereas, in 1996, such deposits were (if possible) withdrawn.

Figure 3. **FOREIGN CURRENCY DEPOSITS IN BULGARIAN BANKS**

US$ million



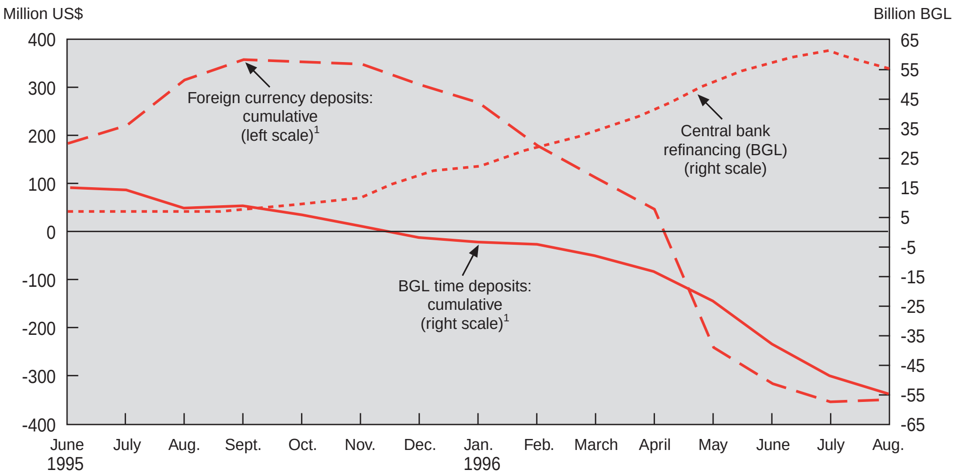
Source: BNB, *Monthly Bulletins* 1993-1996.

The loss of confidence of the population in commercial banks, beginning in the second half of 1995, derives from several factors. First, as shown in Chapter III, 1995 witnessed a substantial deterioration of the banking sector, due in part to a large increase in the share of non-performing credit in bank assets. The net worth of the banking sector (excluding one special bank) became highly negative by the end of the year. In addition, in the absence of prudential regulations on foreign exchange positions, many commercial banks had shifted into (higher yielding) lev-denominated assets in early 1995, while continuing to hold significant hard currency deposits. As the relative return on lev-denominated assets decreased, due to indexation to the basic rate, the ability of many banks to service these deposits became difficult. Third, until December 1995, explicit state deposit insurance did not yet exist, while a proposal for a new bankruptcy law for banks was being actively considered in the government. Finally, the confidence of the population in domestic financial institutions must have been shaken by the successive collapse of a number of financial pyramid schemes in mid-1995.

Rumours began to spread in late 1995 concerning problems of commercial banks in servicing their liabilities, particularly hard currency deposits. This prompted the beginning of withdrawals. From this point on, the crisis began to unravel almost like a vicious circle. The withdrawals further distressed the commercial banks, depriving them also of much-needed liquidity. The BNB responded with an acceleration in the refinancing of commercial banks in an attempt to prevent an overall collapse of the banking system. As seen in Figure 4, this increase in refinance directly mirrored the withdrawal of deposits. This monetary expansion, in turn, further exacerbated the situation in the foreign exchange market, essentially causing authorities to absorb the additional lev liquidity that they themselves were creating through the even more rapid depletion of reserves. The alarming decline in reserves, together with the knowledge that authorities were pursuing two mutually-inconsistent policies at this point, further destabilised expectations. Furthermore, the decline in foreign currency reserves compromised the credibility of any possible attempts by the state to guarantee hard currency deposits.

Ironically, the decision by the BNB to offer explicit deposit insurance in December 1995 may have also adversely affected expectations. Announced specifically as a preparatory measure to carry out future bank liquidations, the insurance offered in December was only partial, covering the first 50 000 leva by 100 per cent and the next 50 000 leva by 50 per cent. A large part of the

Figure 4. **NET INFLOWS OF BANK DEPOSITS AND NATIONAL BANK REFINANCING**



1. 1 January 1993 = 0.

Source: BNB; OECD.

population may have believed in implicit 100 per cent deposit insurance until that time. In response to growing panic, legislation of 8 March 1996 changed insurance to 100 per cent for the first 250 000 leva. The Law on Deposit Insurance, associated with the Action Plan of the Bulgarian Government of mid-1996,[17] further increased insurance to 100 per cent of all personal deposits (50 per cent for others). Due to the low foreign exchange position of the government, however, delays were unavoidably imposed on the access to hard currency deposits. But even the Law on Deposit Insurance did not sufficiently calm depositors, forcing the government into an increasingly difficult situation. Finally, in September 1996, Parliament passed an amendment that delayed the implementation of deposit insurance for banks placed into a state of ‘‘conservatorship (state of possible pending bankruptcy)’’ by the BNB. At this time, 14 banks had been placed in conservatorship.

Income, employment, and welfare

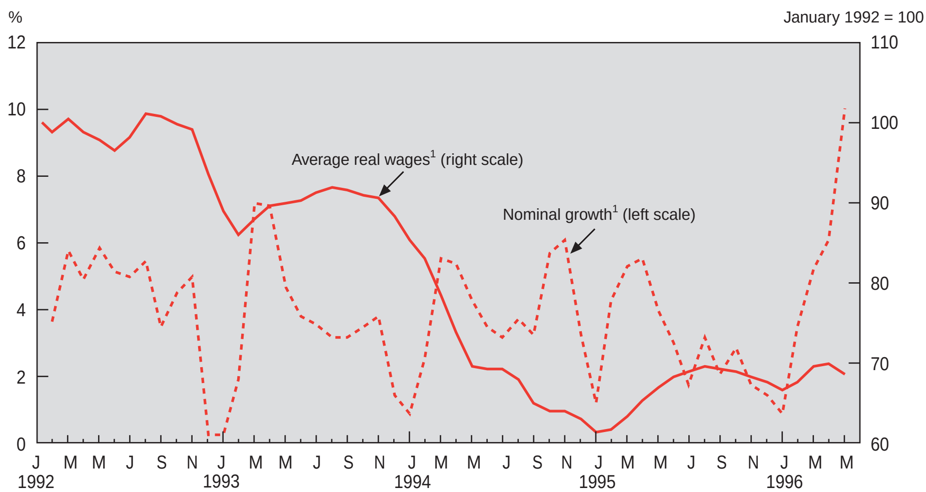
On the eve of economic transition, Bulgaria could boast a higher than average standard of living in the Eastern bloc, including the benefits of guaranteed employment and price subsidies on basic consumer goods. As in other relatively orthodox socialist countries, however, distorted prices, shortages, and repressed inflation (in the 1980s) must be factored into a complete evaluation of economic welfare. Like other socialist countries, Bulgaria also featured a high share of social expenditures in GDP, estimated at 11.4 per cent for cash transfers and 7.5 per cent for health and education in 1987. This compares to an average of 4.7 and 1.8 per cent, respectively, in middle-income developing countries.[18]

The costs of transition have been born by a large part of the Bulgarian population. First, state guarantees of economic security disappeared almost immediately, with unemployment escalating into double digits very quickly, while the real value of social expenditures decreased. Second, the fall in GDP has been accompanied by a decline in real income per capita, estimated by the National Statistical Institute (NSI) at close to 50 per cent for the period of 1989-1995.[19] The crisis of 1996 has brought further declines. Due to significant income and employment in the informal economy that is believed to be underestimated in the data and household surveys of the NSI, however, the declines in official figures on income and employment are likely to be exaggerated. Nevertheless, increasing poverty and hardship for a number of people is reflected in a deterioration of some demographic indicators. Infant mortality rates, for example, were brought down to below 15 per 1 000 births every year between 1986-1990, but averaged 16.2 between 1991-1994.[20] The number of yearly reported crimes has also more than tripled in the 1990s relative to the late 1980s.[21]

An initial sharp decline in income occurred after the release of repressed inflation from the liberalisation of 1991. After a partial recovery in 1992, wages declined considerably during 1993 and 1994, mostly due to inflation and incomplete indexation. In December 1994, real average wages in the public sector were 33 per cent lower than in December 1992. Real wages increased by an estimated 7 per cent in 1995 (December on December), due in part to the combination of lower-than-expected inflation and budgeted allotments that were fixed in nominal terms. The high inflation in 1996 has driven wages to a post-transition low.

Even according to household survey data that most likely underestimate non-wage income, the share of wages in average income has declined every year since 1990, moving from 56 per cent in 1989 to 38 per cent in 1995.[22] Despite the

Figure 5. **PUBLIC SECTOR WAGES**



1. Three-month moving averages.
Source: NSI; OECD.

increasing burden of unemployment benefits and pensions on the consolidated budget, the share of social expenditures in income has also declined from 21 per cent in 1989 to 17.2 per cent in 1995, while the shares of income from household plots and ''other'' sources have simultaneously increased.

Another steady trend in recent years has been the increasing polarisation in the distribution of income and wealth. On the basis of the household surveys of the NSI, estimated Gini coefficients, calculated from total household income, have moved steadily upwards from 21.7 in 1989 to 37.8 in 1995.[23] If this measure is reliable, it is higher than that of any OECD country.[24] Furthermore, the ratio of income received by the richest 20 per cent of the population relative to the poorest 20 per cent has climbed from 3.5 to 6.5, thereby surpassing Japan and most of the countries of Western Europe (Table 9). The distribution of income, as well as unemployment, exhibits a high regional variance in Bulgaria, with low income and high unemployment concentrated in depressed ''smokestack'' industrial regions, some agricultural regions, and areas with a high concentration of ethnic minorities.

Table 9. **Ratio of incomes of the wealthiest 20 per cent to the poorest 20 per cent of the population in selected countries**

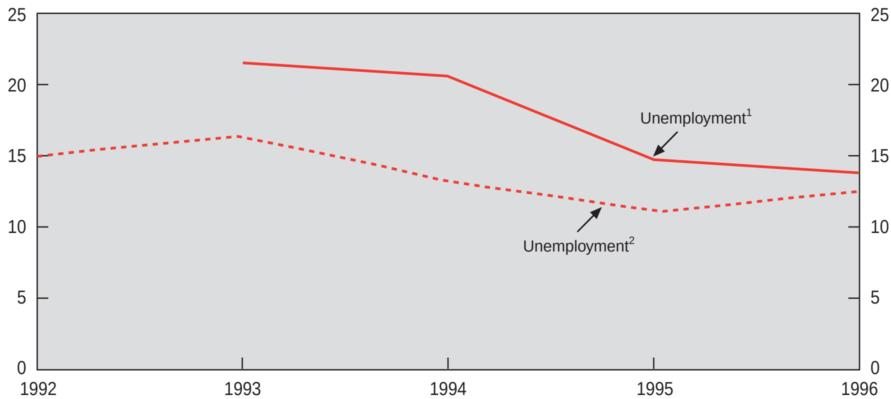
	1980-1992	1993	1994	1995
Bulgaria	**3.5**	**5.1**	**6**	**6.5**
Japan	4.3			
Belgium	4.6			
Sweden	4.6			
United Kingdom	9.6			
USA	8.9			
Germany	5.8			

Source: United Nations Development Project, *Human Development Report,* as reproduced in NSI (1996), *Sotsialno-ikonomichesko Razvitie Bulgaria 95,* p. 94.

Along with the shock of transition in 1991-1992, registered employment fell sharply by 19.5 per cent (from 4.1 million in 1990 to 3.3 million 1992).[25] Among other economies in transition, only Romania has also witnessed a comparable degree of swift labour-shedding. From 1993-1995, however, registered employment has remained quite stable at 3.2-3.3 million. During this time, employment in the state sector continued to decline by 15 per cent, but registration in the private sector increased by approximately the same number of workers (470 000). Employment in trade and services in the private sector has shown particularly high growth.[26]

Given the dynamic of registered employment, official unemployment statistics present somewhat of a puzzle. Beginning from virtual full employment, registered unemployment climbed rapidly to 15.3 per cent of the labour force in 1992, reaching a peak of 16.4 per cent in 1993. This implies that roughly 70 per cent of the employment shedding of this period showed up as registered unemployment. Subsequently, however, registered unemployment has fallen steadily every year, reaching 11.1 per cent in 1995 and a reported 10.0 per cent in mid-1996. Some studies suggest that this can be attributed to declining real unemployment benefits and limited eligibility for those benefits, which may have decreased the incentive for the unemployed to register . Yet, since 1993, on the basis of surveys that follow ILO methodology, the NSI has documented even a stronger declining trend, from 21.4 per cent in September 1993 to 14.7 per cent in October 1995 (see Figure 6), and 13.7 in November 1996. Given the fact that this

Figure 6. **UNEMPLOYMENT**
Percentage of labour force



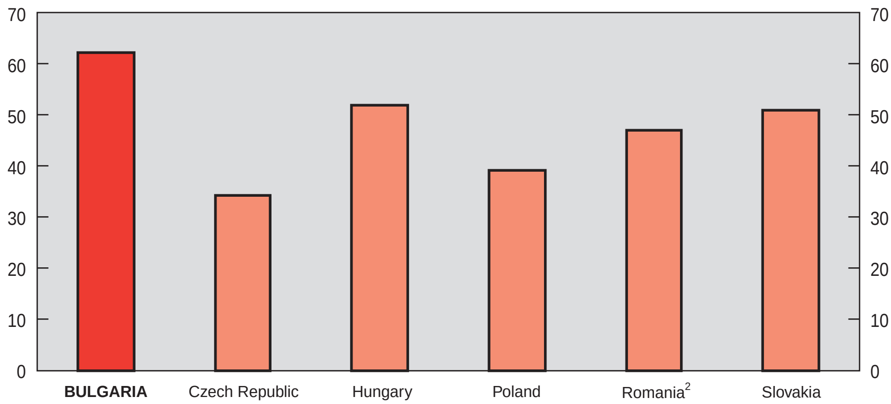
1. Labour force survey (ILO, only since 1993); November.
2. Registered; end-December.

Source: NSI; BNB.

decrease in unemployment is not reflected in new registered employment, it is most likely due to a combination of exit from the labour force and absorption by the large informal sector. On this subject, it should be noted that high social security taxes offer a strong incentive for employers not to register their employees, a strategy that is easier to realise for a small firm in the private (informal) sector. But part of the high exit rate from the registered labour force appears to be from workers between the ages of 50-59 (early retirement) and women.[27]

One striking feature of unemployment in Bulgaria, relative to other economies in transition, is its long duration. As illustrated in Figure 7, the majority of unemployment in Bulgaria is of over 12 month duration, which gives Bulgaria the unfortunate distinction of being the leader among the transition economies in this category. The relatively high number of long-term unemployed in Bulgaria derives from a number of problems in the economy, including the unfavourable initial structure of production, prolonged economic recession, and a slower creation of new jobs in the private sector.

Figure 7. **LONG-TERM UNEMPLOYMENT[1] AS PERCENTAGE OF TOTAL UNEMPLOYMENT**
1996 Q1



1. Over one year.
2. 1995 Q1.

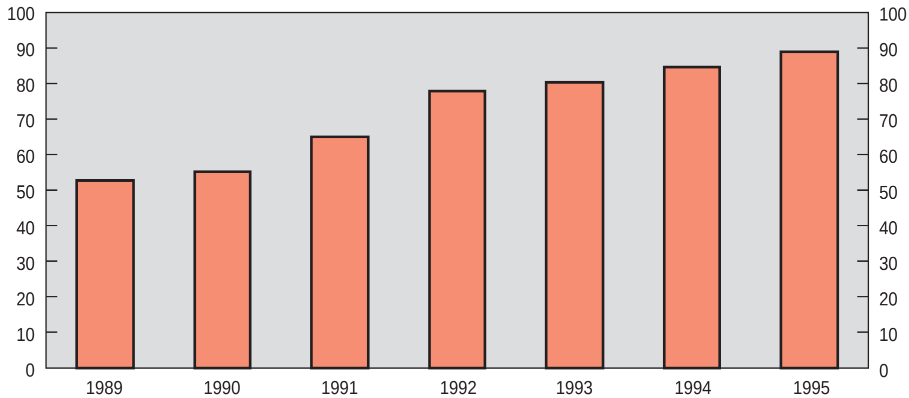
Source: OECD.

High rates of exit from the official labour force, including early retirement, has placed a great strain on the Bulgarian pension system in recent years. At a time when budgetary revenue has been declining as a share of GDP, the dependency ratio (the ratio of pensioners to contributors) in Bulgaria has escalated steadily from 55.1 per cent in 1990 to 89 per cent in 1995, due to both fewer contributors and more pensioners (Figure 8). High social security deductions from wages, as described above, have, in turn, created incentives not to register employment in the private (informal) sector. The social security system is also reportedly burdened by payments arrears, although exact data are not available. Consequently, the social security fund has experienced chronic deficits, and has had to be bailed out by the state budget on several occasions. Nevertheless, like wages, the average real value of social security benefits has declined by something on the order of 50 per cent from 1989 to 1995.

Health and education have also suffered in recent years. While expenditures in those areas are becoming a greater burden on the increasingly strained budget, the level of services has been deteriorating by most measures. While the decline in industrial activities has decreased its level somewhat, pollution remains generally high and a serious threat to human health in some areas of the country.[28]

Figure 8. **DEPENDENCY RATIOS**[1]

In percentage



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

Source: OECD, "Labour Force/Social Policy Survey of Bulgaria", as quoted in World Bank Social Challenges of Transition database.

Increasing economic hardship during transition creates a genuine dilemma for the Bulgarian government at a time when budgetary resources are increasingly scarce. The economic crisis has, unfortunately, still further increased the needs of the population in social assistance. While the government has greatly reduced its social commitments in recent years, bringing combined expenditures on wages and salaries, social security, and direct subsidies below 14 per cent of GDP in 1996, it is not clear how long this trend can be politically sustained. This situation contributes to the very difficult policy environment in the current period.

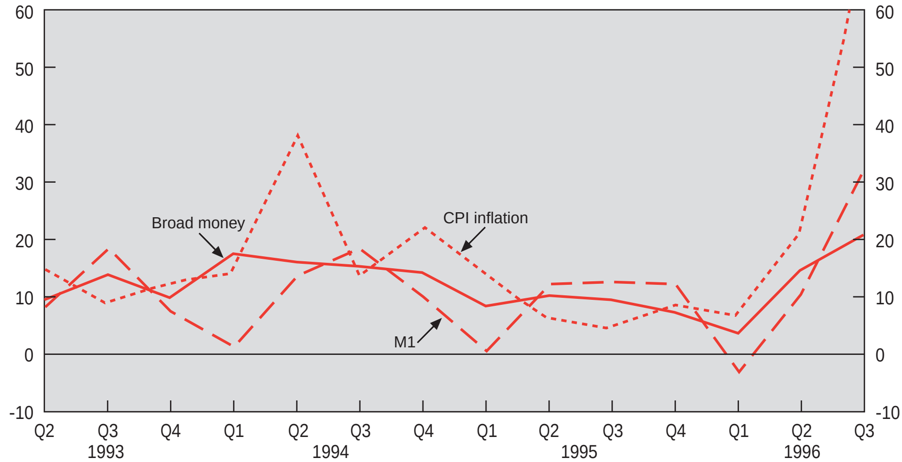
II. Macroeconomic policy

The history of macroeconomic stabilisation policy in Bulgaria has been difficult and frustrating. On the one hand, Bulgaria has made important progress in developing the tools of monetary and fiscal policy for a market economy. Under a very adverse set of circumstances, these tools have been used to control growth in monetary aggregates with at least some degree of effectiveness. But the outcomes in stabilisation could hardly have been more disappointing. In addition to the high degree of instability in inflation and the exchange rate, as discussed in Chapter I, the rapid accumulation of government debt has led to a growing fiscal crisis in 1996. This chapter examines the macroeconomic policy environment in Bulgaria, placing emphasis on important factors that have complicated the pursuit of economic stabilisation and fiscal balance. While questions can be raised concerning the consistency and optimality of the particular fiscal and monetary policy mix that has been pursued at times in Bulgaria, the primary obstacles to stabilisation have been structural in nature. The burden of delays in structural reform, together with problems in the implementation of various laws and regulations, have limited the scope and credibility of macroeconomic policy. An awareness of these limitations underlies the highly unstable behaviour of money demand in Bulgaria, as well as the lack of confidence in commercial banks.

Growth in money supply and credit

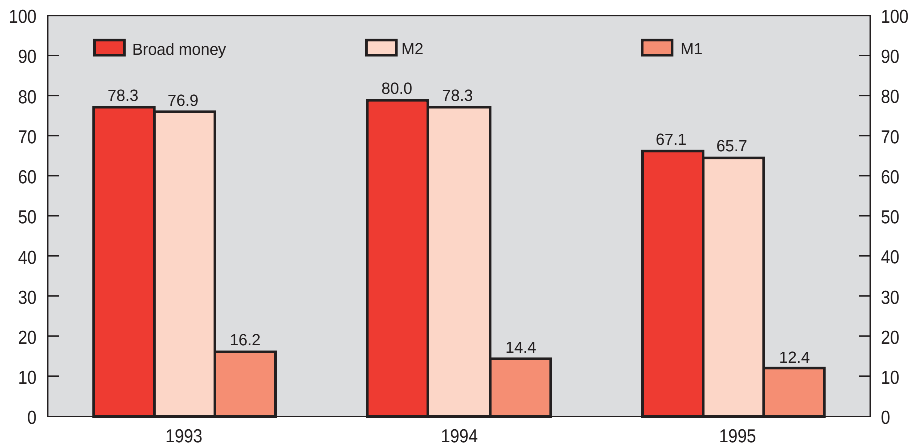
A sole examination of the dynamics of monetary aggregates gives little clue as to the sources of instability that have plagued Bulgaria in recent years. As shown in Figure 9, growth in broad money and M1 does not conform to a pattern that could explain the volatility of inflation and the exchange rate. Furthermore, the ratio of M1 to GDP has declined in both 1994 and 1995, while the ratios of M1, broad money and M2 to GDP all reached a post-transition low in 1995[29] (Figure 10).

Figure 9. **GROWTH IN MONEY SUPPLY AND INFLATION**
Quarter-on-quarter, percentage



Source: BNB, *Monthly Bulletins* 1993-1996 ; OECD.

Figure 10. **MONEY SUPPLY**
As percentage of GDP at 31st December



Source: BNB, *Annual Report 1995* and *Monthly Bulletins* 1993-96.

Although money supply grew at a somewhat faster pace than inflation in early 1995, this actually owes to the fact that inflation was unexpectedly low. Many expenditures in the budget were fixed in nominal terms according to higher expected, as opposed to actual, inflation. Even more important, the very high central (basic) interest rate continued to determine the size of large state expenditures on domestic debt service. But ironically, as described in Chapter I, efforts to bring macroeconomic policy in line with inflation, involving decreases in the basic interest rate, ended up destabilising money demand and setting the stage for the financial crisis of 1996. The increase in the rate of growth of the money supply in 1996, shown in Figure 9, is associated with the accelerated refinance of commercial banks that were experiencing large withdrawals. This acceleration actually began in December 1995, a fact that is masked in the three-month averages in Figure 9 due to seasonal factors.[30] Even before this monetary expansion, the value of the lev was being supported only through the rapid depletion of foreign exchange reserves, which supports the theory, proposed in Chapter I, that the crises of 1994 and 1996 were primarily demand-driven.[31]

As shown in Table 10 below, outstanding credit to both government and the non-financial sector as a share of GDP has also been contracting at a notable pace. But this contraction in credit is a bit deceiving. First, Bulgaria began its economic transition with a very high share of credit in GDP, due primarily to a large amount of outstanding loans that were denominated in foreign currency. The burden of these loans increased enormously with the initial devaluation of the lev. By 1993, the share of credit in GDP had become extraordinarily high at 132.5 per cent. Second, a series of rehabilitation measures between 1992 and 1995 transformed almost all non-performing credits contracted before 1991 into state bonds. Thus, a large share of the decrease shown in Table 10 derives from credit that has been transformed into government debt, the tremendous

Table 10. **Outstanding domestic credit**

As percentage of GDP at 31 December

	1992	1993	1994	1995
Total credit	126.5	132.6	104.0	72.2
Claims on government, net	50.5	64.8	53.0	31.0
Claims on non-financial sector	76.0	67.8	51.0	41.3

Source: NSI, *Bulgarian National Accounts;* BNB; OECD.

burden of which is discussed below.[32] Other older credits have also been devalued through high inflation. 1995 did witness a genuine contraction of bank credit, but domestic credit remained at 72 per cent of GDP, with credit to government at 31 per cent and credit to the non-financial sector at 41 per cent. As shown in Table 18 of Chapter III, Bulgaria is unique among transition countries in maintaining such a high ratio of credit to the non-financial sector in GDP that is based almost entirely on new (post-transition) loans.[33] Roughly 70 per cent of these loans had also become classified as problematic by the end of 1995. The burden of this credit is more visible in the accumulation of domestic debt and decapitalisation of commercial banks than in the aggregate statistics presented in Table 10.

The monetary policy environment

Control over the money supply has been the primary explicit target of monetary policy in Bulgaria. Until 1997, no explicit target for the exchange rate has ever been announced, and the Bulgarian National Bank (BNB) has implicitly pursued a managed float, involving possible participation in the foreign exchange market for short-term smoothing. As discussed in Chapter I, however, the BNB has also implicitly attempted to use the exchange rate as an anchor for stabilisation in recent years. Incomes policies and price controls have played additional, although secondary, roles in stabilisation efforts. But many factors pertaining to the particular nature of the Bulgarian environment, including difficulties in the implementation of various laws and regulations, have complicated the realisation of all of these policies.

a) Control over the money supply

The instruments of control over the money supply have changed considerably in recent years. Until mid-1994, the primary instrument of control was direct ceilings over the expansion of commercial credit. These ceilings were set monthly for each individual commercial bank under an aggregate target for limiting the expansion of credit to the non-financial sector. This target was usually set slightly below expected inflation. Credit ceilings proved somewhat difficult to enforce in practice.[34] Nevertheless, through the continual adjustment of these ceilings, aggregate credit expansion to the non-financial sector was brought roughly in line with somewhat restrictive targets.

The credit ceilings did not cover all important credits, however, including credit to the government. Banks were also unrestrained in the purchase of state securities. In addition, regulations did not apply to a number of other loans, including those denominated in foreign currency and all credits to the agricultural sector. Rather than impose additional administrative restrictions, however, authorities undertook a decision to abolish direct controls in mid-1994 in favour of the indirect tools of reserve policy, refinance policy, and open-market operations.

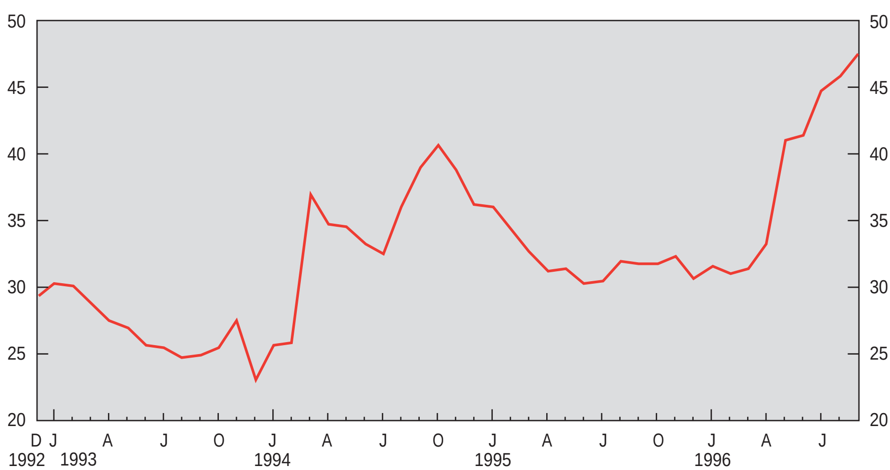
At the time of this decision, reserve requirements for commercial banks were raised from 8 to 10 per cent, and the BNB announced an intention to end all unsecured refinance. Subsequently, very high interest markups were also introduced on overdrafts to discourage their use.[35] Chapter III offers a detailed analysis of the interaction between authorities and commercial banks since this time. Problems emerged due to the fact that financially-distressed banks ended up in chronic violation of reserve requirements and prudential regulations covering capital adequacy, provisions for non-performing loans, and liquidity. High interest rates on overdraft and other BNB loans apparently had a minimal effect on the demand of already-insolvent banks. Although the BNB did succeed in reducing its share of refinancing in GDP,[36] this was a somewhat hollow victory, as it was achieved at the expense of several bailout operations involving government debt and the capital of the BNB and the State Savings Bank (see Chapter III). While the refinance of banks shifted largely to Lombard credits in 1994 and most of 1995,[37] the crisis in the banking sector has witnessed an acceleration of unsecured refinance in late 1995 and 1996.

The direct extension of credit to the government by the BNB was substantially curtailed in 1993-1995. According to the Law on the National Bank of 1991, the BNB may extend only short-run (up to three-month) credit to the government in an amount not exceeding 5 per cent of state revenue. Furthermore, this credit must be paid back by the end of the year.[38] Despite some controversial ambiguities in this law, outstanding credit from the BNB to government was decreased from 11 per cent to 3 per cent of GDP between 1993 and 1995.[39] This has been associated with a shift to sales of securities to banks as an almost exclusive means of deficit finance. But it should be noted that, to the degree to which these banks depend on refinance from the BNB, the conceptual difference between direct credits to the government and the sale of state securities to commercial banks becomes a bit ambiguous. In the context of the growing financial and banking crisis in late 1996, mounting difficulties in placing and servicing state securities led to the approval by Parliament of the extension of a new long-term loan of BLG 115 billion (roughly US$230 million at the time or 6 per cent of GDP) from the National Bank to the Ministry of Finance to cover part of the 1996 deficit.

b) The foreign exchange market

The first signs of macroeconomic instability, which led into the crises of 1994 and 1996, appeared on the foreign exchange market. The particular nature of this market in Bulgaria is an integral part of the macroeconomic picture. Its potential volatility reflects a weak regulatory environment that appears easy to circumvent for rapid portfolio shifts and short-term capital flows. Unfortunately, the nature of existing data makes it quite difficult to determine the degree to which the exhibited volatility has derived from short-term capital flows as opposed to rapid portfolio shifts of domestic savings. Both factors appear to have been important. As shown in Figure 11,[40] deposits in Bulgarian banks have been rather evenly divided between lev and foreign currency accounts in recent years.

Figure 11. **SHARE OF FOREIGN CURRENCY DEPOSITS IN BANK DEPOSITS**
In percentage



N.B.: At current exchange rates.
Source: BNB, *Monthly Bulletins* 1993-1996; OECD.

Furthermore, it is known that, due to preferential tax treatment of personal deposits, a large share of so-called ‘‘household deposits’’ in Bulgaria represent the holdings of businesses. These businesses may be relatively more willing and able than the population on average to carry out large and rapid transactions on the foreign exchange market in response to changes in expected returns.

Regulations on foreign exchange activity include partial current account convertibility of the lev (by Article 14 but not Article 8 of the IMF Articles of Agreement). Exporters have full retainer rights and importers can purchase foreign exchange from commercial banks on the basis of documentary proof of import transactions. Residents can purchase foreign exchange (up to US$2 000) for travelling abroad and can freely open foreign exchange accounts at commercial banks. Registered financial institutions, which include ‘‘financial houses’’ and ‘‘exchange bureaux’’ as well as banks, can engage in foreign exchange transactions if licensed by the BNB. Foreign exchange bureaux, which have become very numerous, are only authorised to service individuals.

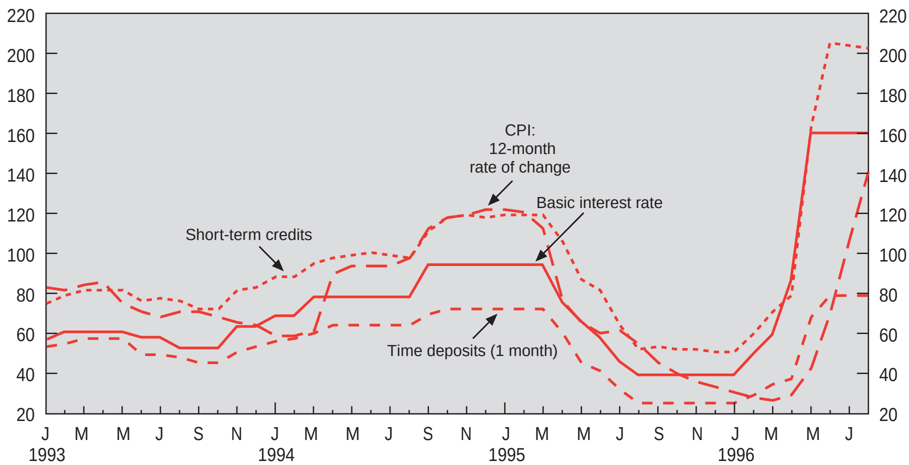
There is evidence that the *de facto* foreign exchange regime in Bulgaria is more liberal than that described in the previous paragraph, due to the fact that the degree of enforcement of these regulations is not believed to be very high. Perhaps most importantly, it is widely believed that significant short-term capital flows have been disguised as import or export operations.[41] Thus, the crises of 1994 and 1996 could very well be related to a ‘‘Peso problem’’. But the enforcement of regulations regarding activities on the foreign exchange market for residents has been quite lax as well. Apparently, in spite of regulations to the contrary, many foreign exchange bureaux have been operating on the wholesale market (such as currency sales to firms) and neglecting restrictions on the amounts of individual sales.

c) The basic interest rate

The basic interest rate of the BNB has played an extremely important role in monetary policy in Bulgaria. As discussed in Chapter I, changes in the basic rate appear to have been important in triggering a destabilisation of the economy in 1994 and 1996. The basic rate is adjusted on an *ad hoc* basis by the BNB, reflecting changing perceptions of the current and expected economic situation, particularly with respect to inflation. Figure 12 indicates a close relationship between CPI inflation and past interest rate policy, as well as the degree to which commercial rates have been synchronised to movements in the basic rate.

Figure 12. **INFLATION AND INTEREST RATES**

In percentage



Source: BNB, *Monthly Bulletins* 1993-96; NSI; OECD.

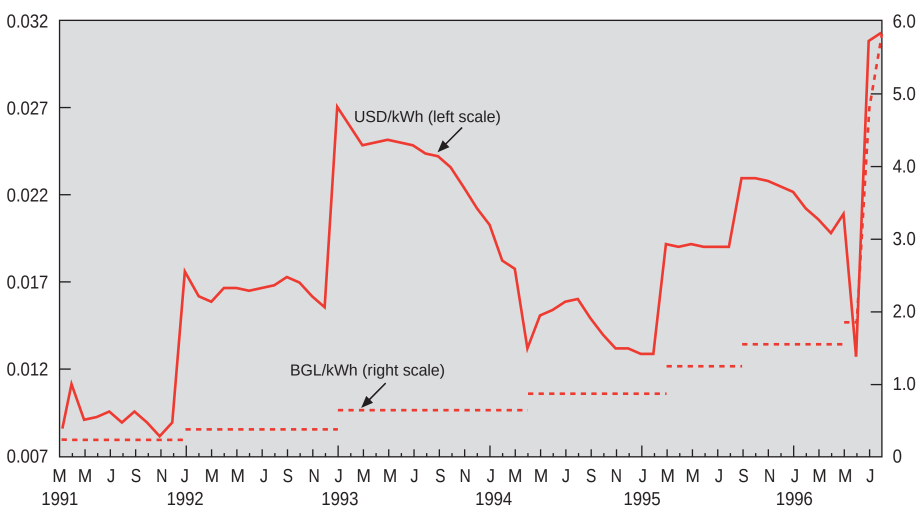
Institutional arrangements in Bulgaria are such that virtually all financial contracts are specified in floating interest as a percentage of the basic rate. This includes commercial loans and state securities. A fundamental problem in monetary policy is that changes in the basic interest rate can have a number of complicated simultaneous effects in various areas of the economy. First, expenditures in the state budget are quite sensitive to the basic rate due to the high demands of domestic debt service. A primary motivation for attempts to decrease the interest rate has come from concern over the state budget. Second, a higher interest rate has typically precipitated more distress among commercial banks and debtor enterprises. For enterprises, this directly increases the burden of debt service and the cost of credit. For banks, a higher interest rate increases the cost of attracting deposits, but does not have a comparable effect on the value of assets. This is due to the high degree of non-performing loans in bank assets and the fact that, at higher interest rates, more loans are likely to become non-performing. Ironically, for this reason, the demand of commercial banks for refinance may actually be an increasing function of the interest rate, despite the fact that refinance rates rise together with the basic rate. Given a very high nominal basic rate in early 1995 and significantly lower-than-expected inflation, both of these effects became important and represented a primary reason why the BNB decreased the basic rate substantially in mid-1995. But this appears to have had a very destabilising effect on the economy, thereby exposing another extremely important potential effect of alterations in the basic rate: the effect on money demand. Due to opportunities for short-term capital flows and rapid portfolio shifts between lev and hard currency-denominated assets, the demand for money can be highly sensitive to movements in the interest rate. Furthermore, as painfully demonstrated by the experiences of 1994 and 1996, money demand is an unstable function of the interest rate alone. Due to the fact that money demand also depends on other economic variables that can be significantly affected by changes in the basic rate (foreign exchange reserves, inflationary expectations), a fall in money demand due to a decrease in the interest rate cannot necessarily be offset by a subsequent increase in the interest rate.

d) Incomes policies and price controls

Another important cornerstone of macroeconomic policy has been control over wages and pensions. Two regulations that control wage growth are applicable only to the state sector. First, the wages of civil servants are subject to periodic indexation according to a pre-announced formula. Second, for growth in the wage fund above a predetermined ceiling, state-owned firms are subject to a highly-progressive ‘‘excess wage tax’’ of over 100 per cent. In addition to these two controls, wages in both the private and state sector are subject to high social security taxes, as discussed below. Pensions have been indexed twice a year according to a formula combining past and expected inflation. As indicated in Chapter I, growth in wages in the state sector and pensions has been kept well below the pace of inflation in recent years. At the same time, the scope for direct controls on incomes in the policy mix has become increasingly limited, due to both the falling share of wages in incomes, and opportunities to evade restrictions, particularly in the growing private sector.[42]

Although the vast majority of prices were fully liberalised in 1991-1992, selected price controls continue to play a role in stabilisation policy. It could be argued that this role is somewhat implicit, however. Most price controls, which affect primarily basic foodstuffs, public transportation, and household utilities, are motivated more by concerns in distribution than stabilisation. But enough products are regulated that the overall impact of controls on inflation appears not to be negligible.[43] Particularly important in Bulgaria have been controls on energy prices.[44] In recent years, energy price subsidies have been reduced and, as of 1996, virtually eliminated. But electricity prices remained highly subsidised until mid-1996. Although the World Bank set a target of 3.5 cents per kwh in 1994, based on an estimate of long run marginal costs in Bulgaria, as a precondition for a loan agreement, the government did not come close to meeting that target until 1996. Electricity prices have been fixed in lev terms on a periodic basis.[45] The dollar price of electricity has, therefore, decreased regularly along with the depreciation of the lev (Figure 13).

Figure 13. **ELECTRICITY PRICES FOR HOUSEHOLDS**



Source: BNB.

Fiscal policy and the budget

State finance in Bulgaria has been increasingly squeezed from both the revenue and expenditure sides. State revenue as a share of GDP has declined steadily from 58 per cent in 1989 to 36 per cent in 1995. Preliminary data indicate that it has declined even further to 31 per cent in 1996. On the expenditure side, the resumption of foreign debt service in 1994 and, especially, the servicing of rapidly-growing domestic debt, have absorbed an increasing share of state resources. These two trends have made the fulfilment of even minimal social policy objectives quite difficult. Consolidated budget deficits of 5.8 and 5.7 per cent of GDP in 1994 and 1995 were obtained only through the generation of primary surpluses of 7.8 and 8.6 per cent of GDP, respectively. The preliminary budget deficit for 1996 is 11.5 per cent, with a primary surplus of 8.2 per cent. The rapid accumulation of government debt has cast an ominous shadow over the pursuit of macroeconomic stabilisation.

As indicated in Table 11, government revenue as a share of GDP has been rather low relative to most other economies in transition. The consolidated budget (Table 12) shows that declines in revenue have come primarily from falls in tax proceeds. The share of tax revenue in GDP has fallen from close to 50 per cent in 1989 to below 25.5 per cent in 1996. This reflects an erosion of the former tax base: the profits of state-owned enterprises. Although, as indicated in Box 1, the government has been pursuing reform that is consistent with broadening the tax base and increasing tax efficiency, the development of fiscal institutions has been a slow and frustrating process. The growing private sector, in particular, has proven very difficult to subject to direct taxation.

The most striking feature of the expenditure side of the budget is the growing burden of interest expenditures associated with the government debt. Between 1992 and 1996, interest on the government debt grew from 6.4 per cent of GDP to almost 20 per cent, with interest on the domestic debt alone reaching 17 per cent. Interest payments have been increasingly crowding out expenditures on wages, salaries, social security, and direct subsidies, the sum of which has declined from 24 per cent of GDP in 1993 to 14 per cent in 1995. As emphasised in Chapter 1, this significant reduction in social funding comes precisely at a time when needs in social protection have been increasing.

As illustrated in Table 13, while the cumulative burden of deficit finance on government debt has been growing steadily, the majority of this debt has been associated with programs to assume liabilities of commercial banks. This involves several operations before 1995 under which the state assumed non-performing credits contracted before 1991, a further bailout operation in 1995, and bonds to insure the deposits of insolvent banks in 1996 (see Chapter III for

Box 1. **The Bulgarian tax system**

The construction of a market-based tax system, consistent with both sufficient state revenue and high-powered economic incentives, has proven to be one of the most difficult tasks in many countries in economic transition. Particularly unfavourable initial conditions make Bulgaria a notable example. The main source of government revenue was formerly profit taxes collected from the state-owned enterprises. A substantial amount of GDP was centralised in this way, with limited direct deductions to municipal budgets beginning only in the late 1980s. On the eve of the transition period in 1989, state tax revenue was close to 50 per cent of GDP. Subsequently, tax revenue has declined faster than GDP, the share of consolidated budgetary tax revenue in GDP reaching, by preliminary data, a low of 25.5 per cent in 1996 (31 per cent for all revenue).

The tax system during transition has relied most importantly on a profit tax, a ''turnover'' tax (a VAT since 1994), a personal income tax, and social security contributions. In addition, there is a special tax on ''excess wages'' that is applicable to state-owned firms only. Individual entrepreneurs pay personal income tax instead of the profit tax. Given very low reported profits in recent years, as well as problems with tax arrears (Table 23), the significance of the profit tax for state revenue has declined dramatically relative to indirect taxes (the VAT). The profit tax accounted for an estimated 41 per cent of tax revenue in 1990, but this number has steadily fallen to under 16 per cent in recent years. By contrast, indirect taxes moved from providing 10 per cent to 30 per cent of all tax revenue during the same period. Tax revenue shares from social security contributions and income taxes have been more stable within the ranges of 27-35 per cent and 14-17 per cent, respectively.

The burden on most firms from direct taxation has been consistently high, with the sum of tax obligations often accounting for a solid majority of all profits. Corporate profit tax rates declined from 65 per cent in 1989-1990 (50 per cent basic rate plus 15 per cent special levies) to 40 per cent in 1991 (50 per cent for financial institutions). In addition, state-owned firms paid a 10 per cent municipal tax. Private firms with profits below a certain minimal level (BGL 1 million in 1994) paid a lower rate of 30 per cent before 1996. For 1996, profit tax rates were both lowered and unified for public and private firms, becoming 36 per cent for companies with profits over BGL 2 million and 26 per cent otherwise. Social security deductions vary from 35 to 50 per cent of gross wages. Personal or single-entrepreneur income taxation is based on progressive marginal rates of 20 to 52 per cent.

Until 1994, indirect taxation was based on a number of turnover and excise taxes that varied widely according to commodity. In 1994, the turnover tax was replaced by a VAT with a unified rate of 18 per cent (increased to 22 per cent for 1996). Differential excise taxation was reduced to fuels, tobacco products, liquor and some luxury goods. By

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most measures, this reform has been successful.[46] Not only has the VAT helped to alleviate price distortions, but it has proved a relatively effective device for revenue procurement. It has become the single greatest source of tax revenue for the Bulgarian government and represents the only means by which the private sector has been subjected to substantial taxation.

Until 1996, the Bulgarian tax system gave numerous benefits to private firms relative to state-owned firms. In addition to potentially lower profit tax rates and exemption from the municipal and excess wage taxes, private firms had numerous exclusive advantages in writing off various expenses, including deductions for repayments of loans and some purchases of land. But a tax reform implemented in 1996 removed almost all of these special benefits, creating close to identical conditions for private and state firms. As an exception, the excess wage tax has been maintained only for firms with over 50 per cent state ownership. The hope is that tax equalisation will decrease incentives for informal transfers from the state to the private sector, as well as improve the ability of the state to subject the private sector to direct taxation. At the same time, however, new amendments were passed to the Profit Tax Law in late 1996 that granted a profit tax holiday to some privatised firms for 3 years, with 50 per cent holidays available for the fourth and fifth year.

Numerous studies and surveys cite high and unstable taxation as a major incentive problem in the Bulgarian economy and a primary reason why tax evasion is so widespread. Other than explicit changes in tax rates, the rules governing the definitions and calculations of various taxes have been altered on a frequent basis, usually with the goal of enhancing state revenue procurement. This not only increases business risk, but can create the expectation that the revelation of substantial profits could lead to unfavourable discretionary adjustments in tax rules (the so-called ‘‘ratchet effect’’). Also, due to high social security deductions, both state and private Bulgarian firms have a major incentive to hire workers officially at close to minimum wages and provide additional compensation by some other means.

Combating tax evasion, especially in the private sector, has been a major battle for authorities. Tax arrears are also an important problem. According to a statement by the Ministry of Finance, the sum of tax arrears reached BGL 60 billion or 6.9 per cent of GDP by the end of 1995 (see also Table 23 in Chapter IV).[47]

details). The decline in the share of debt against bad credits in GDP in 1995 is actually a bit deceiving. A rescue operation at mid-year replaced a large amount of special low-yield (1/3 of the basic rate) bonds in the portfolios of two distressed large banks with new 7-year bonds yielding the market rate of interest.[48] Thus, as shown in Table 12, the burden of domestic debt service remained as high in 1995

Table 11. **Government revenue and expenditure:**[1] **Bulgaria and selected countries**

As percentage of GDP

	1992			1993			1994			1995		
	Total revenue	Total expenditure	Budget deficit	Total revenue	Total expenditure	Budget deficit	Total revenue	Total expenditure	Budget deficit	Total revenue	Total expenditure	Budget deficit[2]
Bulgaria	**40.5**	**46.0**	**–5.6**	**37.2**	**48.1**	**–10.9**	**40.2**	**46.0**	**–5.8**	**36.1**	**41.8**	**–5.7**
Czech Republic	56.0	54.0	2.0	49.7	49.7	0.0	48.7	50.7	–2.0	49.1	49.4	–0.3
Hungary	46.3	53.6	–7.2	46.9	55.2	–8.3	44.4	52.7	–8.4	43.5	51.6	–8.0
Poland[3]	45.1	50.0	–4.9	47.6	49.9	–2.3	48.3	50.5	–2.2	47.8	49.7	–1.9
Romania	37.4	42.0	–4.6	33.8	34.2	–0.4	32.0	33.9	–1.9			
Russia[4]	41.6	60.5	–18.9	37.5	45.1	–7.6	33.6	43.7	–10.1	34.0	40.5	–6.5
Slovak Republic[5]							50.5	49.7	0.8	51.5	48.3	3.2

1. Consolidated government.
2. Preliminary.
3. General government, excluding transfers between state budget, local budgets, extra-budgetary funds and extra-budgetary units.
4. Enlarged government balance.
5. Excluding intragovernment transfers.

Source: Ministry of Finance; IMF; OECD.

Table 12. **Consolidated government budget**

As percentage of GDP

	1993	1994[1]	1995	1996[2]
Revenue	37.2	40.2	36.1	30.7
Tax revenue	28.9	32.0	29.6	25.5
of which:				
Profit tax	2.2	3.7	3.8	4.0
Income tax	5.0	4.5	4.2	4.1
VAT and excise taxes	7.3	10.8	9.5	7.6
Customs duties	3.0	2.8	2.5	2.1
Social insurance contributions	10.1	9.0	8.0	6.8
Other tax revenue	1.3	1.2	1.7	1.0
Non-tax revenue	6.2	7.7	5.7	4.7
of which:				
Extrabudgetary accounts	2.1	0.5	0.7	0.4
Total expenditure	48.1	46.0	41.8	42.2
Current non-interest expenditure	36.8	30.9	26.4	21.9
of which:				
Wages and salaries	6.4	5.3	4.7	3.6
Maintenance and operations	6.5	6.4	5.5	4.3
Defence and security	4.0	3.6	3.6	3.0
Subsidies	2.2	1.4	1.1	0.7
Social insurance expenditure	15.1	13.1	10.9	9.3
Extrabudgetary accounts	2.6	1.0	0.6	0.9
Investment	1.9	1.5	1.1	0.7
Primary balance	–1.5	7.8	8.6	8.2
Domestic interest	8.3	12.3	11.4	16.9
Domestic balance	–9.8	–4.5	–2.9	–8.8
External interest	1.0	1.3	2.8	2.7
Deficit (consolidated government)	–10.9	–5.8	–5.7	–11.5

1. As the NSI began excluding holding gains from GDP figures only in 1994, the figures from 1994 on are not exactly comparable to 1993 figures. If holding gains are included in 1994 GDP estimates, the revenue share becomes 38.3% and the expenditure share 43.7%, generating a 5.5% deficit.
2. Preliminary.

Source: Ministry of Finance; NSI; OECD.

as in 1994. Even so, as illustrated in Chapter III, the situation in the banking sector continued to deteriorate at an alarming pace throughout 1995. Even without the bank runs of late 1995 and 1996, the continued operation of existing commercial banks would most likely have required another large infusion of capital in 1996. Growth in government debt, along with the simultaneous decapitalisation of the banking sector, gives perhaps the best macroeconomic indicator that the burden of problems in structural reform on the state's resources was becoming too great.

Table 13. **Structure of domestic government debt**

Type of debt	31 December 1993			31 December 1994			31 December 1995			30 June 1996		
	Amount (BGL bn)	Share of total debt (%)	Share of GDP (%)	Amount (BGL bn)	Share of total debt (%)	Share of GDP (%)	Amount (BGL bn)	Share of total debt (%)	Share of GDP (%)	Amount (BGL bn)	Share of total debt (%)	Share of GDP (%)
To BNB	33.4	30.1	11.2	40.1	14.7	7.7	26.1	7.6	3.0	30.1	6.2	
Direct debt to other financial institutions[1]	2.7	2.4	0.9	2.2	0.8	0.4	1.7	0.5	0.2	1.5	0.3	
Securities for deficit financing	36.4	32.8	12.2	74.8	27.3	14.3	154.7	44.8	17.8	197.3	40.4	
Securities against bad debts	38.6	34.7	12.9	156.6	57.2	30.0	162.8	47.1	18.7	243.6	49.8	
Securities for state protection of deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	16.4	3.4	
Total	111.1	100.0	37.2	273.7	100.0	52.4	345.3	100.0	39.7	488.9	100.0	

1. State Savings Bank and State Insurance Institute.

Source: Ministry of Finance and BNB, *Government Debt Management 1993-1996;* NSI.

At the end of 1995, foreign debt represented almost twice as large (76.6 per cent)[49] a share of Bulgarian GDP as domestic debt. But the maturity structure of this debt, negotiated largely through a 1994 rescheduling agreement outlined in Box 2, is such that its direct burden on the state budget is significantly lower than that of domestic debt. Nevertheless, given very low levels of external finance in recent years and a negative current account, the demands of external debt service on foreign exchange reserves appear to have been important in the destabilisation of the economy in both 1994 and 1996. As summarised in Chapter 1, expectations that a debt rescheduling agreement would require an up-front payment of over US$700 million at a time when the BNB had depleted foreign exchange reserves to defend the value of the lev may have adversely affected money demand (see Figure 2 in Chapter I). Similarly, during the time that foreign currency reserves were being rapidly depleted to defend the currency in January 1996, authorities were obliged to make a debt service payment of US$136 million. Even more important than this, the prospect that an additional sum of roughly US$1 billion would be due in debt service for the remainder of 1996 may have compromised the credibility of the implicit commitment by the BNB to intervene on the foreign exchange market to defend the lev.

The crisis of 1996 has had a large impact on the problems associated with government debt in Bulgaria. Despite the fact that the rapid inflation of 1996 has devalued part of the principal of this debt, the crisis has greatly increased the burden of both domestic and foreign debt on the state budget. This is due partly to the unfortunate circumstance that a large share of domestic debt is denominated in hard currency, the burden of which has increased with the devaluation of the currency.[50] Second, the emergency measures to stabilise the economy in 1996 included substantial increases in the basic interest rate of the BNB that, for some of the time, even outpaced inflation. In addition to the new issues of state securities to cover deposits in insolvent banks, greater needs in deficit finance in 1996, and severe difficulties in placing medium or long-term securities, have also increased the burden of debt service. These problems, which drove domestic debt service to 17 per cent of GDP in 1996, speak for a mounting fiscal crisis in Bulgaria that is following the monetary crisis.

The bankruptcy of a number of insolvent commercial banks, as petitioned by the National Bank, in the near future will also have an ambiguous effect on the debt problem. On the one hand, this would allow the state to retire the bonds

Box 2. **Bulgaria's foreign debt**

After the Bulgarian government had declared a moratorium on the servicing of foreign debt in March 1990, arrears continued to accumulate. The official external debt, about 85 per cent of which consisted of liabilities to foreign commercial banks, increased from US$10.6 billion at end-1990 to US$12.5 billion at end-1993, representing 115 per cent of GDP and 250 per cent of exports.

During the period of 1992-1993, the government negotiated a series of partial deals that rescheduled the share of external debt (15 per cent) owed to foreign governments under the condition that Bulgaria would resume interest payments on this debt. A large debt restructuring deal was finally worked out with the London Club of commercial banks, covering a debt of approximately US$8.7 billion, in June 1994. Bulgaria received a 74.8 per cent buy-back option, under which 13 per cent of the debt was retired (purchased). Brady bonds with a face value of US$5.1 billion were issued for the remaining part of the debt, consisting of approximately one third discount bonds (DISCs, 30 years maturity, principal to be repaid one-off), one third front-loaded interest reduction bonds (FLIRBs, 18 years maturity, interest paid in growing instalments), and one third so-called interest arrears bonds (17 years maturity). With some minor exceptions, interest on Brady bonds is paid in semi-annual instalments (January and July), generally at LIBOR plus 13/16 per cent. DISCs and FLIRBs may also be used for debt-equity-swaps in the context of privatisation, an option that has so far only been offered by Bulgaria among transition countries.

As a result of the London Club deal, gross foreign debt fell to US$10.4 billion by the end of 1994. In 1995, foreign debt decreased further to US$9.45 billion, due partly to an agreement that cancelled debt to Russian commercial banks, and partly to the beginning of debt-equity-swaps (an estimated US$100 million). The structure of foreign debt also changed; in 1995, commercial banks accounted for 57 per cent of the debt; 25 per cent was owed to official creditors (including unsettled COMECON accounts), and liabilities to IFIs amounted to 18 per cent of the total.[51]

In spite of the substantial relief, debt service still presents a serious financial burden to the country, amounting to roughly US$1 billion in each year until 1999.

held in the portfolios of these banks. On the other hand, according to the recent law, after the declaration of bankruptcy, the government will have to honour insurance on the deposits of these banks. In addition, as distressed banks have been collateralising many of their refinance credits with state securities since 1994, a large share of these securities has subsequently been transferred to the portfolios of solvent institutions.

The dramatic devaluation of the lev has also increased substantially the real burden of external debt, which could still further hamper efforts to restore credibility to exchange rate policies and achieve stabilisation. Problems in foreign debt service may therefore continue to plague Bulgaria for years to come.

The limitations of macroeconomic policy

As summarised above, the scope for macroeconomic policy in Bulgaria has suffered from a combination of difficult initial conditions, problems in the implementation of various economic regulations, and delays in structural reform that have transferred the cost of substantial economic losses to the state. To the first category belong inherited debt, low competitiveness (profits), and the absence of developed financial, fiscal, and monetary institutions. The second category concerns, first and foremost, tax laws, foreign exchange regulations, and prudential regulations for banks. The ability to transfer economic losses to the state, corresponding to the last category of problems, concerns structural questions such as bankruptcy, privatisation, and the leverage of monetary authorities over the commercial banks that they regulate (the ability to discipline management, remove licenses, etc.). All of these factors are, of course, interrelated. Inherited conditions create an environment in which important economic regulations are difficult to enforce, while the effective pursuit of structural reforms requires both substantial short-run social costs and the implementation of key regulations.

While it is clear that the lack of implementation of important regulations has been a major obstacle to the goal of economic stabilisation, it is not always clear to what degree these problems should be conceptualised as endogenous or exogenous to economic policy. Clearly, the effective implementation of ambitious regulations in these areas requires a difficult process of institution-building over a number of years. The current choice of basic regulations, and the allocation of scarce resources to their enforcement, represents the most difficult of all policy problems in economic transition, particularly in a country like Bulgaria that has yet to make significant progress in creating an environment of ‘‘rule of law’’ in the economic sphere. Authorities must confront continuing wide-spread attitudes among the population that largely condone the circumvention of economic laws and regulations. Furthermore, these attitudes will persist as long as laws or regulations appear highly unstable or impossible to comply with. Nevertheless, some immediate improvements in specific regulations, particularly concerning taxation and prudential regulations, could be and were made in 1996. These are discussed, to some degree, in Box 1 and Chapters III and IV of this survey.

Slow progress in structural reform to deal with loss-making commercial banks and enterprises has been a primary barrier to the effectiveness of stabilisation policy from at least three perspectives. First, there are direct expansionary effects from the servicing of government debt, the financing of losses of commercial banks, and the provision of other subsidies. Despite difficult circumstances, the Bulgarian government appears to have succeeded in realising fairly restrictive policies until late 1995, which were consistent with a slowdown in the growth of monetary aggregates.

Second, structural problems have placed important limitations on how the tools of monetary policy can be used. As described in Chapter III, the prospect of massive insolvency in the banking sector, and a very limited degree of leverage (until 1996) of the BNB over commercial banks, presented important limitations in the ability to enforce prudential regulations, as well as on how reserve and refinance policy could be conducted. Perhaps even more critical, in light of the recent macroeconomic instability, are implied limitations on the use of two vitally-important monetary policy instruments: the basic interest rate and the exchange rate. As described above, strong downward pressure on the basic rate has come from government debt service and the deterioration of the banking sector. Yet, in both 1994 and 1996, decreases in the basic rate triggered economic instability. Furthermore, in both cases, structural problems compromised the ability of the BNB to counteract this instability with the only other degree of freedom that it possesses: exchange rate policy.

Finally, it can be argued that the unsustainable trends in the Bulgarian economy in recent years, associated with growing losses in banks and enterprises, have directly affected the expectations of the population and investors, feeding into the instability of the demand for money that has plagued stabilisation efforts. Until there appears a belief that a sustainable recovery in Bulgaria is underway, based on sound economic policies and decisive structural reforms, investors will always tend to the lev-denominated side of their portfolio with a ‘‘shaky hand’’, moving toward the lev only at times when there is a perceived short-run gain from uncovered interest parity. The relationship between the deterioration of the banking sector and the loss of confidence in banks is even more obvious than the question of money demand.

Box 3. **A currency board for Bulgaria?**

The magnitude of the crisis in the Bulgarian economy in 1996, involving a severe loss of confidence in the national currency and domestic commercial banks, has prompted the IMF to propose the introduction of a currency board. In the 1990s, currency boards have been introduced as part of emergency stabilisation packages in Argentina (1991), Estonia (1992) and, more recently, Lithuania (1994).

Under a currency board regime, a commitment to a fixed or rigidly pegged exchange rate is supported by backing the domestic currency 100 per cent with a foreign ''reserve'' currency. The sole responsibilities of a currency board are to issue (demanded) domestic currency in exchange for foreign currency, and purchase (supplied) foreign currency with domestic currency, at the fixed exchange rate. The supply of domestic currency is thereby automatically regulated by demand at the given exchange rate. In the absence of a currency board, a Central Bank typically holds domestic assets, such as government debt, as well as foreign reserves. This allows the flexibility for the conduct of ''monetary policy'', involving possible open market operations and interventions on the foreign exchange market that alter the size and balance of foreign and domestic assets in the Central Bank's portfolio. Thus, a currency board arrangement can be viewed as the substitution of the standard instruments of monetary policy with a simple rule of thumb. As this rule serves to automatically back up the expansion of money supply with an equal amount of foreign reserves, the hope is that such an arrangement could restore much-needed confidence in the national currency and economic policy.[52]

While a currency board itself has no ability to refinance commercial banks and serve as a ''lender of last resort'', the arrangement in Bulgaria would probably follow the experience of Estonia in creating a central ''banking board'' as well. In addition to monitoring and regulating commercial banks, this banking board would hold a certain amount of foreign exchange reserves, which could be converted into leva through the currency board to provide some liquidity to commercial banks in the event of an emergency. But the nature of a currency board restricts such a banking board to operate within the confines of its limited reserves. There can be no (domestic) bailout of the banking board. Thus, a currency board entails an end to the type of refinancing of commercial banks that has occurred in recent years in Bulgaria. This fact speaks for the vital importance of simultaneous measures, together with the introduction of a currency board, to rebuild and restore confidence in the commercial banking sector under these stringent conditions. Such measures would most likely include limitations on the number of banks allowed to operate, a recapitalisation of those banks, and enhanced monitoring by the banking board (National Bank).[53]

A currency board also necessitates measures to ensure fiscal discipline and balance. The government deficit could no longer be financed by the National Bank, either through the explicit purchase of government debt by the National Bank, or implicitly through the

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refinancing of commercial banks that are purchasing state securities. In the near future, an environment of low liquidity and confidence in the economy will also make the placing of state securities with domestic banks or investors for deficit finance extremely difficult. Thus, the implementation of a currency board would require simultaneous measures to help pull Bulgaria out of its current debt trap, as well as provide temporary external support for financing the deficit. As the economy stabilises and interest rates are brought down, the burden of debt service would be alleviated somewhat, and the ability of the state to place securities with banks and other investors would grow. But, given the magnitude of the current overhang of government debt in Bulgaria, supplemental measures to repurchase or restructure this debt are also necessary.

If a currency board can be financed and implemented with appropriate supporting policies, it could become a powerful tool for the relatively rapid stabilisation of the Bulgarian economy. Since its introduction of a currency board, Estonia has been absorbing substantial capital inflows and experiencing a strong real appreciation of the kroon *vis-à-vis* its foreign reserve currency, the Deutschemark. The financial crisis in Bulgaria has depreciated the domestic currency to such a point that, if a currency board succeeds in stabilising expectations, a similar strong real appreciation of the lev, together with substantial capital inflows, could be expected. As this process continues, however, expectations that such an appreciation cannot continue for long may grow, and capital flows may become more volatile and potentially destabilising. It would appear that Bulgaria has already suffered from volatile short-run capital flows in recent years. The need to confront potential fluctuations is one reason why a strong and liquid commercial banking sector is important in this context.

The above-mentioned problem also speaks for the fact that a currency board, in and of itself, cannot stabilise the economy indefinitely. A successful implementation of a currency board in Bulgaria, by stabilising expectations in the short run, would offer a window of opportunity for undertaking much-needed comprehensive structural reforms in the areas of restructuring, banking, privatisation, and the creation of a business environment conducive to foreign and domestic investment. It should further be stressed that, at any point in time, the credibility of a currency board in Bulgaria requires a strong consensus and commitment at all levels of government.

It is possible, with the advantage of hindsight, to question some of the decisions in monetary policy that preceded the crisis of 1996. It appears, for example, that the decision to decrease the basic rate by such a large amount so quickly in 1995 was a mistake, particularly after the warning signal in 1994 of an unstable demand for money. The fact that authorities neglected, until the end of 1995 and 1996, to tackle the issues of state deposit insurance and regulations on the open foreign exchange positions of banks is also regrettable. In addition, as described in Chapter I, once the acceleration of bank refinance began in late 1995, the prospects for the successful defense of the value of the lev moved from questionable to impossible. At this point in time, the policies being pursued by monetary authorities, including the decision to hold down the basic rate until February 1996, clearly lacked consistency and, as in the well-known model of Krugman (1979), an exchange rate crash became the only possible outcome. At the same time, before this monetary expansion began, the instability on the foreign exchange market appeared to be almost entirely demand-driven, and the appropriate macroeconomic response was not obvious. As emphasised earlier, it is not at all clear that the mistake of decreasing the interest rate by such an amount could have been corrected through a subsequent increase. Increases in the basic rate, beginning in February 1996, appear to have had little effect on already-destabilised money demand (see Figure 2 of Chapter I).

Despite some blemishes on the macroeconomic policy record, an examination of the overall Bulgarian experience leads to the general and paradoxical conclusion that monetary and fiscal authorities accomplished quite a bit under exceedingly difficult circumstances. Budget deficits were substantially reduced, even if at the expense of drastic reductions in social policy. The growth in monetary aggregates was largely brought under control. But these ‘‘difficult circumstances’’ are not entirely exogenous. The limitations thrust upon macroeconomic policy by problems and delays in structural reform proved too severe an addition to the already fragile macroeconomic environment. As argued in the next chapter, a key to understanding problems in stabilisation in Bulgaria in recent years lies in the banking sector, in the incentives and behaviour of commercial banks.

III. The banking sector

Introduction

While virtually all countries in transition have struggled with the process of developing and regulating a healthy banking sector, no country has struggled more than Bulgaria. A combination of particularly difficult initial conditions and economic policies have contributed to a spiral of bad loans and bank refinancing that has taken quite a toll on the Bulgarian economy, distorting incentives, polarising distribution, and perpetuating macroeconomic instability. While the Bulgarian National Bank (BNB) and some other government bodies have made a serious effort, under exceedingly difficult circumstances, to adopt a legal, regulatory, and economic environment in the banking sector according to Western practice and recommendations, the experience of 1991-1996 still suggests some important policy lessons. These lessons may prove useful not only for Bulgaria but for other countries that face banking crises.

In assessments of the economic crisis of 1996, much attention has focused on the role of commercial banks in financing the huge losses of state-owned enterprises. This subject is also explored in Chapter IV of this survey. Yet a close examination of the banking sector in Bulgaria reveals that this is only one, although very important, piece of the puzzle. Problems in the allocation of commercial credit in Bulgaria go far beyond a commitment to finance state-owned loss makers. The private sector of the economy, consisting mostly of new start-up firms with little fixed capital, has been absorbing close to half of new commercial credit in recent years, particularly long-term credit. Furthermore, on aggregate, firms in the private sector have the same dismal record of debt service as firms in the state sector. Private banks, which have played a central role in the expansion of commercial credit in recent years, have experienced the same type of financial distress as state-owned banks. An understanding of the critical problems concerning commercial credit expansion and the banking crisis in Bulgaria, therefore, requires a careful consideration of incentive problems in Bulgarian commercial banks, based on the analysis of relations between banks, state authorities and firms. After a description of the evolution of the Bulgarian banking sector until 1996, the remainder of this chapter will address these issues.

The initial conditions

Bulgaria began economic transition with a typical Soviet-type, state-monopolised banking system. The BNB and its regional branches were under the direct control of the Council of Ministers. This centralised network had the dual responsibility of extending credits to enterprises in accordance with administrative planning, and of holding and monitoring the accounts of (state) firms. In addition to the network of branches of the BNB, there existed two other banks: the State Savings Bank (SSB) held all deposits of the population, and the Foreign Trade Bank carried out all foreign economic operations. Some reforms of the banking system began in the 1980s. In 1981, Mineralbank was established with the explicit goal of extending credit to new small and medium-size enterprises. In 1989, seven sectoral banks were created to provide long-term credits in their respective branches of the economy. But the effect of these changes on the operation of the banking system in Bulgaria was quite marginal. In 1989, the banking system was transformed into a two-tier hierarchy, with 59 small to medium-size commercial banks created out of the previous branches of the BNB.

As in many other central and eastern European transition countries, the collapse of CMEA trade and the initial shock of price liberalisation immediately precipitated a crisis in the banking sector. As the majority of enterprises became loss-makers, debt arrears to commercial banks began to mount. This crisis was even more serious in Bulgaria than in other countries of the region for several reasons. First, Bulgaria had a greater dependence on the CMEA market, which accounted for approximately 80 per cent of all foreign trade in 1989.[54] Second, during the 1980s, the Bulgarian government reclassified a large portion of former state investment funds as long-term bank credit, which was channelled mostly through the specialised banks set up in 1989. Although this represented little more than a cosmetic change at the time, commercial banks later inherited this largely-unserviceable debt as assets. Third, and perhaps most important, a significant portion of this debt was denominated in hard currency. Thus, while rapid inflation in the early years of transition eliminated a large amount of lev-denominated debt, the simultaneous steep devaluation of the currency increased the burden of the debt denominated in hard currency.[55] As a result, Bulgaria inherited both a relatively high share of bank credit in GDP and a high share of credit arrears in all credit. Finally, it should be mentioned that, as Bulgaria was less oriented to Western markets before the 1990s than most other central and eastern European countries, the shortage of qualified bank personnel with a knowledge of market accounting and banking practices was also more severe.

The state of the banking sector in Bulgaria: 1994-1995

Although the privatisation of banks was not pursued before 1996 in Bulgaria, prevailing conditions in the early years of transition allowed for the emergence of a number of new private banks. Start-up capital requirements were not very high, particularly for banks that applied for licenses before May 1992. Furthermore, many banks apparently succeeded in starting up on the basis of borrowed funds, reflecting an oversight in the initial legislation. In earlier years, the monitoring of commercial banks and other financial institutions was quite weak, particularly with regard to new private initiatives. Enhanced monitoring by the BNB in 1995 uncovered that a number of registered ‘‘financial houses’’ actually operated illegally as banks, taking deposits and extending loans. As a result of easy entry into banking, Bulgaria ended up with a number of often poorly-capitalised private banks, operating together with remaining state banks. The number of private banks grew steadily from 6 in 1991 to 34 in 1995. Parallel to this development, a large number of mergers among existing state commercial banks caused their number to fall from 72 in 1991 to 12 at the end of 1995. This often took the form of coupling financially-distressed and relatively sound banks as a means of avoiding bankruptcy. Until 1996, there was very little outright exit from the banking sector, even by small private banks. The BNB did take over two distressed private banks in 1995 and early 1996.

In 1994-1995, in addition to the SSB, the structure of the banking sector included nine ‘‘large’’ banks, with over 30 billion leva in assets, eight of which were state-owned. At the end of 1995, among commercial banks, this group accounted for 78 per cent of all financial assets, 75 per cent of all claims on non-financial institutions and clients, and 73 per cent of all attracted resources from non-financial institutions and clients. Occupying a unique place in this group is the state-owned Bulbank, formerly the Foreign Trade Bank, whose base (equity) capital dwarfs that of any other Bulgarian bank (66.5 per cent of aggregate capital in the banking sector in 1994 and over 100 per cent, due to negative capital in the rest of the banking sector, in 1995). Bulbank is also distinguished for its virtual non-participation in the market for commercial loans. Loans comprise less than one per cent of the assets of Bulbank. By contrast, loans to non-financial institutions make up the majority of the assets of remaining banks. Furthermore, Bulbank has adopted the practice of backing up every loan that it makes with 100 per cent provisions.[56]

The implementation of the banking laws and regulations passed between 1991 and 1993, as summarised in Box 4, proved quite complicated in Bulgaria in 1994 and 1995. As summarised in Tables 14 and 15, the overall convergence of the commercial banking sector toward the satisfaction of the rather ambitious capital adequacy and loan provision requirements did not generally materialise. On the contrary, along with the partial recovery in economic growth and apparent progress in stabilisation during 1995, the performance in the banking sector showed a marked deterioration.

Tables 14-17 illustrate what appear to be important differences between the group of large banks and the small and medium-size banks. Once the outlying Bulbank is excluded, the aggregate capital adequacy ratio of the remaining eight large banks deteriorated from an estimated 2.82 per cent in 1994 to a negative level in 1995.[57] Virtually all of these large banks became financially distressed over this period. The BNB filed bankruptcy proceedings against two of them in 1996: First Private Bank (the only large private bank) and Mineralbank. Most others were put in conservatorship in September 1996. The market share (balance sheet total) of banks that managed to satisfy the capital adequacy ratio of 8 per cent also fell from 50.9 per cent in 1994 to 39.6 per cent in 1995, this statistic being biased upward due to the inclusion of Bulbank in this group.

At the same time, according to then-existing Bulgarian accounting standards, small to medium-size banks appear to have almost satisfied capital adequacy and big loan requirements in aggregate in both 1994 and 1995. If these banks had followed the international accounting standard of deducting levels of required provisions for loans in calculating the capital base, however, capital

Box 4. **Pre-1996 Bulgarian banking laws, regulations, and classifications**

From 1991 to 1993, Bulgaria adapted banking laws and prudential regulations that were based to a large extent on Western advice and conventions. The fundamental laws and regulations adapted during this time include the Law on the Bulgarian National Bank (June 1991), the Law on Banks and Credit Activity (March 1992), and prudential regulations for Licenses (February 1993), Big and Internal Loans of Banks (January 1993), the Capital Adequacy of Banks (March 1993), the Internal Control of Banks (June 1993), and the Liquidity of Banks (June 1993). Some of these regulations were amended during 1993-1995. In addition to banks, separate legislation applies to the registration and activities of ''financial houses'', ''brokers'', and ''exchange bureaux'', which can service various delineated activities on financial markets that do not involve deposits or credits. In May 1996, the Law on Banks and Credit Activity was altered and amended in a significant way, as discussed in Box 6.

With the Law on the Bulgarian National Bank, the BNB became, by and large, an independent body, with the responsibility of pursuing macroeconomic stabilisation and regulating commercial banks. The degree of autonomy of the BNB has actually been a bit ambiguous and the focal point of some controversy. Although the Law grants the BNB complete authority over credit expansion, including credits to the government, the Parliament has compelled the BNB on several occasions to extend credits to the Ministry of Finance. A new amendment to the BNB Law of 1996 increases the leverage of the government over the BNB by empowering the Parliament to remove the Governor and Board of the BNB with a qualified majority. At the same time, the BNB has succeeded in functioning largely independently in many areas since the adoption of the Law. Between 1993 and 1995, direct credit to the government was reduced significantly, as discussed in Chapter II.

The Law on Banks and Credit Activity is consistent with the development of universal banking. In addition to usual functions, banks are guaranteed the right to manage capital investment funds, directly acquire up to 10 per cent of the stock of a non-financial enterprise, and can acquire even more stock with permission of the BNB. According to this law, the capital adequacy ratio of the bank must conform to the Basle criterion of more than 8 per cent. Base capital must also be at least $1/8$ of the sum of all big loans (exceeding 15 per cent of equity capital). Any single loan is not permitted to exceed 25 per cent of capital, with further restrictions on the volume of loans to ''insiders''. Commercial banks were granted, in 1992, a period of one year to adjust to the capital adequacy requirement. This period was later extended to March 1995 (now 2001, see Box 6). The BNB is also granted the authority to restrict operations or revoke licenses of commercial banks. But this power was brought into question when the Supreme Court overruled the first decision by the BNB to revoke the licenses of two banks in 1995.

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The prudential regulations on capital adequacy of 1993 set minimum capital requirements at BGL 200 million (US$7 million at the time) for a domestic banking licence and BGL 500 million (US$16 million) for a licence to also conduct operations abroad. After the strong depreciation of the lev in 1994, under these conditions, a few banks managed to obtain licenses for as little as the equivalent of US$3 million before the minimum requirements were adjusted upward at the end of the year to BGL 450 million (US$7 million at the time) and BGL 800 million (US$12 million), respectively. Those who had applied for licenses before 7 May 1992, however, were allowed to begin banking operations in 1993 with as little as BGL 50 million (US$1.5 million at the time), with the obligation to meet the legal requirement within a year.

The regulations on loan classification created a division of loans into four categories: 1) regular; 2) doubtful-type A; 3) doubtful-type B; and 4) uncollectible. Although this division can theoretically be based on various criteria, including an assessment of the solvency of the debtor, the most important factor is payment arrears. A loan is doubtful-type A if it is in arrears less than 30 days, doubtful-type B if in arrears between 30 and 90 days, and uncollectible if in arrears over 90 days. The regulations require banks to provision against 20 per cent, 50 per cent, and 100 per cent of the principal of these types of loans, respectively. Banks were given to the end of 1993 to comply with half of the respective required provisioned amounts, to the end of 1994 for 75 per cent, and to the end of 1995 for 100 per cent. Banks not in compliance with this schedule were forbidden to distribute dividends or service subordinated term debts without special permission from the BNB. This clause also pertains to banks that do not satisfy minimum requirements according to 11 ratios that measure various aspects of liquidity, as prescribed by the Regulations on the Liquidity of Banks.

The Law on Banks and Credit Activity, together with the various prudential regulations, also contains disclosure requirements, corresponding to general operations. Reports to the BNB are required on a monthly and yearly basis. Disclosure requirements to depositors cover only the terms of the specific contract. No explicit deposit insurance existed until December 1995. The details of this and subsequent related legislation are given in Box 6 of this chapter.

adequacy ratios would certainly have been far lower. In addition, these banks fell behind in the satisfaction of their requirements for provisions to an even greater extent that state banks. This latter fact was typically due to a lack of profits out of which provisions could be financed. Given the fact that many small to medium-size banks were known to have been financially distressed, these data could reflect the fact that at least a subset of these smaller banks is performing well. It

Table 14. **Fulfilment of 1991-93 banking regulations**

	Capital base (BGL '000s)	Capital adequacy[1]	Big loans[2]/ base capital	Statutory provisions[3]
1991-1993 Laws and Regulations	n.a.	> 8 [4]	< 8	75 (1994); 100 (1995)
Consolidated, 1994	33 651 000	8.6	2.1	23.6
9 largest banks, 1994	27 404 927	8.5	1.2	24.9
Consolidated minus 9 largest banks, 1994	6 246 073	8.9	6.1	18.1
Consolidated, 1995	21 374 481	4.6	7.7	23.7
9 largest banks, 1995	11 073 452	3.3	8.0	26.7
Consolidated minus 9 largest banks, 1995	10 301 029	8.0	7.4	14.6
Consolidated, excl. Bulbank, 1994	11 264 000	4.5	6.4	23.6
8 largest banks excl. Bulbank, 1994	5 017 927	2.8	6.8	24.9
Consolidated, excl. Bulbank, Dec. 1995	–3 379 519	0.0	–	23.7
8 largest banks excl. Bulbank, 1995	–13 680 548	–0.1	–	26.7

N.B.: Due largely to the effects of the ZUNK bond rehabilitation of the balance sheets of banks in 1993, the data from that year are of limited comparability and are therefore left out of the table; State Savings Bank excluded.
1. Equals bank assets/risk component (assets weighted by risk).
2. Loans > 15% of shareholders' equity.
3. Percentage of required amount.
4. Capital adequacy ratio requirement of over 8% as of 31 March 1995.
Source: BNB, *Annual Report 1995;* Bulbank, *Annual Report 1995;* OECD.

Table 15. **Capital adequacy of commercial banks**

Capital adequacy ratio[3]	1994[1]		1995[2]	
	Banks (units)	Market share[4] (%)	Banks (units)	Market share[4] (%)
> 8	20	51	22	40
4-8	6	23	5	17
0-4	3	10	4	14
< 0	4	14	9	29

1. In 1994, 2 banks (.3% market share) were exempt; 9 banks (1.4% market share) were registered, but non-operational.
2. In 1995, 4 banks (.4% market share) were exempt.
3. Equals bank assets/risk component (assets weighted by risk).
4. Defined as balance sheet totals divided by sum of all balance sheets.
Source: BNB, *Annual Report 1995.*

should be noted that information on these banks could also be incomplete or incorrect, reflecting the fact that the BNB is at a bad disadvantage in monitoring the accuracy of these reports relative to those of the large state banks.

Table 16. **Selected balance sheet indicators, 1994-95**[1]

	Group 1[2]		Group 2[3]		Total banking system	
	Total 1995 (BGL bn)	Growth 1995/94 (%)	Total 1995 (BGL bn)	Growth 1995/94 (%)	Total 1995 (BGL bn)	Growth 1995/94 (%)
Assets						
Claims on banks and other financial institutions	83.9	35.5	23.3	–6.8	107.1	23.4
Claims on non-financial institutions and other clients	344.2	–1.5	115.0	60.8	459.2	9.1
Reported losses	20.3	192.3	8.9	243.5	29.2	206.1
Liabilities						
Attracted resources from banks and other financial institutions	237.0	–29.6	54.0	27.9	290.9	–23.2
Attracted resources from non-financial institutions and other clients	285.4	32.8	106.4	62.2	391.8	39.7

1. Excluding State Savings Bank.
2. Nine largest banks.
3. Other banks.

Source: BNB, *Annual Report 1995*, p. 143.

Table 17. **Commercial bank loans by classification**[1]

Percentage

Loans	1994					December 1995				
	Standard	Doubtful – type A[2]	Doubtful – type B[3]	Uncollectible[4]	Total	Standard	Doubtful – type A[2]	Doubtful – type B[3]	Uncollectible[4]	Total
Total for banking system	17.7	66.9	3.5	12.0	100.0	25.9	54.5	4.2	15.4	100.0
Group 1 (banks with > BGL 30 bn in assets)	11.8	75.1	2.6	10.5	100.0	17.3	64.3	4.0	14.5	100.0
Group 2 (banks with < BGL 30 bn in assets)	41.6	33.7	6.9	17.8	100.0	49.0	28.6	4.8	17.6	100.0

1. As per Regulation No. 9 of the BNB (see Box 1).
2. A loan is doubtful-type A if it is in arrears less than 30 days.
3. A loan is doubtful-type B if it is in arrears between 30 and 90 days.
4. A loan is classified as uncollectible if in arrears over 90 days.

Source: BNB, *Annual Report 1995,* p. 142.

At the same time, the group of small and medium-size banks exhibit some very disturbing trends. These banks possess loan portfolios under which more than half of all claims are doubtful or uncollectible (Table 17), and reported losses that grew from BGL 2.6 billion to 8.7 billion between 1994 and 1995 (Table 16). Such reported losses, furthermore, understate the reality because of the nature of Bulgarian accounting standards. Nevertheless, claims on non-financial institutions of these banks grew by 61 per cent in 1995, nearly twice the rate of inflation. Much of this growth also involved ‘‘big loans’’, the share of which moved from 49 per cent to 61 per cent of all loans for this group of banks. By contrast, aggregate loans of the large banks to the non-financial sector contracted even in nominal terms (–1.5 per cent) in 1995. Given the fact that a greater share of loans of the small and medium-size banks represent new loans, the classification breakdown of their loans, presented in Table 17, is arguably even more disturbing than for large banks. Reported losses for the banking sector overall moved from BGL 9.5 billion to 29 billion between 1994 and 1995, representing 1.8 and 3.3 per cent of GDP, respectively. Large banks were responsible for 70 and 73 per cent of these losses, respectively.

As illustrated in Table 16, another notable trend of 1995, which was reversed in dramatic fashion in 1996, concerns the ability of commercial banks to attract a relatively larger share of savings of the population. This increase was partly at the expense of the SSB, as commercial banks offered higher returns on deposits. It also reflected a willingness of the population to hold a larger proportion of savings in banks (Figure 4), corresponding to the temporary stabilisation, and real appreciation of the lev, as discussed in the previous chapter.

Relations between commercial banks, the Bulgarian National Bank, and the government

Bank rehabilitation through special state bond issues

The Bulgarian government recognised early on that some measures would need to be taken to alleviate the burden of unserviced pre-transition debts on the balance sheets of commercial banks and debtor enterprises. The removal of these loans from the balance sheets of banks and firms could be justified from more than just a practical point of view, as these credits were extended largely on the basis of administrative planning as opposed to market principles and did not directly reflect the initiative of the management of the banks or enterprises involved. Beginning in 1991, a series of measures have been taken by the government to replace some non-performing debt with special state bond issues, placed directly in the portfolios of commercial banks. In 1991, the state first announced its intention to rehabilitate enterprises and banks by replacing all bad loans contracted before 1990 with special issues of state bonds. This operation was implemented gradually, however, and not completed for banks until 1994.

Two separate special bond issues in 1991 and 1992 covered part of the non-performing pre-1990 loans of approximately 125 enterprises. Parliament finally passed the major ''Law on the Settlement of Non-Performing Credits Negotiated Before 31 December 1990 (The Bad Loans Act)'' in December 1993, which covered the remainder of these loans. Under this law, the state issued bonds for the value of remaining debt corresponding to pre-1991 contracts in arrears more than 180 days. Bonds issued for this purpose became known as ZUNKs by their Bulgarian abbreviation. They were directly placed in the portfolios of banks. Lev-denominated loans were covered by lev-denominated ZUNKs (BGL 32 billion or approximately US$1 billion at the end of 1993) and hard currency loans were covered by dollar-denominated ZUNKs (US$1.8 billion). Enterprises remained theoretically responsible to the state for the principal (but not the interest) of these loans. The BNB passed a regulation on the enactment of the Bad Loans Act, whereby any enterprise affected by the programme, and which is also in arrears on a loan negotiated since December 1990 [doubtful type-B or uncollectible (see Box 4)], was to be excluded from receiving any new commercial bank credits.[58]

Due to the major burden on the already-strained state budget of servicing these bonds, the final conditions of the Bad Loans Act actually represented a compromise that left part of the burden of the old bad debts with the banks. First, only the interest due on these loans until June 1993 was covered by the ZUNKs, leaving the remaining interest losses to be financed by the banks. Second, while the dollar-denominated ZUNKs earn the six-month US$ LIBOR (paid in leva at the current exchange rate), the lev-denominated ZUNKs pay only $\frac{1}{3}$, $\frac{1}{2}$, and $\frac{2}{3}$ of the BNB basic interest rate for the first two, second two, and third two-year periods, respectively, while paying the basic rate thereafter. Thus, from the point of view of discounted income flows, the lev-denominated ZUNKs were worth significantly less than their face value. At the same time, ZUNKs can be sold to third parties and redeemed at privatisation auctions at face value, which links their value strongly to progress in cash privatisation. Also, in the course of subsequent years, the BNB issued Lombard Credits to banks against 70 per cent of the face value of ZUNKs (later 40 per cent) and, on one occasion in 1994, purchased ZUNKs from a bank at face value (see Box 5).

After the implementation of the Bad Loans Act, two large subsequent state bond issues to rescue banks and protect depositors followed. The first, described in Box 5, concerned special measures to rehabilitate Mineralbank and Economic Bank in mid-1995. A second bond issue embodied the value of deposits in banks forced out of operation in mid-1996, as discussed in Box 6. The combined effect of the bank rehabilitation programmes on domestic debt has been substantial. They account for roughly half of all domestic debt between 1993 and 1996, and represent one of the primary reasons why domestic debt service accounted for almost 27 per cent of all consolidated budget expenditures in 1994 and 1995.

Bank regulation and refinancing

Other than aid from special issues of government bonds and temporary success in attracting more deposits of the population, several Bulgarian commercial banks relied on continued refinancing of the BNB or interbank credits from the State Savings Bank (SSB) for survival. Figure 14 summarises the dynamics of commercial bank refinancing by the BNB between December 1992 and June 1996, involving Lombard, discount, and overdraft credits, as well as unsecured loans.

The large drop in BNB refinancing in May 1995 corresponded to the state rescue of Mineralbank and Economic Bank, discussed in Box 5, under which the BNB received repayment of a BGL 20.6 billion debt. The drop in BNB refinance in mid-1994 is also a bit artificial, as it is due to the purchase by the BNB of the ZUNK bonds in the portfolio of Economic Bank at face (higher than market) value to induce repayment of its escalating refinance debts. But the BNB has managed to keep the overall growth in commercial bank refinancing below the level of inflation during 1993-1995. The share of commercial bank refinancing in GDP has also fallen (Figure 15). In 1993, 1994, and 1995, December-on-December growth rates of refinancing were, respectively 29 per cent, 68 per cent, and –28 per cent (+31 per cent if the rescue operation is excluded), in contrast to

Box 5. **Mineralbank and Economic Bank**[59]

Mineralbank and Economic (Stopanska) Bank occupy a special place among large distressed banks in Bulgaria. Accounting together for roughly 20 per cent of the assets and liabilities of the banking system as a whole in 1995, non-performing loans from before 1991 were quite concentrated in these banks. Indeed, after the Bad Loans Act, the shares of ZUNK bonds in all of the assets of Mineralbank and Economic Bank were 69 per cent and 64 per cent, respectively. For dollar-denominated assets only, these figures were 74 per cent and 67 per cent. At the time of the rapid depreciation of the lev in early 1994, these banks suffered from low foreign exchange coverage, with foreign exchange assets accounting for less than 30 per cent of foreign exchange liabilities. After the placement of ZUNK bonds in their portfolios in 1994, the mismatch moved to the direction of high foreign currency assets relative to liabilities, and a corresponding excess of leva liabilities over leva assets. This, in turn, gave rise to liquidity problems when the lev appreciated in real terms in 1995.

These two banks accounted for the majority of BNB refinancing in the period from 1994 to mid-1995. They accounted for 21 per cent of refinancing at the end of 1993. (For the level and dynamics of BNB refinancing during this period, see Figure 14.) But this share quickly moved up to 60 per cent by mid-1994, prompting the BNB to purchase all the lev-denominated ZUNK bonds in the portfolio of Economic Bank at face value to institute repayment of these credits. But the combination of the Bad Loans Act and this action proved insufficient to prevent a further deterioration in the situation in both banks. Together, they again accounted for 65 per cent of all BNB refinancing by mid-1995. They also accounted for a large share of interbank borrowing from the State Savings Bank (SSB) (see Figure 15). Beginning in February 1995, the BNB stopped collecting interest on refinance credits to these banks, and finally wrote this interest off altogether. In March 1995, the BNB proposed to the government a plan to purchase all of the remaining ZUNK bonds from both banks, at face value, as a final rehabilitation measure. The government did not approve this plan, but adopted another in which ZUNK bonds in the portfolios of Mineralbank and Economic Bank were replaced by special 7-year bonds, denominated in leva, worth BGL 52 billion and paying the market rate of interest. After the initial announcement of the BNB in March of an intention to rehabilitate the two troubled banks, obligations to the BNB and SSB grew at such a rate that, by the time the bonds were placed in the banks portfolios three and a half months later, the vast majority of these bonds had to be transferred to the BNB (20.6 billion) and the SSB (22.3 billion) as repayment of debts. A condition of this agreement was that the BNB would no longer refinance these two banks in any way. Yet the problems of Mineralbank and Economic Bank continued to the point where this commitment was revoked in early 1996, and major assistance from the BNB and SSB to these banks began again, in addition to the significant resources that were now being absorbed by other banks. As Mineralbank and

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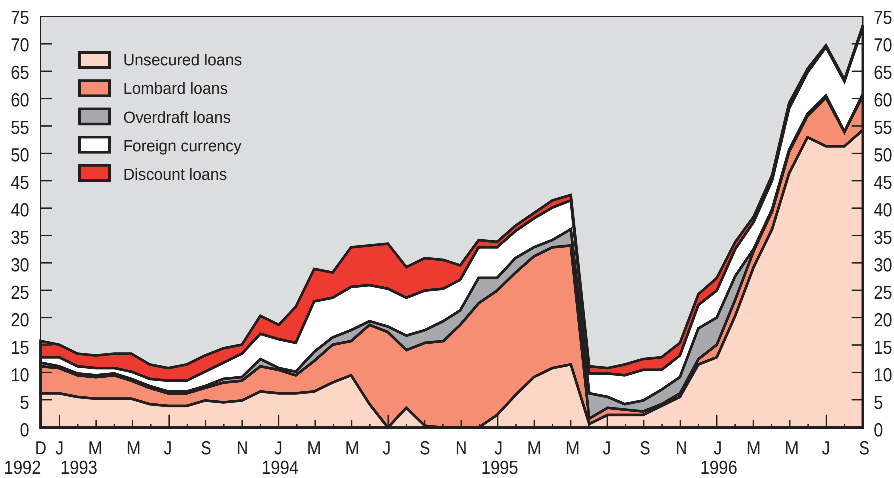
Economic Bank no longer had state bonds in their portfolios against which refinancing credits could be issued, refinance shifted to unsecured loans. The reform programme of mid-1996 has put Mineralbank into conservatorship under a bankruptcy injunction by the BNB. Economic Bank was given partial rehabilitation in mid-1996 under the Bulbank-assisted programme (see Box 6), but was then placed under conservatorship in September. The decision by the Bulgarian government not to honour the obligations of Mineralbank to some foreign lenders stirred a bit of controversy.

CPI inflation rates of 64 per cent, 122 per cent, and 33 per cent. It is interesting to see, nevertheless, that certain accelerations in refinance preceded the financial crises in both March 1994 and 1996. While CPI inflation between November 1993 and February 1994 was 13 per cent, growth in BNB refinance was 47 per cent. With inflation running around 2.5 per cent a month from

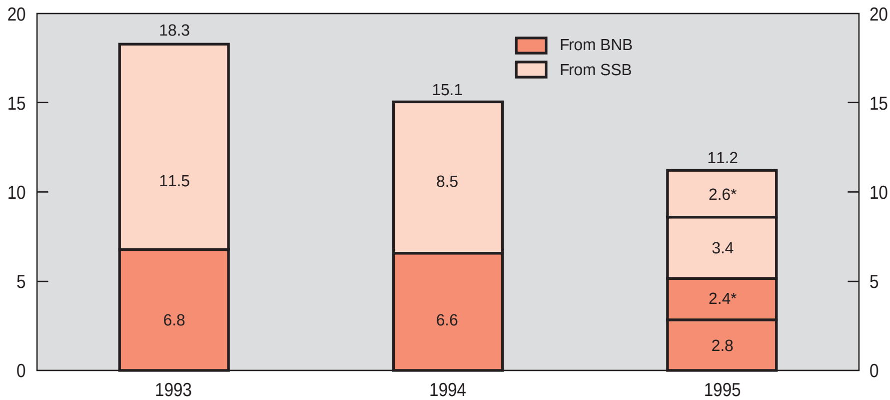
Figure 14. **COMMERCIAL BANK REFINANCING BY THE BNB**
BGL billion



Source: BNB, *Monthly Bulletins* 1993-96.

Figure 15. **OUTSTANDING CREDITS TO COMMERCIAL BANKS FROM NATIONAL BANK AND STATE SAVINGS BANK**

Percentage of GDP



* Repaid to BNB and SSB through special State bond issue of mid-1995 to rescue Mineralbank and Economic Bank.

Source: BNB *Annual Reports* 1993-1995 ; NSI.

October 1995-January 1996, bank refinancing by the BNB grew by BGL 9 billion or 150 per cent in December 1995 alone. In 1996, refinancing grew at an accelerating pace in the face of large withdrawals by depositors.

The structure of BNB refinancing also follows an interesting pattern during the period from 1993 to June 1996. While unsecured loans comprised a large share of refinance in 1993, the BNB announced an intention in mid-1994 to end all unsecured finance as part of a package of measures involving the end of the use of credit ceilings (see below) in controlling commercial credit.[60] A huge shift toward the use of Lombard credits was facilitated by the implementation of the Bad Loans Act, as these credits were issued primarily against ZUNK bonds. But, gradually, the scope for securing credits against ZUNK bonds narrowed, which was reflected in the escalation of largely unsecured refinance toward the end of 1995.

The State Savings Bank has also played a major role in aiding the survival of troubled commercial banks. The growth and quantity of credit from the SSB to commercial banks during 1993-mid-1996 has followed a similar pattern to that from the BNB. The primary source of profits for the SSB comes from the large interest differential between low-interest deposits, supported by explicit 100 per cent state deposit insurance, and a large portfolio of state securities among its assets. Thus, a part of the growth in credit from the SSB to commercial banks must also be conceptualised as financial flows from the state to commercial banks. Figure 15 summarises the relative size of outstanding BNB and SSB credits to commercial banks at the end of 1993, 1994, and 1995. As the special operation in 1995 to rescue the two large banks transferred state budgeted resources to the BNB and SSB as repayment of commercial bank loans, this amount is included in the figures below for conceptual clarity.

As illustrated in Figure 15, before the crisis of 1996, the BNB and SSB had succeeded in reducing the share of their outstanding credits to commercial banks in GDP from 18 per cent to 11 per cent (disregarding the special bailout discussed above). But 11 per cent can still be regarded as a very high absolute level. Additional significant financial flows from the state to commercial banks came from the ZUNK and other special bond issues discussed above. Interest payments by the state on ZUNK bonds alone accounted for 2.1 and 1.6 per cent of GDP in 1994 and 1995. The bailout operation of Mineralbank and Economic Bank induced another (interest) payment from the budget of 11 billion leva at the end of the year. At the same time, reported corporate state tax revenue from all financial institutions in the country comprised only 0.3, 0.1, and 0.4 per cent of GDP in 1993, 1994, and 1995, respectively. This gives at least a partial picture of substantial implicit and explicit financial flows from the state budget, the BNB, and the SSB to commercial banks during the period in question.

Until the second half of 1994, the BNB employed direct ceilings for the expansion of credit by commercial banks. These ceilings were not easy to enforce, however. Monitoring by the BNB in the second half of 1993 led to fines of a large number of banks for exceeding the limits. Mid-1994 represented a qualitative turning point in the BNB regulation of commercial banks, as credit ceilings were abolished and the primary instruments of regulation became reserve policy, refinance policy, and the enhancement and enforcement of prudential regulations. At this time, reserve requirements were gradually raised from 8 per cent to 10 per cent at the end of 1994, and up to 11 per cent by the end of 1995. Commercial banks' access to overdrafts was restricted from 100 per cent to 50 per cent of reserves at this time, and interest rates on overdraft loans were increased substantially.

At the same time, beginning in 1994, the BNB and the Bank Consolidation Company (see below) stepped up measures aimed at monitoring commercial banks and enforcing compliance with laws and regulations. In 1994, with assistance from PHARE, the BNB increased its on-site and off-site monitoring of commercial banks, during which time a significant degree of distortion was discovered in the information that many commercial banks had been supplying the BNB.[61] Special disciplinary measures were taken against some banks. Also, following a collapse of several pyramid schemes in mid-1995, the BNB began to give more attention to the activities of non-bank financial institutions. All applications for the creation of financial houses were refused in 1995 and the licenses of six financial houses were revoked for the illegal practice of banking activities. At the end of 1995, there were still roughly 130 financial houses functioning in Bulgaria.

A controlling interest of the Bank Consolidation Company (BCC), which holds majority shares of stock in state banks, was obtained by the Ministry of Economic Development in 1995 through the transfer of shares from the line ministries and Bulbank. The BNB is the other major shareholder. Since that time, the BCC has also played an autonomous role in monitoring commercial banks under its control. In several cases, the BCC acted to replace management in banks that were either struggling or guilty of violations. This included the complete replacement of the management of three large banks, as well as minor shake-ups in the management of some others.[62] The BNB took over two troubled private banks in 1995 and early 1996, and moved to strip the licenses of two others. But the Supreme Court struck down this initial attempt to revoke licenses from these two banks, and did not acquiesce until mid-1996.[63]

The measures described above, however, were insufficient to prevent a marked deterioration in the banking sector toward the end of 1995 and into 1996. The loss of confidence of the population in commercial banks, escalating into accelerated refinance and mass bank runs by mid-1996 is described in Chapter I. The policy response of the government to the crisis is outlined in Box 6.

Commercial banks and firms: the allocation of credit to the non-financial sector

A common perception at the level of firms is that bank credit has become increasingly scarce. This is supported by the declining share of credit in GDP in

Bulgaria in recent years, as indicated in Table 18. In recent surveys, enterprises, particularly those in the private sector, often cite the short supply of expensive bank credit as a major hindrance to their performance.[64] Many Bulgarian firms function virtually without access to commercial credit. Nevertheless, taking into account the low level of development of financial markets in Bulgaria, aggregate commercial credit expansion to the non-financial sector in 1994-1995 appears to have been excessive.

Table 18. **Ratio: credit to non-financial sector/GDP in selected Central and Eastern European countries**

	1993	1994	1995
Poland	0.21	0.20	0.20
Hungary	0.28	0.27	0.23
Czech Republic	0.57	0.57	0.53
Slovakia	0.70	0.60	0.59
Romania	0.24	0.19	0.23
Russia	0.18	0.10	0.06
Slovenia	0.21	0.23	0.27
Bulgaria	**0.68**	**0.51**	**0.41**

Source: National Banks of Poland, Hungary, Czech Republic, Bulgaria, Slovenia; Statistical Office of the Slovak Republic; Goskomstat of the Russian Federation; Romanian National Commission for Statistics.

While ratios of credit to the non-state sector relative to GDP in the range of 41-68 per cent may appear reasonable by international standards, they are quite high for a former socialist country in transition. Other than the Czech Republic and Slovakia, ratios in the other transition countries, shown in Table 18, are under 30 per cent between 1993-1995, with Poland falling under 20 and Russia under 10 per cent in 1995. These are countries that, in general, had a large part of the former debt overhang removed by brisk inflation in the early 1990s. Commercial bank credit expansion has since remained relatively low as a share of GDP in these countries, naturally reflecting the still low state of development of financial markets. This includes the absence of developed legal institutions for enforcing debt contracts, the lack of significant reliable, pooled information for credit rating and rationing, the lack of businesses ready to defend developed reputations, insider-controlled corporate governance that prevents disciplining incompetent or opportunistic management, and remaining high macro-instability and risk. It is natural to expect commercial credit in these countries to expand gradually over many years along with the process of institutional development. In contrast to the Czech Republic and Slovakia, where relatively low inflation did not wipe out a high degree of debts inherited from the past, the vast majority of old debts in Bulgaria have been eliminated either through inflation or rehabilitation programs, most importantly the Bad Loans Act. Therefore, Bulgaria is unique in having its relatively high ratio in Table 18 maintained by new credits. These new credits have typically become non-performing very quickly.

Bulgaria bears some resemblance to Russia in the degree of its needs in restructuring and the huge impact on the economy of the shock of transition. Conditions in Russia also allowed for rather easy entry by new private banks in the early 1990s. Yet the ratio in Russia of credit to the non-financial sector in GDP is particularly low, reflecting a process whereby profit-maximising banks, under restrictive Central Bank policies, have moved their portfolios away from loans and toward high-yield, low-risk state securities. The relative scarcity of commercial credit in Russia is supported by a recent comparative study that surveys small and medium businesses in Bulgaria and the Krasnoyarsk region of Russia.[65] Despite the presence of high-yield state securities in Bulgaria, Bulgarian banks continued to tie up the majority of their assets in (bad) loans, in the end pumping resources from state institutions (BNB, SSB, Ministry of Finance) to the real sector in a largely unidirectional flow. This seemingly perverse behaviour of commercial banks in Bulgaria, which is explored in the next section, is critical for understanding overall economic developments in the Bulgarian economy in the 1990s.

A detailed picture of the nature of the allocation of commercial bank credit is offered by Tables 19, 20, and 21, all of which are based on outstanding commercial bank credits at the end of 1994 and 1995.

According to these tables, the private sector was already receiving roughly one half of commercial bank credit as of December 1994, and this remained the case in 1995.[66] The loan profiles of private and state firms for both years in all classifications are quite similar. In addition to receiving roughly half of the credit in the economy, the private sector has a similar share of non-performing loans in all classifications. The two exceptions are ‘‘uncollectible loans’’ and interest arrears. The private sector has a higher share of the former, while the state sector

Table 19. **Shares in commercial credit by classification**

Percentage

	Individuals and households	Private firms	State-owned firms	Total
	December 1994			
Total loans	1.8	45.9	52.3	100.0
Standard loans	4.8	48.4	46.7	100.0
of which: Long-term loans	15.1	52.8	32.1	100.0
Doubtful – type A [1]	0.1	47.8	52.0	100.0
Doubtful – type B [2]	0.5	67.2	32.4	100.0
Uncollectible [3]	0.5	48.7	50.8	100.0
Other credits	0.1	30.5	69.4	100.0
Interest arrears	0.4	36.8	62.8	100.0
	December 1995			
Total loans	1.7	51.7	46.6	100.0
Standard loans	4.9	43.8	51.3	100.0
of which: Long-term loans	14.1	28.3	57.6	100.0
Doubtful – type A [1]	0.5	52.6	46.9	100.0
Doubtful – type B [2]	0.7	81.0	18.3	100.0
Uncollectible [3]	0.3	57.0	42.6	100.0
Other credits	0.2	76.1	23.7	100.0
Interest arrears	0.2	45.7	54.1	100.0

1. A loan is doubtful-type A if it is in arrears less than 30 days.
2. A loan is doubtful-type B if it is in arrears between 30 and 90 days.
3. A loan is classified as uncollectible if in arrears over 90 days.

Source: BNB, *Monthly Bulletin* (Bulgarian edition), No. 6, 1995 and No. 6, 1996; OECD.

has a higher share of the latter. As for the maturity of loans, the share of long-term credit (over one year) in all credit for the private sector was substantially larger in 1994. In 1993, this share was even higher. The reported jump in standard credits of over 5-year maturity to state-owned firms in 1995 is a curious puzzle.[67] Given the very undercapitalised nature of the private sector, and the corresponding limited capacity to collateralise loans, the concentration of long-term credits in that sector is rather remarkable. Indeed, Rozenov (1996) estimates that the ratio of own capital to borrowed funds in the private sector is 0.27, as opposed to 1.4 in the state sector, implying that, despite the poor overall debt-service performance of the private sector, the expansion of credit to that sector in recent years was largely unsecured. If Russia is taken again for comparative purposes, the share of long-term credits in all commercial credit to all firms has ranged from 5 to 10 per cent in recent years.[68]

Table 20. **Loan profiles of the private and state sectors**

Percentage

	Standard loans	Doubtful – type A[1]	Doubtful – type B[2]	Uncollectible[3]	Other credits	Interest arrears	Total
				December 1994			
Individuals and households	87.1	1.3	1.8	4.2	0.2	5.4	100.0
Private firms	33.3	17.8	9.9	16.3	3.6	19.1	100.0
State-owned firms	28.2	17.0	4.2	15.0	7.1	28.6	100.0
				December 1995			
Individuals and households	83.7	6.0	3.0	4.2	0.2	2.8	100.0
Private firms	24.1	19.7	10.7	22.2	2.5	20.8	100.0
State-owned firms	31.3	19.4	2.7	18.4	0.8	27.4	100.0

1. A loan is doubtful-type A if it is in arrears less than 30 days.
2. A loan is doubtful-type B if it is in arrears between 30 and 90 days.
3. A loan is classified as uncollectible if in arrears over 90 days.

Source: BNB, *Monthly Bulletin* (Bulgarian edition), No. 6, 1995 and No. 6, 1996; OECD.

Table 21. **Maturity structure of standard loans**

Percentage

	Individuals and households	Private firms	State-owned firms	Total
	December 1994			
Up to 3 months	4.4	23.5	23.8	22.7
3 months up to 1 year	10.6	46.9	57.6	50.2
1 year to 5 years	35.1	25.8	18.1	22.7
Over 5 years	49.8	3.8	0.5	4.5
Total standard loans	100.0	100.0	100.0	100.0
	December 1995			
Up to 3 months	2.8	33.9	15.9	23.2
3 months up to 1 year	11.1	46.6	50.4	46.8
1 year to 5 years	58.0	17.5	10.7	16.0
Over 5 years	28.1	1.9	23.0	14.0
Total standard loans	100.0	100.0	100.0	100.0

Source: BNB, *Monthly Bulletin* (Bulgarian edition), No. 6, 1995 and No. 6, 1996; OECD.

While Tables 18-21 cast serious doubts on suggestions that the private sector in Bulgaria, on aggregate, is being choked for credit due to the direction of commercial bank activities toward loss-making state-owned enterprises, the picture is not at all inconsistent with the virtual unavailability of commercial credit for the vast majority of private firms. In fact, the allocation of credit in Bulgaria, particularly to the private sector, is extraordinarily concentrated around a few big debtors. Table 22 illustrates this point quite dramatically. As indicated in this

Table 22. **Concentration of commercial credit to the private sector, December 1995**

Percentage

Amount of loan (BGL '000s)	< 100	100-1 000	1 000-5 000	5 000-20 000	20 000-50 000	50 000-100 000	> 100 000
Share of credit	0.00	0.03	0.08	0.13	0.13	0.12	0.49
Share of number of loans	0.27	0.41	0.19	0.08	0.03	0.01	0.01

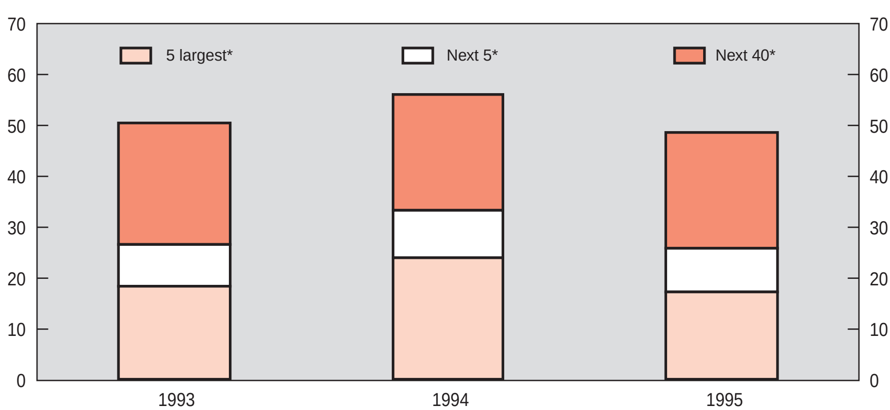
Source: BNB *Monthly Bulletin* (Bulgarian edition), No. 6, 1996; OECD.

table, the number of large loans of over BGL 100 million (US$1.4 million at the time) represent 1 per cent of the number of all loans to the private sector as of December 1995. But the value of these loans represents almost 50 per cent of all private sector credit, an amount equal to 9.6 per cent of GDP. Returning to Table 18, this figure represents a significantly greater share of Bulgarian GDP than the share of all commercial credit in GDP in Russia. This extraordinary statement bears repeating: 1 per cent of the number of all loans to the private sector in Bulgaria, as of December 1995, represented a substantially larger share of credit in GDP than the share of *all* commercial credit in GDP in Russia.

A more general measure of the concentration of commercial credit between 1993-1995 is offered by Figure 16. The five largest debtor enterprises (based on total credit as of 1995) obtained between 17 and 25 per cent of all commercial bank credit in Bulgaria.

Figure 16. **SHARES OF LARGEST CREDIT HOLDERS IN TOTAL COMMERCIAL CREDIT TO NON-FINANCIAL SECTOR**

Percentage



* "Largest" – ranking is by share of outstanding commercial credit as of 31 December 1995.
Source: 21 Century Foundation on the basis of NSI data.

Incentive problems in Bulgarian banking

Providing appropriate incentives for the development and transformation of the commercial bank sector in Bulgaria today, while avoiding an overall collapse of the financial system, has become quite complicated. On the one hand, there is a need for firm guidelines to end the perception that future difficulties will be met by the discretionary accommodation of the BNB or other state institutions. Yet, due to the inherently unstable and unpredictable economic environment, it is difficult not to adjust policies to help troubled banks *ex post*. To induce responsible behaviour among bank management, the BNB and BCC must monitor behaviour closely under the credible threat that, in the event of poor performance, the management will be replaced or the bank shut down. Yet, monitoring is expensive and difficult, and a regime that is too tough can lead to distortions in information reported by banks, roll-overs to disguise bad debt, or, even worse, myopic behaviour by management under the assumption that there is ‘‘no tomorrow’’. The BNB has understandably emphasised prudential regulations associated with big loans as a means of controlling possible corrupt practices of insiders. The statistics presented in Tables 19-22 suggest the extent of this problem in Bulgaria. On the other hand, with negative average profitability in the economy and poor enforcement of legal guarantees for collecting loans, 70 per cent of which are currently in arrears, should properly-functioning banks be expected to diversify their loan portfolios? While deposit insurance may be essential to boost the confidence of depositors, banks should be prevented from exploiting this insurance for short-term gains and long-run bankruptcy.

The analysis of the previous section provides some stylised facts on the behaviour of Bulgarian commercial banks in 1994-1995. To summarise, in comparison with other economies in transition, commercial bank credit to the non-financial sector in recent years has been quite substantial, despite an environment in which 70 per cent of all outstanding loans are delinquent. Commercial bank credit expansion to the private sector, especially involving long-term credits, also appears to have been excessive. Furthermore, roughly half of this credit to the private sector represents a handful of big loans of over US$1.4 million each. The overall share of long-term credits in all commercial credit appears to be very high, given the particular problems and low level of development of Bulgarian financial markets. The discussion below outlines several incentive problems corresponding to the particular nature of relations between Bulgarian commercial banks, state institutions, and enterprises, that could be relevant to explaining this behaviour.

Problems in the feasibility of targets

In retrospect, the goals set out in the legislation of 1991-1993, while possibly feasible for new banks, appear not to have been attainable by a few of the larger distressed banks, irrespective of incentives and management. If regulations or targets themselves are not feasible, incentives will generally be poor, regardless of whether their enforcement is credible, *i.e.* whether or not banks believe that authorities will take significant punitive measures against violators. If it is apparent to the banks that the targets are largely infeasible, they will most likely doubt their credibility under the assumption that they will be altered or revoked after a large percentage of banks fail to meet them. This is related to the difficult policy problem associated with correlated downside risk in the banking sector.[69] On the other hand, if banks do believe in the credibility of the enforcement of targets that are infeasible, incentives can be even worse. Such incentives can support significant investments in information distortion, high-interest roll-overs to disguise bad loans, and, in an extreme case, the sole maximisation of short-term personal gains of employees.[70]

Mineralbank and Economic Bank could have profited from being put under a special regime, including explicit well-targeted schedules for gaining capital adequacy and solvency along with a virtual freeze on all new credits. The Bad Loans Act did not effectively recapitalise these banks. Only a part of non-performing assets were replaced, and the lev-denominated ZUNK bonds paid lower rates of interest than those at which the banks could attract deposits. This immediately placed the heavily ZUNK-dependent banks in an extremely difficult position, and left the banks with little alternative than to lobby the BNB and the state for further assistance. By the time of the bailout of mid-1995, the situation of Mineralbank and Economic Bank had deteriorated to the point where virtually all new capital created needed to be transferred immediately to the BNB and SSB as repayment of past debts, leaving these banks again in the same situation. While it is possible to argue that these banks operated under weak incentives because of an expectation of a bailout, it is not clear that there existed any alternative strategy for these banks that could have made possible their survival.

As outlined in Box 5, Mineralbank and Economic Bank were primary recipients among banks of resources from the BNB, SSB, and state budget during 1994-1995, which played an important role in the subsequent destabilisation of the economy. While the feasibility of targets is, of course, difficult to determine *ex ante,* it is important to realise that over-ambitious goals in banking regulations can have every bit as destructive an impact on incentives as passive policies.

Problems in the credibility of policies

The credibility of regulatory policies in the banking sector has suffered from at least two other important problems. First, the state operated without any well-thought-out comprehensive plan for addressing the problems in the banking sector (before 1996), which gave rise to a policy environment of continual discretionary, largely accommodating measures. In contrast to the problems discussed above for the case of credible but infeasible targets, the expectation of discretionary accommodation can lead to the opposite distortions. Instead of distorting information and rolling over loans to appear more profitable, banks in this case will be motivated to hide profits in order to appear less profitable (adverse selection). The expectation of future adjustments based on discretionary measures by authorities can also give banks incentives to exert less effort to avoid future losses (moral hazard), or waste efforts lobbying for changes in policies (influence costs).[71] Strong incentives in commercial banks depend on a credible, *ex ante* commitment by the BNB and the state to limit accommodation within strict guidelines. Explicit reversals of commitments, such as those to end unsecured refinance in 1994 and end all refinance of Mineralbank and Economic Bank in 1995, can have a damaging reputation effect on the BNB. Authorities should explicitly factor in these costs, along with other costs or benefits, in evaluating various policies.

A second problem with the credibility and effectiveness of bank regulation in Bulgaria stemmed from the limited range of policy instruments at the disposal of the BNB (before 1996) for disciplining banks. The BNB possessed two types of instruments, financial (fines, overdraft interest rates, etc.) and non-financial (stripping of licenses, restrictions of operations). Financial instruments are of limited use as a means of disciplining banks that are already steeped in financial losses. For example, during certain periods of time, the BNB experimented with very high interest rates on overdraft credits to discourage demand (see Table A4 in the Annex). But this had very little effect on the demand of those banks that were fighting for survival amidst huge losses and hoping for a bailout. The demand of such banks was typically only limited by the ceiling of 50 per cent of reserves. At the same time, solvent banks in need of temporary liquidity must have been discouraged from using the overdraft facility, implying a cost to the banking sector as a whole. A very important non-financial instrument of the BNB was credit ceilings up until the time that they were removed in 1994. Until 1996, the BNB had very limited powers to remove the licenses of banks, and virtually no power to shut banks down or declare banks bankrupt. The limits of the BNB's powers were vividly illustrated at the end of 1995, when the Supreme Court struck down the first decision of the BNB to remove the licenses of two banks, which had clearly been guilty of violations.

Perhaps fundamental to understanding the Bulgarian experience, as well as banking problems elsewhere in Central and Eastern Europe, is a possible expectation among banks that the state will remain committed to the continued operation of certain large ''strategic'' firms with high employment. If these firms are unable to service their debt, it could be expected that the state will not hold the banks liable. This perception may have been strengthened by the initial platform of the Bulgarian Socialist Party when it came to power. In fact, in 1995, the then Minister of Industry made a statement encouraging financially-distressed enterprises not to service their debts.[72] While virtually all lending in the Bulgarian economy is of high risk, some banks may have adopted a survival strategy of tying themselves as much as possible to ''strategic'' state enterprises through the extension of credit. It is also the case that some commercial banks may have felt themselves pressured from certain parts of the government to extend credits to priority enterprises. Other than special programmes involving limited credit in the agricultural sector, however, the state has pursued no explicit policies of influencing commercial banks in the direction of credits in recent years.

Problems due to low capitalisation

Another set of problems concerns the fact that regulations surrounding the entry of new banks were quite soft, as discussed above. This, in a sense, created an opportunity to purchase implicit state deposit insurance at a very low cost. Particularly in the difficult environment of the Bulgarian economy, where most ''legitimate'' loans are non-performing, small, poorly-capitalised banks have strong incentives to exploit this insurance by making excessively risky investments, or even just corrupt loans to insiders, under the expectation that their operation will only be temporary. While easy entry for new private banks could have the positive effect of promoting competition and the rapid development of financial institutions in transition economies,[73] it could be argued that the Bulgarian experience clearly demonstrates potential problems from such a strategy. At least in the early years of transition, high capital requirements, significant deductions for explicit state deposit insurance, and active monitoring of existing banks are essential measures for building a healthy banking system.

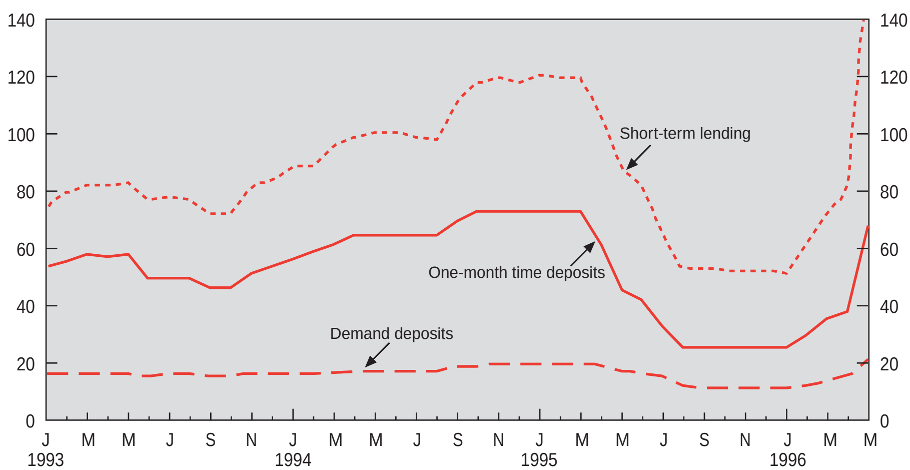
Problems in the interaction of banks and firms

Other potential problems are caused by the distortion of information at the level of debtor enterprises, either in collusion or not in collusion with banks. This is related to the so-called ''interface'' between the state and private sectors of the economy, discussed in Chapter IV. If loss-making state enterprises can receive money from banks, this can be a primary part of the resources shifted to private enterprises through transfer pricing or other mechanisms. Given the overall picture of the Bulgarian banking sector, discussed above, this provides opportunities for transferring the flows of resources from the BNB, SSB, and state budget through the commercial banks and state enterprises, to small private firms. These private firms can often not only profit at the expense of losses in commercial banks and state enterprises, but may also evade taxes on these profits. This result, of course, could also be realised through the more direct means of loans to private firms or individuals, which is consistent with the recent rapid expansion of bad, unsecured and concentrated credit to the private sector. Thus, it can theoretically be in the interest of (colluding) banks and state and private firms to maximise credits to loss-makers that will not be serviced. This process is further complicated in Bulgaria by the presence of some organised business groups, with strong connections in political and economic circles, that could profit from such arbitrage opportunities.[74]

While all of these categories of factors are arguably important in explaining incentive problems in the Bulgarian banking sector, limitations in both the amount and reliability of information make an assessment of their relative significance quite difficult. Banks are also quite heterogeneous themselves. The interaction of several of these problems together can also compound the distortion in incentives. For example, a poorly-capitalised bank lending with little regard for risk might want to cook up its books so as either not to attract the attention of authorities or to take advantage of preferred access to refinancing from the BNB or interbank market. This strategy may be based on an expectation that, when losses finally become too big to hide, the BNB will be forced to accommodate, particularly considering the fact that virtually all other banks are also insolvent. This cuts across virtually all of the categories of problems discussed above.

One interesting indicator that is related to bank incentives concerns the very high spreads between interest rates on deposits and loans in commercial banks.

Figure 17. **INTEREST RATE SPREADS OF COMMERCIAL BANKS**
Annual effective



Source: BNB, *Monthly Bulletins,* 1993-1995.

Such high spreads between lending and deposit rates in Bulgaria present an interesting puzzle, given the number of competing banks. Some authors have argued that the interest-rate spread properly reflects the high risk premium in

Bulgaria and the needs of commercial banks to make extra profits for provisions against bad loans. Higher interest rates, however, depress the demand for credit among those entrepreneurs who truly plan to pay back the loan, increasing the riskiness of the pool of those demanding credit.[75] This factor, as well as the potential for attracting more deposits, limits the interest spread under conditions of competition and ‘‘good’’ incentives in commercial banks. But very high interest rates on loans are convenient for banks that are trying to hide their losses for two reasons. First, the initial creation of the loan places a large sum on the ‘‘performing’’ asset side of the bank’s balance sheet. Second, prudential regulations require commercial banks to provision only against the principal and not the interest on doubtful or uncollectible loans. Thus, a low-principal, high-interest loan that is not serviced is preferable to the bank to a similar high-principal, low-interest loan. But such loans can also be convenient for a borrowing (loss-making) enterprise, since the bank is more willing to lend at a higher rate and the loan will probably not be paid back anyway. This is particularly the case if the bank or enterprise expects that the state will accommodate the losses. This corresponds in particular to cases of collusion for the transfer of funds between banks and firms, under which interest rates are important only for their effect on the bank’s balance sheet.

During the monitoring of commercial banks in 1994-1995, the BNB uncovered a significant amount of information distortion. Evidence on the growth of big and internal loans was particularly highlighted.[76] Such loans could be associated with many of the problems discussed above, including a willingness by banks to target specific strategic enterprises, as well as corruption and collusion. It has been suggested by Rozenov (1996) that the primary recipients of many of these large loans are the so-called business groups, which would be consistent with the extraordinarily high concentration of credits in the private sector.

But it should be noted in general that, in the context of the Bulgarian economy, the presence of a large share of big loans could also correspond to a situation with ‘‘good’’ incentives in the banking sector. In the absence of the financial institutions used to ration credit in a developed market economy, as discussed above, and in the presence of a negative average return on loans, a profit-maximising Bulgarian bank should not be expected to hold a well-diversified portfolio of loans. On the contrary, such a bank would loan to the real sector only under conditions of a special relationship, including (costly) monitoring and repeated interaction to support trust.[77] This fact alone would favour a concentration of credit in a limited number of firms. Here is an area where the complete adaptation of legislation from developed economies, which boast developed financial institutions, could be a mistake. Despite the apparent corrupt practices associated with many big loans in Bulgaria, an argument could be made to the effect that prudential regulations in Bulgaria should not target ‘‘big loans’’ *per se,* but insist only on a balance between assets in loans to the real sector and other less risky or more liquid assets, such as state securities. The problems associated with ‘‘bad’’ big loans in Bulgaria were a consequence of primary distortions in bank incentives, in particular the ability of commercial banks, which are often poorly-capitalised, to either siphon money from state sources or exploit implicit state deposit insurance at negligible cost. Those are the problems that need to be addressed directly.

As illustrated by the example of China, there exist economic conditions under which even the activities of various morally-questionable groups are not inconsistent with producing value-added for society as a whole, even if at the expense of a polarisation in distribution.[78] What is perhaps most disturbing for the case of Bulgaria is that, due to basic distortions in incentives, some of these activities not only polarise the distribution of wealth, but may contribute very little to value-added. On the contrary, if one considers the opportunity costs of the time and effort involved in influence activities for distorting information and lobbying state sources for finance, this activity is can be value-subtracting. Thus, the use of the commercial banking system as a means of securing unidirectional transfers of resources from the state budget and the BNB is destructive for the Bulgarian economy from almost any point of view, including GDP growth, stabilisation, and the distribution of wealth.

The 1996 Action Programme of the Bulgarian government and concluding comments

The 1996 Action Programme for the banking and enterprise sectors addresses many of the problems emphasised in this chapter, and will hopefully serve as a first building block for a new financial sector based on more sound economic incentives. Of particular importance for the banking sector is the expansion of the authority of the BNB for taking punitive measures against

Box 6. **Banks and the 1996 Action Programme of the Bulgarian government**

The Action Programme of the Bulgarian Government of mid-1996, which was amended later in the year, features a series of harsh measures aimed at bringing under control the rapidly deteriorating situation in the banking sector and the economy as a whole. As discussed in Chapter II, this restructuring action programme was developed in close consultation with the IMF and World Bank, and represented a cornerstone of the agreement to renew the financial assistance of International Financial Institutions to Bulgaria. For the short-run, the essence of this programme is the bankruptcy (liquidation) of several enterprises and banks, and the isolation of others from any activities involving bank credit, with a threat of eventual bankruptcy. Tight guidelines were also set for the future path of flows of state resources into the banking sector.

This programme provided for the adaptation of two essential pieces of legislation in mid-1996. First, the Law on Banks and Credit Activity of 1992, discussed in Box 4, was significantly altered and amended.[79] The revised law expands greatly the power of the BNB to regulate commercial banks. A special section on insolvency grants the right to the BNB, and only the BNB, to file bankruptcy proceedings against commercial banks, after which the insolvency of the bank must be established in court. Additions to the law empowered the BNB to replace the management or supervisory boards of banks even without documentation of explicit violations. The BNB may also place commercial banks believed to be ‘‘near bankruptcy’’ into ‘‘conservatorship’’, whereby the activities of the bank are essentially suspended, and the institution is placed under the control of an appointed ‘‘conservator’’. A new law also expands deposit insurance in an attempt to placate depositors. As opposed to the limited schemes announced by the BNB in December 1995 and March 1996, the law protects all depositors with personal accounts through 100 per cent state guarantees. Corporate accounts are insured 50 per cent.

In mid-1996, the BNB immediately put five banks into conservatorship and filed applications for their bankruptcy. This included two banks that the BNB had attempted to strip of licenses already in 1995. But also among this group are the only large existing private bank (First Private Bank) and one of the two major problem state banks (Mineralbank). State bonds with a value of about BGL 28 billion were issued to cover the liabilities to depositors of these banks. The SSB received the responsibility of servicing the leva deposits of the two large banks, while Post Bank, which received most of the special hard-currency-denominated bonds, services hard currency deposits. The First Private Bank and Mineralbank deposits began being serviced in mid-June. Foreign currency deposits were to be withdrawn only in 25 per cent portions over a period of two years, while the leva equivalent at the existing exchange rate could be withdrawn immediately. But this has already been changed (see below).

(continued on next page)

(continued)

At the same time, 64 enterprises, which account for an estimated 29 per cent of the losses in the economy in 1995 and employ roughly 24 000 people, were to be shut down immediately, which was to be accompanied by a special World Bank-financed programme to help aid affected workers in these enterprises. In addition to the usual unemployment compensation benefits, these workers were promised six months of the gross average monthly wage as a separation grant. But the shutting-down of most of these enterprises, as well as the disbursement of foreign aid has been delayed. Another group of 70 loss-making enterprises, accounting for an estimated 58 per cent of losses, was put on an ''isolation list''. These enterprises are to be isolated from commercial bank credit while, at the same time, suspending their service of outstanding debts. Two enterprises on this list, the National Electricity Company and Bulgarian State Railroads, will remain eligible for loans from commercial banks. Subsequently, an exception was also made for the large steel plant, ''Kremikovtsy''. But all exceptional loans must receive the explicit approval of the Ministry of Finance.[80] Other financial help can come from a special extrabudgetary ''State Fund for Reconstruction and Development''. In one subgroup, enterprises will face liquidation if they cannot demonstrate a positive cash flow within a fixed period. Special strategic enterprises, such as Balkanair, energy, and transportation firms, will be treated on a case-by-case basis. For energy-producing enterprises, regulated output prices are one of the reasons for low profitability. The action plan, therefore, foresees large energy price adjustments, as discussed in Chapter II. Workers released from enterprises on the isolation list will be eligible for the same benefits as workers from the liquidation-list firms.

As regards banks allowed to remain in operation, the Action Programme includes a number of restrictions on the their activities and the degree of future financial assistance from the BNB and SSB. No large re-capitalisation programme is included in the initial programme. Only limited measures were taken to allocate new capital to selective banks, essentially via a purchase from Bulbank of US$400 million of ZUNK bonds. This plan was proposed already in 1995, but is far short of what would be needed to eliminate the negative net worth of the sector. Those banks exhibiting negative net worth are forbidden from undertaking any new lending.

All banks that have been re-capitalised under the Bulbank programme, or that have negative net worth, were required to present to the BNB detailed Memoranda of Understanding, which propose explicit guidelines, under which banks are to strive for solvency and the satisfaction of prudential regulations. Progress under these guidelines is to be monitored on a monthly basis by the BNB. A new schedule for achieving capital adequacy requires banks to meet a 2 per cent ratio by 1 January 1998, 4 per cent by 1 January 1999, reaching 8 per cent by 1 January 2001. Until reaching 4 per cent, banks cannot distribute dividends. The open foreign exchange position of commercial banks is restricted to less than 30 per cent of capital as of 1 January 1997. Commercial banks are

(continued on next page)

(continued)

not permitted to extend credits to any firm that has arrears to banks of over 30 days. A new law of late 1996 should also facilitate the ability of banks to seize collateral from defaulting borrowers.

As of 1 June 1996, the SSB has been prevented from offering unsecured credits and deposits on the interbank market, and is under increased supervision, with the medium-term goal of satisfaction of prudential regulations and its full conversion into a commercial bank. Increases in BNB refinancing in 1996 are to occur within strict limits.

As the crisis and panic of depositors did not substantially subside, even after the announcement of the mid-year package, the Bulgarian government was compelled to undertake new actions in September and October 1996. In late September, the BNB Board decided to place nine more banks under conservatorship, allowing only 13 banks to continue normal operations. The new deposit insurance law was amended in October to exempt banks in conservatorship from servicing their deposits. Claims of depositors, which are still covered by the law (100 per cent personal and 50 per cent corporate insurance), can be obtained only after a final bankruptcy decision. In addition, the state announced a special emergency privatisation programme, involving 18 of the most profitable Bulgarian companies and 25 per cent of the Bulgarian Telecommunication Company, as a means toward meeting the eventual claims of depositors.

poorly-performing banks, and the potential bankruptcy of insolvent banks and enterprises. The schedule for the achievement of capital adequacy requirements appears considerably more realistic than in the past. Given the degree to which the credibility of government and National Bank policies has suffered in the recent past, particularly in 1996, it is of crucial importance that precedents be set involving the genuine enforcement of the tough and controversial commitments of the new programme. Although rapidly-changing and unstable circumstances require some policy flexibility, the costs of further compromising the credibility of state commitments are also substantial, and must be explicitly considered at each juncture. Due to the unfortunate sequence of events in 1996, it is unreasonable to expect a quick restoration of confidence in Bulgarian banks and other financial institutions. Current policies must be designed with realistic goals and expectations of gradually building up this confidence over time. This process could potentially be accelerated in the context of a comprehensive programme, proposed by the IMF in late 1996, involving the creation of a currency board, backed by substantial external financial support, for achieving stabilisation.

In contrast to the past, the Bulgarian Action Programme takes a strategy of solving the so-called ‘‘flow problem’’ in commercial bank credit before the ‘‘stock problem’’, associated with outstanding bad loans. The primary motivating factor here is the lack of state or foreign resources for the complete recapitalisation of the majority of banks. There is a need to proceed here with great caution, however. As long as the balance sheets of commercial banks are contaminated by an overhang of bad loans, this will imply important distortions in commercial bank incentives, as discussed earlier, and will imply the need for close supervision by the BNB. The establishment of a currency board, which would greatly curtail the possibilities of bank refinancing, would probably need to include a programme to recapitalise those commercial banks that are allowed to continue operations.

The unfortunate consequences of the adverse developments in the banking sector in the 1990s, leading to the crisis of 1996, will be felt throughout the Bulgarian economy in future years. A well-designed programme that is consistent with building sound incentives in commercial banks, at this point, will imply a major shortage of domestic credit for several years to come. The real sector will be plagued with severe liquidity constraints, and various political groups can be expected to push platforms aimed at feeding the credit-starved economy. But the Bulgarian government, and the BNB in particular, must beware of these trends and not compromise the credibility of their commitment to carry through banking reform to its positive conclusion. It would also be advisable to consider emergency measures to promote, at least temporarily, the expansion of activities of foreign banks in Bulgaria during this very difficult period.

IV. Restructuring and competitiveness

Introduction

Chapter I of this survey identified the two primary sources of the renewal of modest growth in the Bulgarian economy in 1994 and 1995 as: 1) export oriented firms, largely in the state sector; and 2) the private sector. Chapters II and III have indicated how the channelling of substantial state resources, largely through non-performing commercial credit, to the state and private sectors has contributed to the destabilisation of the economy and economic crisis of 1996. This chapter re-examines these questions from a microeconomic perspective, based on an analysis of Bulgarian firms. A first section discusses the nature of state-owned enterprises in the Bulgarian economy, concluding with estimates of their share of losses in GDP and how these losses have been financed. A second section examines export competitiveness, and the last part focuses on the newly-emerging private sector.

The governance of state-owned enterprises

State-owned enterprises in most of the economies in transition have been characterised by a high degree of insider control. Consequently, a primary goal in privatisation programmes has been the promotion of institutions of outside corporate governance for the monitoring of management, and its replacement in the case that it is ineffective. Until the development of outside corporate governance, the efficiency of these firms may be seriously impaired, and their ability to attract external funds for restructuring will typically be very limited. Outside corporate governance can be developed either through outside ownership (the stock market) or the activities of lenders (banks), under arrangements that allow them to assume control of debtor firms in the event of default. Managers of Bulgarian enterprises have received a very high degree of *de facto* control in the transition period, while the slow pace of privatisation and continued access to ''soft'' bank credit have stalled the development of governance institutions.

With the abolition of central planning, state-owned firms in Bulgaria were granted full legal autonomy. Direct budget subsidies were drastically reduced and confined to some specific branches such as coal mining, energy, and public utilities. A process of corporatisation of state-owned firms had started even before these policy changes, resulting in their transformation into joint-stock or public limited-liability companies (100 per cent owned by the state). An important element of the Bulgarian reform was the organisational restructuring of large monopolistic state-owned firms through the Law for Protection of Competition of 1991. In 1991-1992 most of the large state monopolies were broken up into smaller, independent competing units.

The goals of this policy were to make enterprises more responsive to changes in demand and to introduce competitive pressures in order to foster their restructuring. But problems of the transition period, including the loss of traditional CMEA markets, low domestic demand, supply disturbances, a lack of marketing and managerial skills, and imperfect domestic markets, made this adaptation difficult. Furthermore, in the virtual absence of bankruptcy, such adaptation was not an absolute necessity. Loss-making state-owned firms in Bulgaria continued to operate on a large scale for the first five years of transition. With access to new markets and *de facto* control over their enterprises, insiders could also derive private benefits through ''spontaneous privatisation'', associated with the ability to transfer state assets into the private and, perhaps, informal sector.

In recent years, the influence of the state over the operation of state-owned firms may have strengthened somewhat, although control by insiders remained quite high. State-owned firms technically still belong to the line ministries. The basic sources of continued leverage of the ministry over enterprises are: *a)* the nomination of the board of directors; and *b)* the direct negotiation of contracts with the executive directors of the company. The board of directors of a typical large state-owned firm has a predominant representation of government administrators and commercial banks. It is difficult to assess the degree to which ministries have influenced the operations of enterprises in recent years, since this influence is no longer based on formal legislation or rules. The Minister of Industry that served during 1995 had a reputation of favouring more involvement of the ministry in the regulation of enterprises. The danger is that such involvement could have a political or ‘‘non-market’’ motivation. As an example, an exporter could be approached by the ministry with a (non-obligatory) ‘‘request’’ to fulfil some orders for domestic firms before making shipments abroad. Anecdotal evidence suggests that the number of ‘‘requests’’ of this and other types from ministries may have increased in early 1995, along with the initial platform of the Socialist Party, but apparently subsided by the end of the year.

The current crisis in the banking sector, as well as the general low degree of confidence of the population in domestic financial assets, will certainly have a detrimental impact on the development of effective corporate governance in Bulgaria in the near future. But without a certain degree of market-based outsider control, Bulgarian firms will have very limited success in attracting outside investment funds in the post-1996 situation of tight credit. Some features of the Bulgarian environment favour an active role for banks in the development of outside corporate governance.[81] But the unfortunate current crisis in the banking sector should limit the role of domestic banks in this area for several years to come. As discussed in Chapter V, an increase in sales of Bulgarian enterprises to foreigners may be the only way of accelerating the development of institutions of corporate governance in Bulgaria in the immediate future.

Financial constraints and losses in the state sector

The fact that so many loss-making state enterprises have continued their operations implies that they found alternative sources than profits to finance their operations. Such sources can include defaults on liabilities and delays or failures in delivering contracted output. On the liability side, many of these firms have attracted new bank credit, while simultaneously becoming delinquent in their debt service, payments of taxes, social security contributions, payments to suppliers, and payments of wages. As demonstrated in Chapter III, the private sector is also responsible for a large share of financed losses in the economy. But the absence of data does not allow the same type of analysis of the private sector financial accounts as we present in this section for the state sector.

Table 23 presents information on various arrears of state-owned firms. An important share of arrears is interest due to banks. Profit and social security taxes have also been approximately 30 per cent in arrears between 1993 and 1995,

Table 23. **Tax and interest arrears of state-owned firms**

Paid as percentage of due

	Excise duty	Turnover tax (VAT)	Profits tax	Interest	Social security taxes
I-XII 1992	87.7	77.0	66.3	59.3	68.1
I-XII 1993	96.5	70.8	71.2	42.6	68.0
I-XII 1994	89.6	88.2	70.1	59.0	65.0
I-IX 1995	89.9	. .	71.6	52.7	73.7

Source: NSI; Agency for Economic Co-ordination and Development, Business Survey Series, *Monthly Business Survey*, No. 2, 1996, p. 45.

while the introduction of the VAT in 1994 apparently improved indirect tax collection in the state sector as well as in the private sector.[82] In addition to arrears to the state and financial institutions, interenterprise arrears accounted for an estimated 14 and 12 per cent of GDP in 1994 and 1995, respectively.[83] The most important such arrears are to the energy sector. A 1995 World Bank Report of December 1995 estimated arrears to energy enterprises to be 4.5 per cent of GDP,[84] while losses in the energy sector were at 8 per cent of GDP. Surveys conducted in 1993 and 1994 confirm attitudes among some Bulgarian enterprise managers that arrears from customers will eventually be monetised (subsidised) through the banking system.[85]

As discussed in Chapter III, policies in the banking sector were not successful in significantly reducing the supply of new bad loans to the non-financial sector, including those to state firms. The lack of bankruptcy legislation in the first years of transition also impeded the enforcement of hard budget constraints. The final adoption of a new bankruptcy law in 1994[86] did not result in a major change in the behaviour and performance of firms, as no bankruptcy procedures were initiated by creditors for any large or medium-sized state-owned firms until mid-1996; the few cases of such procedures affected small and mostly private businesses. There appear to exist major problems in the institutional and economic environment (expected long duration of court hearings, gaps in legislative norms, low asset liquidity) which made bankruptcy procedures unattractive to creditors, particularly if there is an expectation of an eventual bailout by the state.

The escalation of bad credit and arrears to the budget and banks constituted the equivalent of a new type of state subsidy that sheltered many state enterprises from the market. Such subsidies can be even more destructive than direct budgetary outlays, which, at least in theory, can be regulated, made conditional on performance targets, and not ruin the balance sheets and incentives of commercial banks. In addition to the difficult initial conditions of transition, the slow process of restructuring in Bulgaria also reflects incentive problems deriving from a lack of financial discipline, particularly the threat of bankruptcy. The accumulation of huge losses has, at the same time, taken a heavy toll on the stability and health of the economy.

The financial accounts of state-owned enterprises collected by the National Statistical Institute, although imperfect, give at least a rough estimate of the magnitude of losses generated in the public sector. If measured by ''net profit after taxes'', for which adjustments were made to remove both direct and indirect subsidies, the cumulative losses of all state-owned firms in 1993 amounted to over 30 per cent of GDP, decreasing to 22 per cent in 1994, and 14 per cent in 1995.

The accounts data permit a rough calculation of the contribution of the budget and banks to the financing of losses of state-owned enterprises. As seen from Table 24, the two most important sources are the state budget and commercial banks. Under the so-called Bad Loans Act, pre-1993 interest arrears on non-performing loans contracted before 1991 were assumed by the state through special bond issues in 1994 (see Chapter III). This debt relief corresponds to the high burden of budgetary finance in 1994. Other than this, the primary source of budgetary finance is tax and social security arrears. Commercial banks finance another significant portion of losses. Of particular interest here is the continual expansion of credit through new loans, as highlighted in Chapter III. ''Other sources'' are difficult to identify. They may involve some additional sources of external funding, such as that from extra-budgetary funds.[87] But they also include internal sources such as wage arrears and, perhaps, decapitalisation. This figure most likely also contains a large statistical discrepancy due to distortions in the data. In order to reduce tax obligations, firms have an incentive to understate profits, which implies that losses in Table 24 are most likely overstated. But these estimates, rough as they may be, are consistent with the notion that the operations of loss-making state-owned enterprises have been largely financed through state resources in recent years.

A calculation of the entire quasi-fiscal burden to the state would also require a consideration of the private sector. As indicated in Chapter III, the private

Table 24. **Aggregated financial accounts of Bulgarian state-owned firms**

Percentage

	1993	1994	1995
	Aggregated profit and cash flows as share of GDP		
Gross operational income before interest and taxes [1]	–17.5	–6.6	–2.9
Gross profit before taxes [2]	–28.2	–17.7	–10.3
Net profit after taxes [3]	–30.7	–22.2	–13.9
Gross cash flow [4]	–23.0	–17.0	–9.8
Net cash flow [5]	–42.8	–26.7	–20.6
	Financing of cash flow losses as a percentage of net cash flow		
Budget	19.5	66.6	22.4
of which:			
Subsidies	8.0	9.3	7.1
Tax and social security arrears	11.5	17.8	14.7
ZUNK operations [6]		39.5	0.6
Commercial banks	41.2	13.7	31.7
of which:			
Net new lending	15.2	11.3	12.7
Loans and interest arrears	26.0	2.4	19.0
Other sources	39.3	19.6	45.9
Total	100.0	100.0	100.0

1. Operational revenue (net of direct and estimated indirect subsidies) minus operational expenditure. ''Operational'' excludes revenue and expenditure on financial markets.
2. Total revenue (net of direct and estimated indirect subsidies) minus total expenditure before profit taxes.
3. Gross profit (net of direct and estimated indirect subsidies) minus profit taxes.
4. Net profit plus depreciation.
5. Gross cash flow minus capital expenditure plus net new long-term loans.
6. The cash flow effect of the writing-off of interest arrears due to the banks under the Bad Loans Act.

Source: NSI; World Bank; OECD.

sector has been absorbing a greater or equal amount of non-performing loans as the state sector in recent years. Furthermore, many private firms are also notorious for tax evasion and payment arrears, as discussed below.

The competitiveness of Bulgarian industry

Exporters, largely based in the state sector, were responsible for some of the renewal in economic growth in Bulgaria in 1994 and 1995. But numerous distortions associated with the transition period complicate the overall assessment of the competitiveness of Bulgarian industry. As in other transition countries, liquidity constraints have limited the range of strategies at the firm level for improving competitiveness through large fixed investments. In addition, some exporting firms have reportedly expanded production and exports under conditions involving energy subsidies, loose commercial bank credit for financing possible losses, and payment arrears for inputs, taxes, and debt service. Another important factor concerns the high degree of macroeconomic instability in Bulgaria, and a corresponding low degree of confidence in the national currency, which has depreciated the lev to a point well beyond what could be sustainable in a robust economic recovery. Although virtually all of the European economies in transition have experienced strong pressures for currency appreciation following improved expectations for stabilisation and growth, such pressures could be particularly strong in the future in Bulgaria. As can be seen in Table 25, from the point of view of purchasing-power-parity, even after the significant real appreciation of the lev in 1995, Bulgaria remained far from other central and eastern European economies. But even this amount of appreciation was reportedly enough to cause serious problems for exporters by the end of the 1995. The destabilisation of the economy in 1996 witnessed a depreciation of the lev by over 600 per cent, which has significantly increased the discrepancy illustrated in Table 25 still further, temporarily increasing the profitability of export-oriented sectors that may face serious problems in the medium and long-term. At the same time, however, the financial crisis of 1996 has reduced access of exporters to commercial credit and energy subsidies.

Table 25. **Ratio of nominal exchange rate to purchasing power parity for selected transition countries**

	1992	1993	1994	1995[1]
Czech Republic	3.1	2.8	2.6	2.2
Bulgaria	**4.1**	**3.3**	**4.0**	**3.2**
Hungary	1.6	1.6	1.6	1.5
Poland	2.0	2.1	2.1	1.7
Slovakia	2.9	2.8	2.6	2.2
Romania	4.2	3.2	3.0	2.7
Ukraine	7.8	5.6	3.6	3.4
Russian Federation	7.7	4.2	2.4	1.7

1. Preliminary.
Source: OECD; Vienna Institute for Comparative Economic Studies (WIIW, 1996).

Despite the advantage for Bulgarian exporters of an undervalued national currency, it has been suggested in several studies that the correlation between firm profitability and export performance in Bulgaria may be quite weak.[88] In a recent study involving a representative sample of (state) firms, Avramov and Sgard (1996) found a negative correlation between exports/sales ratios and profitability in their sample. This lends support to theories, often appearing in the Bulgarian press, that the so-called ''star'' exporters are also some of the worst loss-makers in the economy, being propped up by special commercial bank credit, energy subsidies, and the accumulation of payments arrears. Such a conclusion would not bode well for short-term projections on the potential rebounding of Bulgarian exports in the aftermath of the current economic crisis, which demands a major tightening of credit and financial discipline. But the yearly financial reports (on an accrual basis) of enterprises to the National Statistical Institute provide some evidence that such conclusions may be exaggerated. While it is true that a few notorious loss-making exporters may fit the above description, this may not be a general characteristic of the major exporting sectors of the economy.

The top five firms in each branch, ranked by exports in 1995, account for a solid majority of all exports from their corresponding industrial branches in each year. The ten largest exporters across all industries are responsible for 40 per cent of all Bulgarian exports. Several interesting (tentative) conclusions can be reached on the basis of the figures in Table 26. First, in every one of the four main export branches of industry, the five largest exporters showed higher profitability than the industrial branch as a whole in every year from 1993-1995. This is what might be expected from an economy engaged in restructuring toward the world market, but is a bit contrary to some conjectures discussed above for the case of Bulgaria. Furthermore, apart from ferrous metallurgy, which has continually operated at a loss, the top five exporters in the major export branches all exhibited positive gross (before tax) profits in both 1994 and 1995. The above tables are also indicative of the high burden of interest payments in the Bulgarian economy, which is responsible for the significant decrease in the profitability measures in columns 1 and 2. On the other hand, with the possible exception of non-ferrous metallurgy, the above figures do little to dispel doubts as to the sustainable competitiveness of these export branches if the lev should appreciate strongly in the future.

Table 26. **Profitability in industry and main export branches**[1]

Percentage

	Profitability[2] (before taxes and interest payments)	Gross profitability[2] (before taxes)	Net profitability[2] (after taxes)	Share in total branch export sales
	1993			
All firms				
Total industry	0.4	–12.8	–14.8	
Ferrous metallurgy	–5.4	–23.1	–23.1	
Non-ferrous metallurgy	–3.4	–10.7	–12.8	
Chemicals and petrochemicals	5.8	–0.6	–3.8	
Food processing, beverages and tobacco	3.4	–9.5	–11.9	
The largest exporters				
Total industry – 10 largest	2.6	–4.1	–6.6	
Ferrous metallurgy – 5 largest	–4.5	–21.6	–21.7	
Non-ferrous metallurgy – 5 largest	3.9	–1.8	–4.2	
Chemicals and petrochemicals – 5 largest	5.8	3.8	0.3	
Food processing, beverages and tobacco – 5 largest	..	..	..	
	1994			
All firms				
Total industry	6.7	–2.2	–6.0	
Ferrous metallurgy	6.9	–5.5	–6.6	
Non-ferrous metallurgy	21.2	18.2	6.2	
Chemicals and petrochemicals	6.7	1.1	–1.8	
Food processing, beverages and tobacco	12.3	0.3	–4.5	
The largest exporters				
Total industry – 10 largest	7.8	3.9	1.0	
Ferrous metallurgy – 5 largest	5.2	–2.5	–3.7	
Non-ferrous metallurgy – 5 largest	26.4	25.5	11.0	
Chemicals and petrochemicals – 5 largest	3.6	0.4	–0.6	
Food processing, beverages and tobacco – 5 largest	21.5	14.9	4.3	
	1995			
All firms				
Total industry	5.2	–0.6	–4.0	
Ferrous metallurgy	2.9	–3.2	–4.6	
Non-ferrous metallurgy	13.7	11.1	2.9	
Chemicals and petrochemicals	7.1	3.0	–0.8	
Food processing, beverages and tobacco	9.0	0.5	–2.9	
The largest exporters				
Total industry – 10 largest	7.1	4.0	0.3	39.2
Ferrous metallurgy – 5 largest	3.4	–2.6	–4.0	100.0
Non-ferrous metallurgy – 5 largest	19.1	18.1	7.8	81.0
Chemicals and petrochemicals – 5 largest	6.5	4.2	0.8	68.2
Food processing, beverages and tobacco – 5 largest	8.6	4.3	–0.8	35.2

1. Financial accounts data reported by enterprises to the NSI on an accruals basis.
2. Profitability equals (profits-losses)/sales.

Source: 21st Century Foundation on the basis of NSI data; OECD.

It should be noted that the financial reports of enterprises, upon which Table 26 is based, present a number of difficulties for interpretation. First, the absolute levels of profitability in these tables could be somewhat inflated by input price subsidies. In recent years, this concerns primarily electricity prices (see discussion in Chapter II). Chavdarov and Pishev (1996) argue that electricity subsidies may be quite substantial for the main industrial exporters. On the other hand, high and unstable taxation in the Bulgarian economy gives direct incentives to minimise reported profits and divert funds to the informal economy, in which case the above tables could understate the general case for profitability and competitiveness.

As in many other transition economies, it is still difficult to draw conclusions about where the medium and long-run competitiveness of Bulgaria will lie. The particular circumstances of transition in Bulgaria have supported high exports in some sectors that may have very little long-run viability (ferrous metallurgy) and others where long-run viability appears questionable at best (chemicals). But the overall high level of education (human capital) in Bulgaria, combined with wage rates that should remain well below the average in Eastern Europe for several years to come, promise a potential for competitiveness that could be exploited through fixed investment. As an example, Bulgaria has already made significant progress in reorienting its large wine industry, which dominates beverage exports, to the tastes of Western consumers. But given the very problematic state of the economy and financial markets, the attraction of significant foreign capital, which might be possible through the improvement of the investment environment, may represent the best opportunity for Bulgaria to promote lasting improvements in competitiveness in the near future (see Chapter V).

The private sector

One of the primary sources of economic growth in Bulgaria in recent years has been the private sector. Although the share of the private sector in economic activity remains a bit lower than in most eastern European countries, its rapid growth is perhaps no less remarkable. As a relatively orthodox member of the socialist block, Bulgaria began transition with a very small private sector (about 5 per cent of GDP in the late 1980s, which consisted mostly of imputed rents to owner-occupied dwellings). While the outright privatisation of state firms has also been proceeding relatively slowly in Bulgaria, as summarised in Chapter V, the restitution of a large number of buildings and land in recent years has helped to provide an infrastructure for private sector growth (see Chapter V). The National Statistical Institute estimates that, in 1995, the private sector already accounted for an estimated 48.3 per cent of value added in the economy (41.2 per cent if imputed rents on owner-occupied dwellings are excluded). With the partial exception of agriculture, growth in the private sector in Bulgaria before 1996 was based primarily on the emergence and expansion of new firms. Several recent studies identify such new private firms, along with a handful of other firms receiving significant foreign investment, as the primary sources of increased economic efficiency for the European economies in transition as a whole.[89] While this is probably also the case in Bulgaria, persisting distortions in economic incentives, discussed below, make assessments of the contribution of the private sector complicated.

As can be seen from Table 27, similar to other transition economies, the share of the private sector has grown particularly fast in areas that were relatively neglected in the period of economic planning and feature relatively low fixed costs of entry. To this category belongs trade and services, where the private sector is dominant. The increasing share of transportation in the hands of the private sector has been an important development, promoting competition in the

Table 27. **The private sector as a share of value-added**

Percentage

	1992	1993	1994	1995
Industry – Total	2.8	6.9	8.3	14.6
Construction	24.9	40.9	52.5	63.3
Agriculture	58.8	74.6	84.6	81.8
Forestry	0.8	1.0	1.2	1.7
Transport	14.9	24.6	26.0	40.0
Communication	0.0	0.9	1.0	3.1
Trade	41.5	54.4	61.7	70.2
Business services	58.3	80.7	84.8	92.4
Housing, public utilities and amenities	90.1	93.6	91.7	92.7
All branches	26.5	37.9	41.6	48.3

Source: NSI.

industry and providing an alternative to the former state-monopolised railway and trucking network for shipping goods. The rise of the private sector in agriculture has been a direct consequence of the restitution policies discussed in Chapter V. While the state sector continues to dominate in industry, the private sector has taken over the majority of construction in the economy. From minuscule levels in 1992, the estimated share of investment coming from the private sector has jumped to over 40 per cent in 1995.[90] At the end of 1996, 313 547 private firms were registered in the economy, versus 20 177 in the state sector. 61 per cent of all private firms were in trade.[91] Not all of these registered firms are operating, however, and the National Statistical Institute receives (required) financial reports from roughly half this number. Private firms tend to be quite small, with the large majority employing less than five workers.[92]

In surveys, firms in the private sector in Bulgaria cite limited access to credit, high interest rates, and high and unstable taxation as the major constraints to the expansion of their activities.[93] Several studies recommend special policies to aid the expansion of cheap credit to the private sector. At the same time, as shown in Chapter III, although access to affordable credit appears to have become relatively more difficult in 1994-1995, the aggregate expansion of credit, including long-run credit, to the private sector in Bulgaria has still been substantial, and well over half of the loans to that sector had become delinquent by the end of 1995. But these credits have also been highly concentrated in a small number of large loans.

Reported aggregate profitability in the private sector has been rather low, although higher than in the state sector. Interestingly enough, due to both a higher variance in (official) profitability in the state sector and the many tax advantages for private firms described in Box 1 of Chapter II, the aggregate burden of taxes on reported profits in the private sector (on a accruals basis) has been substantially lower than in the state sector. In 1994 and 1995, the private sector posted substantially higher aggregate profits than the state sector, but also owed only 6 and 10 per cent of all profit tax, respectively (see Table 28). In addition, due to wide-spread tax evasion in the private sector, it is generally accepted that the official reports significantly underrepresented actual profits.[94]

Given enhanced opportunities for tax evasion, the special legal tax benefits (especially before 1996), and the particular nature of relations between firms and commercial banks in Bulgaria, substantial incentives have existed for transferring

Table 28. **Aggregate reported profits (losses) in the private sector**

	1994	1995	1994	1995
	BGL billion		Share of GDP (%)	
Reported net profits (after-tax)	–2.22	6.95	–0.4	0.8
Reported gross profits (before taxes)	4.96	10.97	0.9	1.3
	Share of total (%)			
Shares of profit taxes owed				
Public [1]	94	90		
Private	6	10		

1. Excluding agricultural firms.
Source: NSI, *Tekushcha Stopanska Koniunktura*, March and June 1995, February and July 1996; OECD.

resources from the state to the private sector. The so-called ''interface'' between the state and private sector in Bulgaria has been discussed in several recent studies.[95] Several possibilities exist for realising such transfers. As state firms are concentrated in industry and private firms are concentrated in trade, transfer pricing can be an effective mechanism; private firms can sell inputs to state firms at inflated prices and purchase outputs at discounted prices. It has been pointed out by Miller (1994) that the rather high rate of growth of the CPI index in Bulgaria relative to the PPI index for extended periods of time may be indicative of this phenomenon. Other transfer mechanisms include joint ventures and leasing arrangements. In such arrangements, the private sector partner can even be set up by the management of the state firm itself. It has been argued by Avramov (1994) and Avramov and Sgard (1996) that the transfer of resources through such relationships has been so substantial that it has been responsible for a significant decapitalisation of state enterprises during the transition period. This would contrast with many other transition countries, where some studies have found little evidence of outright decapitalisation in the state sector.

The costs to society from these transfers are not transparent. *De facto* privatisation in virtually all of the countries in transition has involved a substantial transfer of resources from the state to the private sector. The slow pace of explicit privatisation in Bulgaria has contributed to the extent of ''spontaneous privatisation''. In many cases, the resources may be put to more efficient use after the transfer, implying a potential net benefit to society. But the costs to society are also substantial. First, there is the direct opportunity cost of resources to the state that are lost in the process. For the case of Bulgaria, this not only concerns lost tax revenue, but the cost of bank credit and other subsidies for financing corresponding losses in the state sector. It can be argued that these factors have contributed significantly to the overall destabilisation of the Bulgarian Economy, as discussed in Chapters II and III. Second, this type of activity most likely contributes to the polarisation of the distribution of wealth in Bulgaria. As illustrated in Table 9, even based on officially reported income, inequality has rapidly accelerated to a rather high level during the transition period. If earnings from the informal sector could be included in this measure, it would almost certainly be much higher. The lost tax revenue also has an implicit distributional effect by limiting state expenditures for the poorer segments of the population. Finally, there are potential incentive problems. As long as rent-seeking activities alone, based on pilfering state resources, can secure high profits, there will be a lower incentive to divert energies to activities with genuine value added.

Bulgarian authorities are very much aware of these difficult problems. Certainly, the decision to equalise the tax treatment of state and private firms in 1996 made good sense. As long as the state cannot monitor and control effectively flows of resources between the state and private sectors, preferential tax treatment of the private sector will bring little gain. But the problem of bringing the informal sector into the ''official economy'' and subjecting it to equal taxation, has no easy solution in the Bulgarian context. It can only be solved gradually through a combination of efforts that: *a)* alleviate somewhat the overall legal tax burden on enterprises; *b)* insure a basic level of stability in existing tax rates and rules; and *c)* increase state resources in tax auditing. These measures may pose the difficult dilemma of placing an increased short-run strain on the budget, although the long-run effects of such policies should have exactly the opposite effect.

V. Privatisation and foreign investment

Introduction

Bulgaria has lagged behind most other central and eastern European countries in privatisation and the attraction of foreign investment. The problems affecting these two areas are very similar, if not entirely transparent. Since 1991, Bulgaria has drafted a series of ambitious privatisation plans and liberal laws for foreign investment. But, as of September 1996, the share of medium and large-scale state enterprises privatised by more than 67 per cent (the amount necessary for full control, see below) was less than 4 per cent.[96] After five years of reform, the land restitution programme appeared to have stalled, with the status of over half of agricultural land yet to be resolved. Foreign investors continue to assess the overall environment in Bulgaria as one of the least hospitable in Eastern Europe, and have responded by investing elsewhere. As of mid-1996, per capita foreign investment in Bulgaria was less than 6 per cent of that in Hungary, 12 per cent of the Czech Republic, and one quarter of Poland; it is also less than in Albania and Romania. At the same time, state assets and resources have been transferred to the private sector, both through restitution and ‘‘spontaneous privatisation’’. The second half of 1996 may have witnessed a turnaround in the privatisation process, with reported substantial increases in cash privatisation sales and the final launching of a mass privatisation programme.

As has been stressed several times in this study, given the current difficult situation in the Bulgarian economy, an acceleration of privatisation, including sales to foreign investors, could serve as a crucial impetus to Bulgaria’s economic recovery and development. Recent studies confirm that sales of firms to foreign investors have been critical in facilitating economic restructuring and enhanced efficiency in Eastern Europe.[97] With a virtual collapse of domestic financial markets, Bulgarian entrepreneurs are already facing an extreme shortage of capital. The role of domestic financial institutions should also be quite limited in the near future for the development of institutions of corporate governance. Bulgaria could therefore profit greatly from addressing the problems that will be outlined in this chapter.

Privatisation

Methods and laws

Privatisation in Bulgaria has been pursued along three separate lines: *a)* restitution of land and urban property to former owners and their heirs; *b)* cash sales of state assets; and *c)* mass (voucher) privatisation. These three methods have featured different approaches, and have been based largely on separate laws.

The first privatisation initiative in Bulgaria was associated with restitution. The government of the Union of Democratic Forces passed a comprehensive law on the restitution of urban property in late 1991, with implementation beginning immediately in early 1992. Restitution was either in kind, or through securities for property that had been substantially upgraded or extended. The Land Act of early 1991 proposed an elaborate procedure for the restitution of agricultural land through so-called ‘‘municipal land commissions’’. Additional amendments to this law in 1992 simplified the procedure, and provided for the creation of ‘‘liquidation commissions’’ for dividing up the property of former co-operatives.

Ambiguities over property rights in the context of the restitution programme, as well as some controversies within the government, apparently delayed the implementation of the cash privatisation law, the Law on the Transformation and Privatisation of State and Municipal Enterprises (LTP), until 1993. This law provides a broad framework for sales of state assets (see Box 7). The implementation of the LTP, however, raised ambiguities concerning the exclusive use of state property such as land and mines. To address these problems, a separate Concession Law was passed in 1995. The government initially intended cash sales to be the primary method of medium and large-scale privatisation. More recently, however, due to difficulties and delays in cash privatisation, a voucher-based mass privatisation programme has been launched roughly along the Czech model (see Box 8). The first bidding associated with these auctions took place in October 1996.

Restitution: outcomes and problems

The first successful privatisation programme in Bulgaria has been that associated with the restitution of urban property. As of September 1996, close to 90 per cent of all submitted claims had been resolved, involving the restitution of more than 22 000 sites, with an estimated value of approximately US$200 million, to previous owners or their heirs. Roughly half of these sites are shops.[98] The economic impact of urban restitution has been substantial. The transfer of assets has provided the infrastructure for the explosive growth of private trade and services discussed earlier (see Tables 4 and 27). Virtually overnight, inefficient state trading and service companies, not being in a position to pay market-based rents, left restituted commercial buildings largely to new private entrepreneurs.

Land restitution has been more problematic and more controversial. According to data of the NSI, as of September 1996, while most arable land has been at least assigned for temporary use, final land commission decisions have been issued for 54 per cent of this land. Only 18 per cent has been officially returned to owners within defined boundaries, although operational use rights are believed to be exercised on a wider scale. Furthermore, actual legal titles have been issued only for 6 per cent of this land, due primarily to the fact that the process of obtaining a title can be costly and cumbersome. In addition, the process of land restitution has stalled since mid-1993, and only 3 per cent of arable land has been returned in defined boundaries in the last one and a half years (Table 29).

Table 29. **Progress in land restitution**

Percentage of total arable land; end-of-period

	1992	1993	1994	1995	July 1996
Restituted ownership in real boundaries (Art. 18, Item G, Section 1)	6.0	12.7	15.8	17.1	18.1
of which: Legal titles issued				3.0	5.9
Decisions of the municipal land commissions according to the approved Land Division Plan (Art. 27, Section 1)	0.7	2.3	18.0	32.7	36.1
Permissions for temporary use of arable land (Art. 18, Item I, Section 1)	5.7	23.0	36.3	36.3	33.4
Co-operatives (number)		1 007	1 638	2 623	3 048
Land held by co-operatives		14.4	25.3	38.9	41.9

Source: NSI.

Slow recent progress in land restitution reflects mounting political controversies, which, in turn, echo many practical difficulties with the programme. Problems in establishing documentation of previous ownership have been more difficult for land than for urban property. Many deeds had been lost and claims have significantly exceeded available land.[99] The construction of a proper cadastre has been a long and difficult process. Due primarily to previous inheritance laws that enforced subdivisions between heirs, the pre-socialist distribution of land was very fragmented. About 1.1 million private farms, each averaging 4.3 hectares, consisted of 10-15 plots of land that were located in different areas. Average plot size was only 0.26-0.39 hectares.[100] Current situations of multiple heirs can create even more fragmentation. Moreover, according to a recent survey, more than half of new owners of returned land live in urban areas and do not have the intention of moving to the countryside or engaging in farming activities.[101] Farmers that do not possess titles for their land (the vast majority) are also generally unable to provide collateral for any commercial credit.

These problems can potentially be solved through the development of well-functioning markets for the sale and leasing of land. But these markets are of yet poorly developed in Bulgaria, as is witnessed by the very large amount of restituted land that is currently left idle. Cultivated land shrank by an estimated 13 per cent between 1992 and 1995, while orchards and vineyards contracted by 27 per cent.[102] Small plot size, depressed agricultural markets subject to price and export controls, and high transactions costs associated with documentation and contracting, all contribute to a lack of willingness on the part of many urban owners to transfer use or property rights over their land. Even a major political commitment to the rapid completion of restitution and promotion of land markets could not achieve an overnight miracle under these difficult circumstances.

But few in the current Bulgarian government propose such a policy commitment. On the contrary, the government of the Bulgarian Socialist Party has been promoting the formation of new agricultural co-operatives in order to combat fragmentation and the inherent weakness of small creditless farmers. Some in the socialist government may also perceive agricultural co-operatives, as opposed to private farmers, as a potential important source of political support. According to a Law on Co-operatives of 1991, farmers can decide to join co-operatives and pool specially-determined ‘‘shares’’ instead of receiving actual property titles for private farms. Thus, a land commission can legally establish a co-operative as an alternative to the individual distribution of plots. Several attempts by the current government to amend the Land Law to further promote the creation of co-operatives have been refused by the Constitutional Court. Nevertheless, by July 1996, co-operatives accounted for a reported 42 per cent of all arable land for the country as a whole, as opposed to 14 per cent in 1993.

Table 30. **Land restitution status by region**

Percentage of total arable land as of July 1996

	Restituted in real boundaries	Municipal land decisions according to the Land Division Plan	Land for temporary use	Co-operatives
Total for the country	18.1	36.1	33.4	41.9
Bourgas	4.9	40.1	42.9	60.9
Varna	3.5	62.5	17.3	48.8
Lovech	19.8	41.5	28.8	44.5
Montana	20.5	19.9	51.1	39.3
Plovdiv	29.0	25.3	28.7	33.1
Rousse	4.2	54.7	40.5	50.6
Sofia City	40.1	4.5	10.3	3.2
Sofia Region	52.1	11.1	16.8	10.1
Haskovo	18.8	22.4	42.7	41.7

Source: NSI, *Tekushcha Stopanska Koniunktura*, July 1996, p. 31.

Cash privatisation

Like most transition countries that have pursued ambitious strategies for cash privatisation, results have fallen short of expectations. In the case of Bulgaria, they have fallen well short. But the pace appears to have picked up considerably in 1996. After concluding 114 deals worth the equivalent of US$355 million in the three-year period of 1993-1995, the Privatisation Agency has reported sales of 148 firms for the equivalent of US$394 million for 1996 alone. Part of this acceleration reflects a greater priority for cash privatisation in the context of the fiscal crisis of the second half of 1996. During this time, 18 of the potentially most valuable Bulgarian firms, together with 25 per cent of the Bulgarian Telecommunications Company, were placed on a new ‘‘emergency

Box 7. **Cash privatisation: the legislative and organisational framework**

The Law on Transformation and Privatisation of State and Municipal Enterprises (LTP) was passed in April 1992. This law provides for a wide range of privatisation methods: auctions, tenders, direct negotiations, debt/equity swaps,[103] public offering of shares, management and employee buy-outs, sales of separate parts of enterprises, and (after 1994) mass privatisation schemes. Various state agencies are entitled to initiate privatisation deals: the ministries, the Privatisation Agency, the Council of Ministers, and municipalities (for municipally-owned enterprises). The mass privatisation program is handled by a separate body (see Box 8). The specifics concerning assessments, organisation of auctions and tenders, and distribution of the proceeds are regulated with Government decrees. Under the LTP, all state-owned enterprises are divided in several categories. Small state-owned enterprises (with asset value below BGL 70 million (US$3 million)[104] are to be privatised by the line ministries. Larger enterprises (over 50 per cent of state assets) are handled by a special government body: the Privatisation Agency. This agency, which is managed by an Executive Director and works under a Supervisory Board appointed by the government, also serves as a co-ordinating body for ministerial and municipal-level privatisation. The Privatisation Agency has changed executive directors four times, and experienced numerous reshufflings of its Supervisory Board since 1992. The transactions approved by the Privatisation Agency do not need the formal approval of the Council of Ministers, but at least informal approval appears to be needed for important sales (see below). The law also provides for lists of enterprises that are exempt from privatisation, or which can be privatised only with the special permission of the Council of Ministers. These lists are determined each year by the Parliament with the adoption of the annual privatisation programme. In 1995 and 1996, these lists comprised some 36 per cent of all state assets in the economy.[105]

The LTP prescribes a fairly complicated procedure for cash privatisation, including specific legal and economic assessments of the enterprise, a decision on the method of privatisation, the evaluation of bids, and extensive post-privatisation control of the implementation of investment and debt-repayment commitments. The LTP has been amended many times, including a recent addition to make the law consistent with the mass privatisation programme. Other amendments have established more preferential treatment for employees, in contrast to the virtual absence of favouritism in the initial law. Now, employees are allowed to purchase up to 20 per cent of those shares of a company offered for cash privatisation at a 50 per cent discount. If part of the company is also offered for mass privatisation, they may obtain free of charge an additional 10 per cent of these shares (see Box 8). Those leasing small state-owned enterprises are entitled to acquire them without auction at a ''nominal'' price. Finally, both managers and workers can defer payments for the purchase of small state-owned enterprises (less than BGL 150 million).

privatisation list''. One of these firms, Sodi Devnya, a large soda producer, was reportedly sold to a Belgian firm for US$160 million at the end of the year. It should be stressed, however, that the Privatisation Agency reports sales on a contractual basis only. It is widely believed that actual revenue is substantially lower than that reported in Table 31 due to various deferred payment options.

In addition to Sodi Devnya, several other recent sales of large enterprises involve foreign investors, and have been concentrated in food processing (breweries, confectionery plants), electrical engineering, and hotels. At the line-ministerial level, relatively more deals have been achieved in trade, tourism, and construction, while privatisation in agriculture, industry, and transportation has been slower. Despite the wide range of possibilities in the cash privatisation law, almost all medium and large-scale deals have involved direct negotiations with potential buyers. Debt-equity swaps have comprised roughly 25 per cent of privatisation revenue. Municipal privatisation, on the other hand, has been based primarily on auctions, and has proceeded at a somewhat faster pace in recent years.

The recent amendments to the Privatisation Law that favour employees may have increased somewhat the share of state firms sold to insiders, which reportedly rose in the first half of 1996 (Table 32). The share of foreign investment in privatisation revenues is in the range of 25 per cent.

Cash-based privatisation programmes have experienced trouble in many transition countries, particularly in the case of limited interest of, or access by, foreign investors. Basic problems concern the low level of wealth of the population, the low level of development of capital markets, and the degree that information is concentrated among insiders. In Bulgaria, resistance has also come from many of the important players in the process, few of which have strong incentives to pursue rapid privatisation. This includes line ministries, employees, municipalities, and many of those profiting in the private sector.

The line ministries typically had little interest for two main reasons. First, privatisation threatens to limit directly their influence over firms in their industries. Second, a number of senior ministerial officials serve on the boards of directors of state-owned enterprises, typically receiving pay or perquisites that far exceeds their ordinary wages as civil servants. In addition to delaying the privatisation of enterprises under their jurisdiction, ministries have also lobbied the government on occasion to obstruct potential deals of the Privatisation

Table 31. **Type, number and proceeds of cash privatisation sales**[1]

Type of privatisation	1993	1994	1995	1996	Enterprises and parts of enterprises privatised 1993-1996	Total number of firms in public ownership in 1993
Municipally-owned enterprises						
Number of small-scale sales	53	384	1 213	1 206	2 856	7 500
Proceeds contracted (in mn US$)[2]	*2*	*16*	*60*	*25*	*103*	
Investments contracted (in mn US$)[3]	..	..	..	..	..	
State-owned enterprises						
Privatised by branch ministries						
Number of sales with fixed assets < 70 mn BGL[4]	52	128	240	366	786	
Proceeds contracted (in mn US$)[2]	*20*	*33*	*87*	*41*	*181*	
Investments contracted (in mn US$)[3]	*2*	*25*	*79*	*13*	*119*	
Privatised by the Privatisation Agency						
Number of sales with fixed assets > 70 mn BGL[4]	11	34	69	148	262	
Proceeds contracted (in mn US$)[2]	*54*	*203*	*98*	*394*	*749*	
Investments contracted (in mn US$)[3]	*57*	*170*	*76*	*161*	*462*	
Subtotal	63	162	309	514	1 048	3 500
Proceeds contracted (in mn US$)[2]	*74*	*236*	*185*	*435*	*930*	
of which: Corporate liabilities assumed by buyers (in mn US$)	*30*	*91*	*74*	*235*	*430*	
Investments contracted (in mn US$)[3]	*59*	*195*	*155*	*174*	*583*	
Total number of sales	**116**	**546**	**1 522**	**1 720**	**3 904**	**11 000**
Proceeds contracted (in mn US$)[2]	***76***	***252***	***245***	***460***	***1 033***	
Investments contracted (in mn US$)[3, 5]	***59***	***195***	***155***	***174***	***583***	
of which:						
Number of larger sales to foreign investors	2	10	5	14[6]	31[6]	
Proceeds contracted (in mn US$)[2]	*22*	*144*	*28*	*47*[6]	*241*[6]	
Investments contracted (in mn US$)[3]	*30*	*110*	*55*	*33*[6]	*228*[6]	
Number of sales involving debt-equity swaps[7]	..	..	..	..	..	
Proceeds contracted (in mn US$)	..	*87*	*66*	*82*[6]	*235*[6]	

1. Including privatisation of whole enterprises and parts of enterprises (defined as privatised if more than 50% of assets have been transferred to private ownership); US$ values are given at the exchange rate prevailing at the time of the deal; figures correspond to contracted deals and not actual payments.
2. Apart from cash payments contracted, these amounts also include Brady bonds and bonds from internal debt rescheduling programmes (''ZUNK bonds''), which were exchanged for shares, as well as debts of privatised enterprises assumed by buyers.
3. Future investment commitments that are part of privatisation contracts.
4. Book value according to the latest revaluation of assets in 1992. At the then-prevailing average exchange rate, this threshold amounted to US$3 million.
5. Without municipal privatisation deals.
6. Only until 11 November 1996.
7. The legal preconditions for using Brady bonds and bonds from internal debt restructuring programmes (''ZUNK bonds'') were created in the second half of 1994. Such deals do not only pertain to foreign investors, since domestic investors may and do also use ZUNK bonds for privatisation transactions.

Source: Privatisation Agency.

Table 32. **Privatisation by type of buyer**

Shares of number of units privatised (in percentage)

	Enterprise employees			Bulgarian nationals						Foreign investors		
				Individuals			Legal entities					
	Until 1994	Until 1995	Until July 1996	Until 1994	Until 1995	Until July 1996	Until 1994	Until 1995	Until July 1996	Until 1994	Until 1995	Until July 1996
Total	5.7	7.9	8.7	52.5	64.8	65.4	39.4	26.2	24.9	2.4	1.1	1.0
Companies	12.3	23.3	25.7	18.5	14.0	12.9	55.4	52.6	52.1	13.8	10.1	9.3
Untransformed enterprises and parts of enterprises	4.8	6.5	7.3	57.6	69.3	69.5	36.9	23.8	22.8	0.7	0.4	0.4
State enterprises	20.0	25.8	31.8	23.0	32.8	31.3	50.0	37.1	33.3	7.0	4.3	3.6
Companies	10.3	22.0	25.3	13.9	11.9	10.9	60.3	54.2	52.9	15.5	11.9	10.9
Untransformed enterprises and parts of enterprises	27.8	28.0	35.1	30.5	44.5	41.2	41.7	27.5	23.7	0.0	0.0	0.0
Municipal enterprises	0.8	3.7	3.3	62.7	72.3	73.3	35.7	23.6	23.0	0.8	0.4	0.4
Companies	28.6	30.0	28.6	57.1	25.0	23.8	14.3	45.0	47.6	0.0	0.0	0.0
Untransformed enterprises and parts of enterprises	0.3	3.3	3.0	62.9	73.1	74.0	36.0	23.2	22.6	0.8	0.4	0.4

Source: NSI, *Tekushcha Stopanska Koniunktura,* July 1996, p. 22; *Statistical Yearbook, 1994,* p. 406; *Statistical Yearbook, 1995,* p. 211.

Agency. As for municipalities, they were required, until late 1994, to transfer most of the proceeds from privatisation to the central government. This greatly weakened their incentives to sell, as oppose to lease, property.

Most managers have already obtained *de facto* control rights in their enterprises during the transition period. In addition to the threat that they could be deprived of their jobs, control, or special privileges by new outside owners, some managers may profit directly from the presence of state ownership if it has helped access to various subsidies and credits. This is related to the so-called ''interface'' between the state and private sectors, discussed in Chapter IV. Workers may also be afraid of loosing their jobs as a result of privatisation.

An unusually high degree of political instability has been another important problem for privatisation in Bulgaria. The seven successive governments since 1990 have had, in general, different attitudes toward the privatisation process. This has been reflected in quite frequent changes in legislation, as well as the continual reshuffling of institutions and personnel. Since its establishment in 1992, the Privatisation Agency has experienced four changes in directors, and the Supervisory Board has also changed frequently. Changes in personnel and the line ministries were even more frequent, often resulting in staff changes at still lower levels.[106] Along with personnel changes has come a lack of continuity in policy. In some cases, new officials refuted already approved deals or pressed for renegotiating already closed transactions.

An additional problem has been a certain lack of political clout of the Privatisation Agency itself, which has made it vulnerable to pressures of the Council of Ministers and Parliament, usually exercised through the Supervisory Board. In several cases, the Council of Ministers has rejected or postponed transactions already approved by the Privatisation Agency.[107]

The complicated and lengthy procedures prescribed by the LTP have also been associated with delays. The law specifies over 15 necessary, and often time-consuming, procedures that are prerequisite to any sale. This includes a legal analysis and an economic appraisal. This appraisal requires competitive bidding, evaluation and approval, even when the price will be determined on the market through auction or tender. There is typically a huge backlog of privatisation deals in preparation at any moment in time. By July 1996, privatisation procedures had been opened for 1 404 state-owned enterprises, representing 20 per cent of all state-owned assets. But only 364 enterprises, or 3.8 per cent of assets, had been privatised by more than 67 per cent (necessary for full control)[108] at the time. This backlog is especially notable at the Privatisation Agency and Ministries of Industry, Agriculture, and Transportation.[109] For some cases, there are pending projects since 1993.

Some of these problems were addressed in recent changes in the LTP, as well as in the conditions of the new mass privatisation programme. As illustrated in Table 31, privatisation by municipalities accelerated immediately following the amendment that allowed them to keep the majority of revenues. The interest of employees in privatisation has apparently picked up due to a combination of the new opportunities created for insiders and the increased threat of outsider control from mass privatisation. More generally, the impending voucher programme may be a primary cause of the rush to conclude cash privatisation deals for enterprises that will be affected. A large amount of privatisation revenue, on an accruals basis, appears to have come in the second half of 1996, although a considerable share of these payments may have been deferred. This acceleration could continue in the immediate future, as preliminary plans for privatisation in 1997 remain ambitious.

Mass privatisation

With the goal of accelerating the privatisation process and overcoming the problems that were delaying cash privatisation, the Bulgarian government has launched a programme of mass voucher privatisation. The decision to pursue mass privatisation actually dates from 1994, but it did not gain momentum until 1995. A specific feature of the Bulgarian mass privatisation programme is that it combines cash and mass privatisation for the same enterprises, while incorporating several concessions for employees (see Box 8).

Two waves of privatisation are scheduled. The first began in January 1996, with the registration of participants, and is expected to be completed by March 1997. Another round will begin in the fall of 1997. Mass privatisation has already raised public awareness and involvement in the privatisation process, with half of the adult population participating in the programme. The vast majority (80 per cent) of participants have decided to bid their vouchers through one of 81 new privatisation funds, the majority of which are privately owned. As a side benefit, as discussed above, it appears to have succeeded in improving the incentives for cash privatisation. It may also help to promote the development of Bulgarian financial markets, including the market for corporate control.

Box 8. **The Bulgarian mass privatisation programme**

The Bulgarian mass privatisation programme (MPP) was announced in 1993. However, the necessary legal and institutional framework was finalised only in 1995, when the practical preparation of the program began. A new government agency associated with the Council of Ministers, the Centre for Mass Privatisation, has been made responsible for the administration of the process.

The Bulgarian MPP is a voucher-type privatisation close to the Czech model. Each adult citizen is entitled to purchase vouchers worth ''Investment Leva'' 25 000 for a small fee (students and pensioners enjoy substantial discounts). Current and retired employees from state-owned enterprises included in the MPP list are entitled to receive up to 10 per cent of the shares designated for mass privatisation free of charge. By November 1996, roughly half a million citizens had registered for free shares. Vouchers are not tradable, and can be transferred only to close relatives or privatisation funds. The voucher distribution campaign started in January 1996 and took five months to complete. About 3 million Bulgarians, or slightly less than 50 per cent of the eligible population, have purchased vouchers; more than half of them are pensioners. The vouchers are divisible in coupons which can be used by the holders to bid for the shares of one or several enterprises included in the MPP list. The bids can be done directly, or through privatisation funds, which can compete for the vouchers of participants. Most of the participants (about 80 per cent) decided to bid through privatisation funds in the first round. Eighty-one privatisation funds succeeded in accumulating sufficient capital (equal to a minimum of 2 000 participants). Six funds have apparently succeeded in accumulating over half of all vouchers. Most of the sponsors of the privatisation funds are private and public banks, companies, trade unions, foundations, and even political parties. Foreign participation is allowed and present in roughly a dozen funds.

On the supply side, the MPP includes 1 050 state-owned firms from all branches of the economy. Only minority shares are typically offered from the big enterprises, while the small enterprises will be privatised up to 90 per cent (the remaining 10 per cent reserved for restitution claims). If the transfer of complete control to the private sector is used as a benchmark (over 67 per cent of the stock), some 8 per cent of the state assets will be privatised in the first wave of the programme. The MPP consists of two waves, each of them with three centralised computerised auctions. The participants bid for the selected enterprises individually by specifying the number of shares and the price, which cannot be less than the minimal price published before the auctions. All unsold shares and unused vouchers enter the second and the thirds rounds respectively. The remaining unsold shares after the third round are transferred to a special mutual fund. The first wave is expected to be completed by March 1997, and the second wave is tentatively scheduled for the autumn of 1997.

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The holders of the shares of the privatised enterprises may not dispose of them until six months after the completion of the last auction. Afterwards, the shares are freely tradable on the stock exchange.

Foreign investment

Background

Bulgaria was actually among the first of the central and eastern European countries to allow foreign direct investment on its territory, passing a joint venture law in 1980. But rigid price and trade regulations, together with a state monopoly on foreign trade, limited greatly the scope for foreign business activities. By 1989, there were 31 joint ventures operating in Bulgaria, mostly in machine building and electronics. At the outset of economic transition, Bulgaria was again among the first countries of the region to adopt legislation to attract foreign investors. The Law on Foreign Investment, passed in 1991, was among the most liberal in the region, providing national status to all foreign investors, allowing for 100 per cent foreign ownership, setting very low entry barriers, and offering easy registration. In addition, the law provided for unrestricted profit repatriation, supported also by foreign exchange legislation. Tax incentives were offered for large investment in priority areas.

The normative framework for foreign investment was supplemented by the Privatisation Law, which allows equal access of foreigners to the enterprises in the privatisation process. The Bank and Credit Law provided for the limited presence of foreign banks in Bulgaria. Finally, the Concession Law, passed in 1995, has opened the doors to foreign green field and infrastructural investments. The only sector which is currently closed for foreign investors for five years is insurance. Recent amendments of 1996 to the Profit Tax Law offer newly-privatised firms, including those sold to foreign investors, major tax holidays during their first years of existence. The Foreign Investment Agency, associated with the Council of Ministers, was set up in 1995 as an intended ‘‘one stop shop’’ for assisting foreigners through the entire investment process and problem resolution.

The scale of foreign investment activity contrasts sharply with these seemingly strong legislative and administrative commitments. As of September 1996, the total stock of foreign direct investment in Bulgaria amounted to some US$719 million,[110] distributed among almost 7 100 projects. This figure is equal to 2-3 per cent of total foreign investment in Central and Eastern Europe. In per capita terms, Bulgaria trails all countries except some of those of former Yugoslavia and the former Soviet Union (see Table 33).

Most foreign investments in Bulgaria are also quite small: as of the end of 1995, 65 per cent of all investments were for less than US$1 000, and another 22 per cent did not exceed US$10 000. On the other hand, there are 36 ventures exceeding US$1 million, and representing 90 per cent of total investment.[111] As

Table 33. **Per capita foreign direct investment in CEE countries**

US$

	1992	Mid-1996
Visegrad Countries		
Czech Republic	151	586
Slovakia	44	152
Hungary	457	1 299
Poland	37	265[1, 2]
Southeastern Europe		
Albania	51	97[3]
Romania	24	84[2]
Slovenia	522	895
Croatia	128	268
Bulgaria	**18**	**69**
Baltic States		
Estonia	156	424
Latvia	78	145[4]
Lithuania	20	85[5]
CIS		
Russia	19	44
Ukraine	3	21

1. Due to a change in the definition of FDI, the 1992 and mid-1996 figures for Poland are of limited comparability.
2. July 1996.
3. March 1996.
4. End-1995.
5. October 1996.

Source: Foreign investment: Austrian Federal Ministry of Economic Affairs, national statistics; population: *World Bank Development Report*, 1995.

Table 34. **Foreign direct investment in Bulgaria**[1]

	To end-1992	1993	1994	1995	30 Sept. 1996
Number of contracts per annum	73	604	2 277	1 938	2 196
Cumulative	73	677	2 954	4 892	7 088
Annual inflows (mn US$)	65	127	220	105	202
Change over previous year (%)		95	73	–52	
Cumulative inflows (mn US$)	65	192	412	517	719
Index, 1992 = 100	100	295	634	795	1 106
Average size per project (US$ ’000s)					
Per annum	890.4	210.3	96.6	54.2	92.0
Cumulative	890.4	283.6	139.5	105.7	101.4

1. These figures correspond to the definition of the Foreign Investment Agency, representing the value of capital actually transferred and registered in the courts plus investment from retained earnings of foreign-owned firms.

Source: Foreign Investment Agency; OECD.

of September 1996, the average value per project in Bulgaria is US$101 000, almost three times less than Hungary, Russia and the Czech Republic, and 2.5 times lower than Poland.

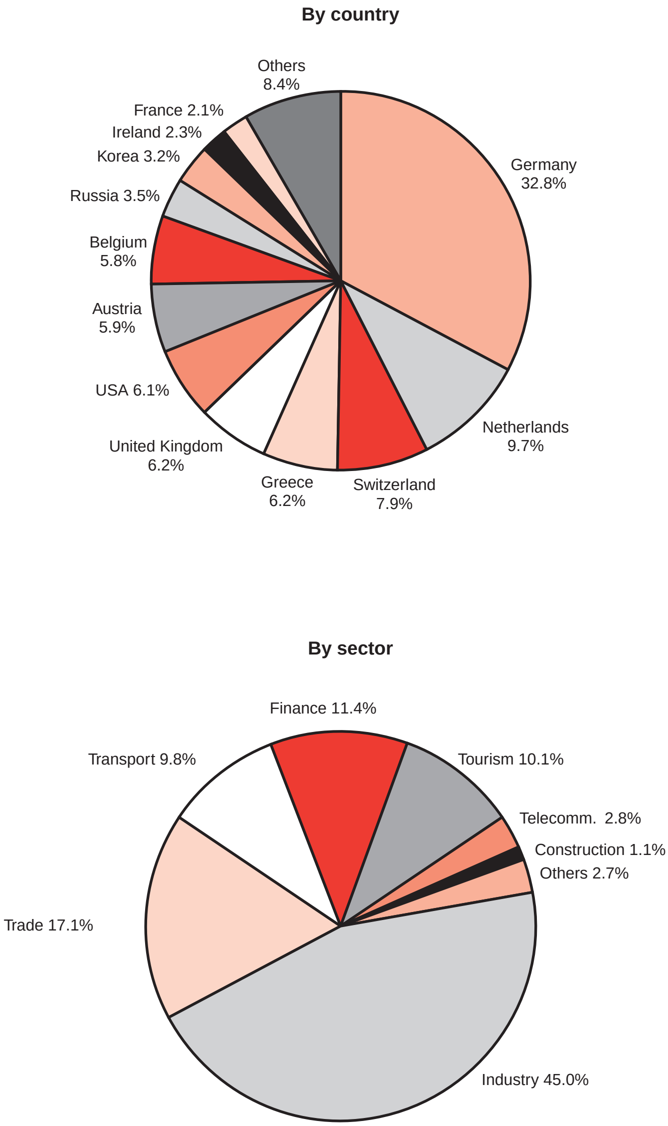
By economic sectors, the bulk of foreign investment (45 per cent) goes into industry, primarily food processing, electronics and non-ferrous metallurgy. Trade (17 per cent) has also attracted a substantial share. The breakdown of FDI by countries is highly correlated with trade patterns. Approximately 80 per cent of investment comes from OECD countries, with Germany alone accounting for 33 per cent, as shown in Figure 18.

Problems

The explanation for low levels of foreign investment in Bulgaria, despite quite favourable FDI legislation, involves many problems. It should be noted first that a number of particular geographic, demographic, and cultural factors make the attraction of foreign investment to Bulgaria relatively more difficult. Bulgaria represents a small and poor domestic market that is both culturally and geographically farther away from most OECD countries than many competing transition economies. Bulgaria also has limited endowments of natural resources and relatively poor infrastructure and communications. The restructuring of manufacturing toward international competitiveness requires significant overhead investment in an uncertain and unstable environment.

Figure 18. **FOREIGN DIRECT INVESTMENT**

Total: US$718.5 million as of 30 September 1996



Source: Foreign Investment Agency.

Nevertheless, surveys of foreign investors indicate a potential keen interest in Bulgaria. This primary attraction is the Bulgarian labour force, which is perceived as well-qualified, well-motivated, and very cheap, even relative to other transition economies. Foreign investors also cite relatively easy access to the domestic market as an advantage for business in Bulgaria.[112] Preferential access to the large Russian market, as well as the direct link between Europe and Asia through Bulgaria, could also be potentially strong lures.

But the perception of foreign investors appears to be that the foreign investment environment in Bulgaria not only represents ‘‘one of the most difficult in the world’’, but that, even during the marginal recovery of 1994-1995, this environment has deteriorated.[113] This is reflected in the decline in foreign investment in 1995 relative to 1994, as indicated in Table 34, including a drop in the reinvestment of profits of foreign businesses from 14 per cent in 1994 to 7 per cent in 1995.[114] A survey from 1995 indicated that 35 per cent of managers of joint ventures in Bulgaria did not plan to expand and 31 per cent would not have recommended their partners to invest in Bulgaria at all.[115]

Although the persistence of high macroeconomic instability certainly has a direct negative impact on assessments of investment opportunities in Bulgaria, most foreign investors cite other primary problems as well. Many of these problems are closely related to those already discussed above for privatisation. Among complaints of foreign investors, common themes concern the instability and lack of transparency of various rules, procedures, laws, and government commitments, as well as various bureaucratic delays that surround investment activities. As is the case with privatisation in general, many of these difficulties, in turn, most likely reflect incentive problems. Insiders in various capacities that profit from current arrangements could perceive the presence of foreign interests as a threat to their welfare and security.

Investors complain of frequent discretionary decisions on the part of various officials that alter or nullify what were understood by foreign partners as implicit or explicit contractual commitments. Telecommunications, the low development of which also impedes foreign investment from the supply side, represents a particularly strong example. Since 1991, several foreign companies have expressed interest in Bulgarian telecommunications, leading to a number of joint ventures and special contractual agreements. But, in the course of five years, these companies have faced a such a barrage of changing rules and conditions, including the removal of special tax breaks and of lowered import duties, that the investment process in that sector came to a virtual standstill by the end of 1995.[116] Most recently, a major agreement under which a US-based firm would service long-distance calls of Bulgarian hotels was suddenly cancelled unilaterally by the Bulgarian government.[117] The same problem exists for laws and regulations. In 1995, for example, the government suddenly altered the conditions associated with debt-equity swaps in privatisation, which had formerly been virtually unrestricted. Under the new conditions, debt-equity swaps involving Brady Bonds are limited to 50 per cent of payments, profits on enterprises acquired through debt-equity swaps cannot not be repatriated for four years, and capital cannot not be repatriated for ten years. At the end of 1996, Parliament passed new amendments to the Foreign Investment Law that discriminate against small investors, raising the minimum base capital requirements to US$50 000 for any investment to qualify as ‘‘foreign’’. Such types of alterations or nullifications of previous contractual conditions or regulations are perceived as common occurrences by foreign investors,[118] and as a primary hazard associated with investing in Bulgaria.

High and unstable taxation has also been a deterrent to foreign investment.[119] Foreigners must face the same combination of rapidly changing tax laws, rules, decrees, and practices as their domestic counterparts. One particular point should also be highlighted here. In the current Bulgarian environment of high and unstable taxation, together with the weak enforcement of tax laws, the success of a Bulgarian business often depends on bending or breaking laws, as well as on possible special relationships with various officials that can do the same. This concerns in part the common evasion of direct taxes and customs duties.[120] Such a situation can place reputable foreign businesses, which are liable to be more reluctant and less able to engage in these practices, at an immediate disadvantage.

Given these problems, as well as the overall difficult current economic situation in Bulgaria, it is understandable that many foreign investors are taking a ‘‘wait and see’’ attitude. The slow progress in foreign investment is, of course, directly related to slow progress in privatisation. As indicated by Tables 31 and 34, a large share of foreign investment concerns privatisation deals.

Concluding comments

The problems affecting privatisation and foreign investment in Bulgaria appear to be quite similar, and reflect complicated and ambiguous attitudes toward these processes on the part of Bulgarian officials and insiders. Some of these attitudes may be understandable. But the current economic crisis in Bulgaria warrants a much greater commitment to both of these processes. This concerns not only the short-run effect of generating much-needed state revenue. More importantly, after the virtual collapse of domestic financial markets in 1996, foreign businesses, including financial organisations, can serve as important pillars for restoring and further developing these markets, which are essential to the future sustained growth and welfare of Bulgaria.

Amidst the crisis of 1996, the pace of privatisation and foreign investment has picked up significantly. A successful outcome of this process will depend on a greater commitment on the part of the government to create stable conditions under which privatised and foreign businesses can operate profitably. Of particular concern here, as in other areas of economic policy, is that the Bulgarian government begin to build a reputation for honouring its commitments, including at least a number of the important commitments of past governments. This involves both limiting the number and range of commitments made, and properly accounting for the costs of loss of credibility for reversing previous commitments.

Notes

1. OECD-CCET (1992), *Bulgaria: An Economic Assessment*.
2. It should be noted, however, that measures of investment in official statistics are considered by many to be highly unreliable.
3. Bulgarian National Bank (1996), Annual Report, 1995.
4. See Koparanova (1995) for a detailed discussion of this.
5. Data are not available for the private sector.
6. The reported trade figures, cited here from the current account, are on a fob-fob basis.
7. See Box 2 of Chapter II.
8. Agency for Economic Coordination and Development (AECD) (1996), *The Bulgarian Economy in 1995.*
9. Agency for Economic Coordination and Development, *op. cit.*
10. See the survey in Dobrinsky and Yaneva (1996).
11. National Statistical Institute, *Statisticheski Izvestiya*, 1994, 1995, 1996.
12. For a discussion of some factors that may have reduced the costs of the embargo to Bulgaria, see AECD (1994).
13. Only September 1995 was higher at 4.8 per cent.
14. In all cases, the treatment of ''uncovered interest parity'' in the text is a bit different than the (crude) estimate in Figure 2. The estimate in Figure 2 depends only on the nominal exchange rate and the interest rate, not inflation. But, in reality, inflation changes actual uncovered interest parity through expectations.
15. It should be noted that, by measures such as purchasing-power parity, the lev remained well undervalued even after the appreciation in 1995 (see Table 25 of Chapter IV). Given the growth in exports in 1995 and the strengthening of the current account (preliminary estimates even showed a current account surplus in 1995 of over US$300 million), authorities may have believed that such downward pressure on the lev would only be temporary.
16. There are some elements of this story that relate to the model of Krugman (1979). In both cases, Bulgarian authorities were implicitly attempting to use the exchange rate as a stabilisation anchor at a time when other policies and economic changes were exerting continual pressure for depreciation. In this case, the *only* rational expectations equilibrium outcome is an exchange rate crash. Furthermore, this crash must come before reserves

actually decline to 0. See also Agenor and Flood (1994). But, as discussed in Chapter II, there were features of the Bulgarian experience that do not exactly conform to this model, and multiple equilibria may have been possible.

17. As described in Box 6 of Chapter III.
18. Walton (1995).
19. National Statistical Institute (1996), *Sotsialno...*, p. 89.
20. National Statistical Institute (1996), *Statistical Yearbook, 1995,* p. 67.
21. National Statistical Institute (1996), *Zhizneno...*, p. 90.
22. National Statistical Institute (1996), *Sotsialno...*, p. 91.
23. National Statistical Institute (1996), *Sotsialno...*, p. 93.
24. OECD (1995), ''Income Distribution in OECD Countries...''.
25. National Statistical Institute (1996), *Statistical Yearbook, 1995.*
26. National Statistical Institute (1996), *Statisticheski Spravochnik.*
27. See OECD-ELS (1996).
28. OECD-CCET (1996), *Environmental Performance Reviews: Bulgaria.*
29. The reason that the ratio of broad money to GDP did not decline in 1994 concerns the strong devaluation of the lev in March and April of that year, which increased greatly the lev value of the hard currency component of money.
30. Credit for the refinancing of commercial banks almost doubled between November and December 1995. Growth in M1 for December/November 1995 was 18.1 per cent.
31. Some studies have cited an acceleration of the growth in BNB refinance, beginning in mid-1995, as evidence that supply-side factors were already at work at this time. But this is really a statistical artefact. A bailout operation at midyear, under which two commercial banks received state bonds that were used partly to repay loans to the BNB, reduced outstanding BNB refinance credit from BGL 37 billion in May 1995 to 7 billion in June. The reduction in this absolute level made subsequent growth rates appear relatively (artificially) high, whereas an examination of the data shows that the real acceleration in refinance did not begin until December 1995.
32. Thus, virtually all of the reduction in the share of outstanding credit to the non-financial sector in GDP in 1994 was offset by a corresponding increase in government debt to cover bad loans (see Table 14 and the discussion below).
33. That is to be distinguished from the other two transition countries with very high ratios of credit to the non-financial sector to GDP, the Czech Republic and Slovakia, which maintain these ratios due largely to inherited debt. As argued in Chapter III, while many developed economies also have high ratios of credit to GDP, this reflects developed financial institutions still lacking in the transition economies.
34. See discussion in Chapter III.
35. See Table A4 in Annex I.
36. See Figure 15 in Chapter III.

37. The opportunity for shifting to Lombard credits was created by the special state ''ZUNK'' bonds that were placed in the portfolios of banks 1994, representing the value of non-performing credits contracted before 1991. Lombard credits were written primarily against those bonds. See Chapter III for details.
38. Article 46, Law on the National Bank, 1991, in Bulgarian National Bank (BNB) (1995), *Banking Laws and Regulations.*
39. Bulgarian National Bank (1995), *Annual Report, 1994* and Bulgarian National Bank (1996), Annual Report, 1995.
40. It should be noted that, as Figure 11 is calculated at the current exchange rate, the dynamics of this curve should not be interpreted as representing shifts in portfolios. See Figure 3 of Chapter I on this point.
41. Many believe that this is one reason why foreign trade data based on payments of banks typically far exceed the customs-based data (Table A2). Some of the payments could be disguised capital account transactions. But this data must be treated with caution as it is believed to also suffer from many other problems (there is apparently double counting of some bank payments, for example).
42. As indicated in Chapter I, by household survey data of the National Statistical Institute, the share of wages in income declined from 56 per cent in 1989 to 38 per cent in 1995. Although many specialists doubt the validity of this data, it does give a rough picture of that (reported) part of wages that authorities might theoretically control.
43. The increase in CPI inflation in September 1995, for example, is often attributed to a relaxation of price controls on public utilities. The number of products subject to price controls has been over 20 per cent in recent years, and has apparently increased in 1996 (World Bank sources).
44. Mitov (1995) presents a very insightful discussion of problems in policies that regulated gasoline prices in the earlier years of transition. An attempt by authorities to subsidise households by creating a large wedge between wholesale and retail prices ended up creating major arbitrage opportunities as well as other distortions, also depriving the state of potential tax revenue.
45. Electricity prices for industrial use have been higher than for households, but still well below world market levels. This raises questions about electricity-intensive exporters that have been expanding production in recent years (see Chapter IV).
46. For a detailed assessment of its initial success in 1994, see Bogetic and Hillman (1995) and The World Bank (1996*b*), *Bulgaria: Private Sector Assessment*. It should be noted, however, that since 1994, the success of the VAT is more questionable.
47. A statement of Deputy Minister of Finance, Bisser Slavkov, as quoted in the newspaper *Trud,* 19 January 1996.
48. This operation is discussed in Chapter III.
49. *Ministry of Finance: Government Debt Management,* July 1996.
50. The majority of domestic securities that are denominated in hard currency represent so-called ZUNK bonds that were placed in the portfolios of commercial banks in 1994, equal to the value of non-performing hard currency loans contracted before 1991. Thus, it can be

argued that Bulgaria is again paying a high price for the accumulation of hard currency debt that took place *before* the transition period.

51. *Bulgarian National Bank (1996), Annual Report,* 1995.

52. Hanke and Jonung (1993) give a detailed account of the potential benefits of a currency board for a transition economy.

53. It should also be noted that, while a currency board would insure the value of cash leva with foreign reserves, the same is not true for bank deposits, *i.e.* aggregates such as M1 or M2 may very well exceed foreign reserves under a currency board. Thus, individual commercial banks should hold substantial reserves themselves. This is one reason why a currency board is still not a guarantee against a general financial crisis. See J. Williamson (1995) on this point.

54. OECD-CCET (1992), *Bulgaria. An Economic Assessment.*

55. Discussed in Dobrinsky (1994).

56. Bulgarian National Bank (1996), *Annual Report* 1995, Bulbank (1996), *Bulbank Annual Report of 1995,* other materials acquired from Bulbank (1996).

57. Bulgarian accounting practices, until 1996, actually seriously overestimated both capital adequacy and profitability. Banks were not required to deduct provisions against classified (non-performing) credits from assets, as is the case in international accounting standards. As of 1996, however, banks have been required to do this.

58. Bulgarian National Bank (1995), *The Bulgarian Banking System.* This provision apparently did limit bank credit to many state firms, but quite a few exceptions were made subsequently.

59. Information for Box 5 was taken from two primary sources: 1) Bulgarian National Bank, *Annual Reports,* 1993-1995; 2) Balyozov (1995).

60. Bulgarian National Bank (1995), *Annual Report* 1994.

61. Bulgarian National Bank (1995, 1996), *Annual Reports,* 1994, 1995.

62. From an interview with the head of the BCC, Dimiter Dimitrov, in May 1996.

63. *Bulgarian Economic Outlook,* 26 July-3 August 1996.

64. For example, see PHARE SME Programme (1996), Dobrinsky, Yaneva (1996), Pissarides, Singer, Svejnar (1996).

65. Pissarides, Singer, Svejnar (1996).

66. It should be noted that the figures for the private sector here include the co-operative sector as well as strictly private firms. Most co-operatives function much like private firms. One exception concerns agricultural co-operatives that could be a target of preferential credit. But we do not believe that the picture is highly distorted due to this fact. The same data exist for 1993, but according to a more narrow definition of the private sector that excludes co-operatives. This fact, and particularly the effect of the Bad Loans Act on the portfolio of credits to state firms, make the 1993 data incomparable with 1994 and 1995. Therefore, we do not present these data here. But we can report numbers for the more narrowly-defined private sector for that year. Despite the large amounts of pre-1991 credits to state firms that still had yet to be written off the balance sheets of the banks, the narrowly-defined private

sector already accounted for 26 per cent of all bank credit in December 1993. Furthermore, 53 per cent of these loans were already classified (non-performing). Perhaps most amazing, the share of long-term credit in all credit to the private sector at this time was 45 per cent [Bulgarian National Bank, *Monthly Bulletin* (Bulgarian edition), No. 6, 1993 and OECD calculations].

67. Based on conversations with Bulgarian officials, this figure would appear to be misleading. No large jump in long-term lending to state-owned enterprises apparently occurred in 1995. The data for 1994 and 1995 may have been classified according to different definitions or methodology, and may therefore be of limited comparability for understanding the *dynamics* of credit allocation.
68. Central Bank of Russia (1994-1996).
69. See Stiglitz (1994) and Mitchell (1993).
70. See Aghion and Bolton (1996).
71. For a discussion of influence costs, see Milgrom and Roberts (1990).
72. Dobrinsky, Dochev, and Nikolov (1996).
73. Claessens (1996) makes a very strong such argument.
74. See Oxford Analytica (1996) and Rozenov (1996). It is also widely believed that a primary explanatory factor for the failure of the Bank for Agricultural Credit (taken over by the BNB after a number of alarmist news reports in early 1996 that were followed by a series of runs on the bank) was due to an attempt on the part of the bank to collect debts from one of these groups. See Petrov (1996).
75. Stiglitz and Weiss (1981).
76. Bulgarian National Bank (1995, 1996), *Annual Reports*, 1994, 1995.
77. Williamson (1995) refers to such a relationship as a ‘‘governance structure’’.
78. See Nee and Su (1993).
79. *Bulgarian Business News* (1996), ‘‘Law on Banking...’’.
80. *Bulgarian Business News*, 15-21 July 1996.
81. These conditions are summarised in Aoki (1995).
82. See Box 1 in Chapter II.
83. National Statistical Institute estimate.
84. The World Bank (1995), Quarterly Report No. 1.
85. See Perotti and Kotzeva (1996).
86. The 1994 bankruptcy legislation is in fact an amendment to the 1991 Commercial Law, and regulates the bankruptcy procedures of all firms except banks. As noted in Chapter III, a special bankruptcy law for banks was only adopted in 1996.
87. For example, the State Fund for Reconstruction and Development and the Energy Fund.
88. See, for example, Rozenov (1996) and Chavdarov and Pishev (1996).
89. See Aghion and Carlin (1996).
90. National Statistical Institute (1996), *Sotsialno...*

91. National Statistical Institute (1996), *Statisticheski Spravochnik.*

92. The World Bank (1996*b*), *Bulgaria: Private Sector Assessment.*

93. See Pissarides, Singer, and Svejnar (1996) and Phare SME Programme (1996).

94. See The World Bank (1996*b*), *Bulgaria: Private Sector Assessment.*

95. See, in particular, Bogetic and Hillman (1995), Avramov and Sgard (1996).

96. World Bank estimate.

97. See Aghion and Carlin (1996).

98. Information supplied by the Bulgarian Privatisation Agency.

99. OECD-CCET (1994), p. 31.

100. Kopeva (1995).

101. *Bulgarian Business News* (1996*a*).

102. World Bank estimate.

103. Bulgaria is the only central and eastern European country that allows debt for equity swaps during privatisation. Both domestic and external debt can be directly exchanged for equity. Up to 50 per cent of the privatisation price can be paid with Brady bonds (see Box 2); discount bonds are redeemed at face value, and front loaded interest reduction bonds – at 50 per cent of the face value. Domestic bonds can also be used to acquire up to 50 per cent of equity. The ZUNK bonds (see Chapter III) can be used to purchase property with a 40 per cent premium on face value.

104. The assets of the state-owned firms were revalued in 1992, and not adjusted since, despite substantial subsequent inflation. Therefore, the asset values are estimated in US dollars at the average exchange rate for 1992: BGL 23 per US$.

105. World Bank estimate.

106. For example, the Ministers of Agriculture and Industry have been changed no less than six times since 1992.

107. The privatisation of the World Trade Center in Sofia is an example: the first offer was rejected as it was considered not implementable; the second was seen as too low, and a third was approved, but the investor was forced to agree to pay the US dollar equivalent at a much higher exchange rate. Finally, after the deal was approved, the bank which was to extend the credit was put under conservatorship (source: World Bank).

108. World Bank estimate. According to the Bulgarian Commercial Code, for joint stock companies, 67 per cent is required for control over decisions involving the expansion or decrease of capital, or the transformation of the company into another type (including mergers). Limited liability companies need a two-thirds majority for liquidation.

109. National Statistical Institute, *Tekushcha Stopanska Koniunktura,* July 1996, p. 21.

110. According to the definition applied by the Agency on Foreign Investment, representing the value of the capital actually transferred and registered in the courts.

111. Djarova (1996), p. 120.

112. Djarova (1996), pp. 126-127.

113. BIBA (1996). This paper, prepared by the Bulgarian International Business Association in 1996 for the Bulgarian government, summarises the attitudes of various foreign businesses in Bulgaria.

114. Bobeva (1996).

115. Bobeva (1996).

116. See BIBA (1996), pp. 20-23. The process may receive a boost, however, by the decision in late 1996 to sell 25 per cent of the Bulgarian Telecommunication Company through cash privatisation.

117. See *Bulgarian Business News* (1996*b*), p. 16.

118. The recent failure of the car manufacturer, Rover Group Ltd., has received particular attention in the press due to the fact that the initial large amount of sunk capital from this firm had been highlighted as the ''flagship'' foreign investment in Bulgaria. Although the conditions under which Rover pulled out of Bulgaria are quite complicated and controversial, the publicity has unfortunately further damaged the credibility of the Bulgarian government in the eyes of foreigner investors. Rover claims that it sank the capital after a commitment from government officials to purchase a minimum quantity of cars and offer special lower import duties. No written contract of this nature was signed, however, and the Bulgarian Parliament rejected these conditions [based on *Bulgarian Economic Outlook* (1996*a*), pp. 1-2, *Bulgarian Business News,* (1996*c*), *Bulgarian Business News,* (1996*d*), a telephone interview with Vincent Hamersley, press officer of Rover Group Ltd., 2 July 1996].

119. For a summary of the Bulgarian tax system, see Box 1 in Chapter I.

120. In BIBA (1996), p. 12, foreign investors complained in particular of the degree of discretion for changing and bending rules exercised even by low-level Bulgarian customs officials.

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Annex

Price and export regulations in Bulgarian agriculture

Apart from other factors (sluggish land restitution, difficult access to credit for farmers, low domestic demand, and loss of external markets), the development of agriculture in Bulgaria has suffered from substantial and unstable price and trade regulations. Most of these regulations have been aimed at ensuring low domestic prices on basic agricultural products as indirect subsidies to consumers. But large state-owned processing enterprises, which enjoy considerable power on the domestic market, appear to have profited most from these controls. While figures were not available for 1995 and 1996 at the moment of writing, the agricultural producer price index increased by about nine times in the period 1990-1994, whereas the input price index grew more than 23 times and retail food prices expanded 24-fold during the same period.[1] In addition, state mills and grain traders have benefited from an approximate US$60/ton difference between domestic purchase and international prices during the 1992-1995 period.[2] While this has boosted the profit margins for traders, low output prices have weakened incentives for primary producers. Problems related to regulatory policies in agriculture culminated in the so-called ‘‘bread crisis’’ of mid-1996, when marketed domestic supplies of grain and bread decreased alarmingly, leading to shortages of basic breads (the Bulgarian staple) in stores and fuelling public discontent.

Agricultural price regulations have often taken the form of direct controls over profit margins at different stages of production for certain ‘‘monitored products’’. In 1994, for example, the list of monitored products included sunflower oil, butter, sausages, eggs, white sugar, lentils, rice, potatoes, and baby food.[3] Other basic foods have been subject to control through ceiling prices. The state sets explicit procurement prices for grain. A Law on Prices, passed in September 1995, applies price ceilings and controlled profit margins to roughly 20 major food products. Export controls have included quotas and special taxes. A comprehensive foreign trade regime was first introduced in 1992, comprising specific regulations applying to agriculture and food products: registration, licensing, quantitative restrictions for exports (later partly replaced by export taxes), export bans for specific products, import taxes, import duties. Subsequently, however, these conditions have been quite unstable. In 1993, for example, the government waited until after the harvest (*i.e.* after most supply-side decisions had been made) to set new low purchase prices for grain, which were combined with an export ban. This ban on grain exports was extended until September 1994, and then later until the end of 1995.

Very low domestic agricultural prices continued to prevail during 1994 and 1995, particularly for grain. In 1995, however, the grain export ban was replaced, first by an export quota, and later by an export tax. This tax, which was first introduced at US$35/ton, and later increased to US$55/ton, was still insufficient to cover the differential between the domestic and world market price of grain. Wheat exports rose sharply from 15 000 tons in 1994 to 774 000 tons in 1995.[4] Also, private grain hoarding apparently increased in possible expectation of domestic price increases. As a result, in the fall of 1995, the state agencies did not succeed in buying an amount of wheat deemed necessary to secure bread supply for the population. Despite the reintroduction of an export ban in October 1995, and its extension until the end of 1996, the domestic supply of grain and bread continued to deteriorate in the first months of 1996, leading to the ''bread crisis'' of mid-year.

The year 1995 also witnessed the introduction of the Law on the Protection of Agricultural Producers, which had the intention of providing a new comprehensive and stable basis for regulatory policies in agriculture, in contrast to the discretionary interventions of the past. Yet this document preserves the basic spirit of the policies which have been pursued in recent years. ''Protective purchasing prices'' were established, at which the state ''Agricultural Fund'' is to purchase pre-determined quantities of a wide range of goods, including wheat, corn, sugar beet, potatoes, milk, and meat. Export restrictions or import measures can be used to ensure low prices on these products. As of March 1996, the domestic price of grain was still roughly half of the world market price. In mid-1996, prices of a number of products, including wheat, pork, tobacco and sugar beets, have not covered costs.[5] Thus, the reduction and rationalisation of price and export regulations in agriculture remains an urgently required direction of reform in Bulgaria, and a necessary ingredient of an overall strategy to promote the recovery of agriculture and the creation of land markets.

Notes

1. OECD-CCET (1996), *Agricultural Policies...*, p. 209.
2. Information supplied by World Bank Resident Mission, Sofia.
3. OECD-CCET (1995), p. 32.
4. Information supplied by World Bank Resident Mission, Sofia.
5. *Bulgarian Business News*, various issues in the summer of 1996.

Table A1. **Consolidated government budget**

Actual, in million BGL

	1993	1994	1995	1996[1]
Revenue	111 264	209 924	314 094	533 318
Tax revenue	86 468	167 110	257 943	443 719
of which:				
Profit tax	6 714	19 416	33 137	68 989
Income tax	15 008	23 337	36 469	71 377
VAT and excise taxes	21 736	56 553	82 522	131 936
Customs duties	9 109	14 802	21 425	36 771
Social contributions	30 074	46 841	69 815	117 757
of which: Unemployment funds	4 374	6 826	10 310	
Other tax revenue	3 827	6 161	14 575	16 889
Non-tax revenue	18 646	40 021	50 007	81 815
of which: Extrabudgetary accounts	6 150	2 793	6 144	7 784
Total expenditure	143 802	240 077	363 689	733 534
Current non-interest expenditure	110 117	161 217	229 524	379 903
Wages and salaries	19 048	27 606	40 460	61 968
Maintenance and operations	19 523	33 616	48 131	75 568
Defence and security	11 986	18 968	31 667	52 299
Subsidies	6 458	7 243	9 341	12 846
Social expenditure	45 279	68 512	94 642	162 374
of which: Unemployment Fund	2 854	3 730	5 950	
Extrabudgetary accounts	7 823	5 272	5 283	14 848
Investment	5 727	8 046	9 985	11 441
Primary balance	1 147	48 707	84 572	153 415
Domestic interest	24 832	64 251	99 541	294 550
Financial sector reform	1 959	10 825	25 487	
Deficit financing	22 873	53 426	74 054	
Domestic balance	–29 412	–23 590	–24 956	–152 576
External interest	3 126	6 562	24 641	47 641
Deficit (consolidated government)	–32 538	–30 153	–49 595	–200 216
Financing				
External	–3 666	–2 750	–11 713	–36 480
Loans	210	51	113	13 100
Repayments	–3 876	–2 801	–11 826	–49 580
Clearing accounts		–870		
Repayment on loans	–489	–1 377	–7 177	
of which: Paris Club	–429	–379	–3 898	
External loans interest arrears	–2 484		–3 385	
Former CMEA arrangements	–903	–554	–1 265	
Domestic	36 204	32 902	61 308	236 696
Non-bank, net	3 447	3 886	18 600	23 122
Bank financing	32 757	29 016	42 708	213 574
Government securities	24 831	33 456	51 465	
Issue	48 773	57 601	106 432	
Repayment	–23 942	–24 145	–54 967	
Bulgarian National Bank	10 528	7 878	–4 013	
Credit	12 274	11 100		
Repayments	–1 746	–32 222	–4 013	
Deposit	–301	–12 067	–3 960	
Other banks, net	–2 301	–251	–784	
Total financing	32 538	30 152	49 595	200 216

1. Preliminary.
Source: Ministry of Finance.

Table A2. **Balance of payments**

Million US$

	1991	1992	1993	1994	1995	Jan.-Sept. 1996[1]
Current account	–77.0	–360.5	–1 097.9	–31.9	–25.6	–33.7
Goods, services and income, net	–146.1	–403.3	–1 134.8	–198.6	–157.6	–128.2
Credit	4 192.4	5 151.3	4 990.6	5 276.5	6 926.2	4 447.3
Debit	–4 338.5	–5 554.7	–6 125.4	–5 475.1	–7 083.8	–4 575.5
Goods, net[2, 3]	–32	–212.4	–885.4	–16.9	121.0	131.8
Exports	3 737	3 956.4	3 726.4	3 935.1	5 345.0	3 337.2
Imports	–3 769	–4 168.8	–4 611.9	–3 952.0	–5 224.0	–3 205.4
Services, net[4]	–85.9	–95.4	–57.1	10.8	153.4	122.0
Credit	399.9	1 069.8	1 171.5	1 256.8	1 431.5	993.2
Debit	–485.8	–1 165.2	–1 228.7	–1 246	–1 278.0	–871.2
Income, net[5]	–28.1	–95.6	–192.3	–192.5	–432.0	–382.0
Credit	55.6	125.1	92.6	84.6	149.8	116.8
Debit	–83.7	–220.7	–284.9	–277.2	–581.8	498.9
Current transfers, net	69.1	42.9	36.9	166.7	132.0	94.5
Credit	123.4	114.1	285.9	357.1	256.9	183.5
Debit[6]	–54.3	–71.2	–249	–190.4	–124.9	–89.0
Capital and financial account[7]	–153.6	389.7	1 080.9	–40.6	–113.8	58.6
Capital account	0.0	0.0	0.0	763.3	0.0	49.5
Capital transfers, net	0.0	0.0	0.0	763.3	0.0	49.5
Credit	0.0	0.0	0.0	763.3	0.0	49.5
Debit	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	–153.6	389.7	1 080.9	–803.9	–113.8	9.1
Direct investment[8]	55.9	41.5	40.0	105.4	98.4	81.6
Portfolio investment	0.0	0.0	0.0	–231.8	–65.8	–183.8
Other investment	101.1	939.6	794	–333.8	87.3	–652.5
Assets	–191.9	244.3	338.4	–209.2	404.2	–608.1
Loans	92.4	307.7	285.5	263.1	292.6	258.8
Monetary authorities	0.0	0.0	0.0	0.0	0.0	0.0
General government[9]	92.4	307.7	285.5	263.1	292.6	259.1
Banks	0.0	0.0	0.0	0.0	0.0	–0.3
Currency and deposits	–284.3	–63.4	52.9	–472.3	171.4	90.7
Other assets	0.0	0.0	0.0	0.0	–59.9	–80.7
Other[10]				0.0	0.0	–877.0

Table A2. **Balance of payments** *(cont.)*

Million US$

	1991	1992	1993	1994	1995	Jan.-Sept. 1996[1]
Liabilities	293	695.3	455.6	–124.6	–316.9	–44.4
Loans[11]	537.5	325.4	28.5	–391.7	–306.4	–214.4
Monetary authorities	393.1	285.4	45.8	559.1	–240.1	–70.2
General government	192.5	172.2	–27.6	–894	–1.9	–40.7
Banks	–48.1	–132.2	10.3	–56.8	–64.4	–101.6
Other sectors						–1.9
Currency and deposits[12]	–244.5	–147.6	–0.1	17.0	–29.8	43.9
Other liabilities	0.0	0.0	0.0	–57.0	33.0	126.1
Other[13]	0.0	517.5	427.2	307.1	–13.6	0.0
Reserves (increase: –)	–310.6	–591.4	247	–343.7	–233.7	763.9
Foreign exchange	–310.6	–591.4	239.3	–329.7	–219.0	743.2
Net errors and omissions	230.6	–29.2	17	72.5	139.4	–24.9

N.B.: In accordance with IMF 5th edition of the *Balance of Payments Manual.*
1. Preliminary.
2. Customs data supplied by NSI.
3. Settlement data received from commercial banks.

	1991	1992	1993	1994	1995	Jan.-Sept. 1996[1]
Trade balance	–32.0	484.5	–476.7	417.5	182.1	–172.2
Exports, f.o.b.	3 737.0	5 093.0	4 890.1	9 228.6	8 491.5	2 734.7
Imports, f.o.b.	3 769.0	4 608.5	5 366.8	8 811.0	8 309.4	2 907.0

4. Includes transportation estimated by BNB; travel: BNB estimates based on data provided by NSI; other services.
5. Since 1995 on a due basis, except for 1995 interest receipts; since 1996 Q3 includes employee compensation.
6. Including data provided by Agency for Foreign Aid.
7. For assets, a (–) denotes an increase in holdings and a positive figure represents a decrease; for liabilities, a positive figure shows an increase and a (–) shows a decrease.
8. Ministry of Finance data on direct investment in Bulgaria.
9. Includes gas deliveries under the Jamburg agreement.
10. Includes other short-term assets.
11. Since 1995 includes rescheduled payments and arrears.
12. Includes clearing account repayments to former CMEA countries.
13. Includes unclassified capital and short-term capital, estimated by BNB.

Source: BNB, Economic and Monetary Research Dept., Balance of Payments and External Debt Division.

Table A3. **Monetary survey**

End-period, million BGL

	1991	1992	1993	1994	1995	September 1996
Foreign assets, net	–206 901	–239 584	–340 089	–131 710	–10 344	–102 836
Foreign assets	49 231	71 218	77 458	208 486	254 844	616 663
Less: Foreign liabilities	256 132	310 802	417 547	340 196	265 188	719 499
Domestic assets, net	318 509	398 150	574 161	549 719	594 007	929 309
Domestic credit	167 271	254 022	396 278	543 224	628 485	1 208 129
BGL		125 923	214 783	308 301	494 768	539 498
Convertible currencies		128 099	181 495	234 923	133 717	668 631
Claims on central govt., net	52 994	101 354	193 579	276 727	269 378	494 625
BGL		34 250	103 137	119 963	207 108	301 054
Convertible currencies		67 104	90 442	156 764	62 270	193 571
Claims on non-financial public enterprises	104 744	134 827	166 735	189 884	169 023	320 615
BGL	59 395	73 832	75 682	111 725	97 576	102 541
Convertible currencies	45 349	60 995	91 053	78 159	71 447	218 074
Claims on private sector	9 533	17 841	35 964	76 613	190 084	392 889
BGL			25 408	37 525	106 393	135 903
Convertible currencies			10 556	39 088	83 691	256 986
Other items, net	151 238	144 128	177 883	6 495	–34 478	–278 820
Capital and reserves	–28 760	–39 188	–66 664	–170 322	–190 338	–464 067
Valuation adjustments	183 632	200 574	251 796	111 242	–2 761	–177 670
Other items, net	–3 643	–17 258	–7 249	65 575	158 621	362 917
Broad money	111 608	158 567	234 072	418 009	583 663	826 473
BGL	68 702	117 585	186 468	281 612	424 899	475 704
Convertible currencies	42 713	40 542	46 295	133 023	158 764	350 769
Non-convertible currencies	193	440	1 309	3 374		
Money (M1)	26 890	37 833	48 303	75 131	107 886	142 663
Currency outside banks	11 866	18 268	25 151	38 498	61 615	85 438
Demand deposits	15 024	19 565	23 152	36 633	46 271	57 225
Quasi-money	81 132	117 149	181 619	333 978	463 419	651 749
Time deposits	25 867	59 409	109 966	164 954	255 570	275 370
Savings deposits	15 945	20 217	28 049	40 851	57 819	51 822
Foreign currency deposits	39 320	37 523	43 604	128 173	150 030	324 557
Import and restricted deposits	3 586	3 585	4 150	8 900	12 358	31 887

Source: BNB, Monthly Bulletins.

Table A4. **Interest rates**

Annual effective, in percentage

	Basic rate	Overdraft (–3 days)	Overdraft (3+ days)	Unsecured deposits	Interbank market[1]	Lombard[2]	Lombard[3]	Preferred customer discount[4]	Commercial rates on lev transactions			Average annual yield of government securities issues[5]
									Short-term lending	One-month time deposits	Demand deposits	
Jan-93	55.93	69.59	88.33	61.65	61.73	55.95		57.05	74.47	53.46	15.81	56.77
Feb-93	60.61	76.19	95.60	66.37	62.12	60.61		63.21	78.90	55.31	16.18	55.68
Mar.93	60.61	76.19	95.60	66.37	64.88	60.61		63.21	81.77	57.32	16.21	54.59
Apr-93	60.61	76.19	95.60	69.78	66.43	60.61		63.21	82.06	57.07	16.02	61.36
May-93	60.61	.19	95.60	69.78	66.28	60.61		63.21	82.24	57.14	16.06	60.33
Jun-93	57.35	90.12	63.84	63.84	59.84	57.35		58.57	77.04	49.18	15.31	53.12
Jul-93	57.35	90.12	63.84	63.84	60.12	57.35		58.57	77.81	49.32	15.56	48.43
Aug-93	51.81	64.78	83.04	65.92	56.63	51.81		52.57	76.30	48.79	15.56	55.00
Sep-93	51.81	64.78	83.04	57.72	54.38	51.81		52.57	71.87	45.67	15.33	50.36
Oct-93	51.81	64.78	83.04	58.27	54.66	51.81		52.57	71.81	45.68	15.21	49.54
Nov-93	63.05	138.18	138.18	70.96	68.15	63.05		64.78	81.63	51.22	15.63	56.54
Dec-93	63.05	77.88	97.46	72.53	71.76	63.05		64.78	83.59	53.59	15.56	58.44
Jan-94	68.90	108.95	108.95	88.90	77.66	68.90		71.22	88.65	56.09	15.65	66.52
Feb-94	68.90	108.95	108.95	92.73	75.66	68.90		71.22	87.81	58.12	15.67	65.19
Mar-94	77.96	310.99	310.99	213.84	79.35	77.96		81.30	95.10	60.84	16.04	70.53
Apr-94	77.96	149.50	149.50	127.33	84.45	77.96		81.30	98.17	63.92	16.56	74.79
May-94	77.96	149.50	149.50	127.33	85.58	77.96	79.62	81.30	99.78	63.98	16.47	75.35
Jun-94	77.96	116.94	116.94	95.60	84.78	77.96	79.71	81.30	99.93	63.96	16.47	72.69
Jul-94	77.96	116.94	116.94	95.60	87.92	77.96	79.55	81.30	98.56	63.96	16.49	70.64
Aug-94	77.96	653.85	653.85	95.60	85.01	77.96	79.55	81.30	97.88	63.99	16.51	71.74
Sep-94	98.33	213.84	213.84	114.92	103.61	93.88	97.25	99.33	110.90	69.10	18.54	82.33
Oct-94	98.33	213.84	213.84	114.92	105.11	93.88	102.80	113.59	117.55	72.21	18.75	81.10
Nov-94	98.33	138.18	138.18	114.92	108.44	93.88	109.62	113.59	118.79	72.31	19.50	87.78
Dec-94	98.33	138.18	138.18	114.92	105.26	93.88	104.78	113.59	117.69	72.37	19.55	92.04

Table A4. **Interest rates** *(cont.)*

Annual effective, in percentage

	Basic rate	Overdraft (–3 days)	Overdraft (3+ days)	Unsecured deposits	Interbank market[1]	Lombard[2]	Lombard[3]	Preferred customer discount[4]	Commercial rates on lev transactions			Average annual yield of government securities issues[5]
									Short-term lending	One-month time deposits	Demand deposits	
Jan-95	98.33	138.18	138.18	94.70	106.93	93.88	102.28	113.59	119.89	72.53	19.50	90.55
Feb-95	98.33	138.18	138.18	94.70	106.77	93.88	98.45	113.59	118.96	72.56	19.52	93.07
Mar-95	98.33	138.18	138.18	94.70	106.09	93.88	98.45	113.59	119.54	72.66	19.43	88.81
Apr-95	74.90	112.91	112.91	75.66	87.92	74.90	78.73	77.88	105.96	60.92	18.80	81.75
May-95	69.95	81.30	101.22	66.68	75.41	65.95	69.34	67.97	87.30	45.07	16.38	65.75
Jun-95	57.35	71.22	90.12	58.06	67.75	57.35	60.18	58.57	81.31	41.37	15.81	63.03
Jul-95	45.08	57.05	74.52	45.75	53.89	45.08	48.42	45.37	64.65	32.61	14.70	50.21
Aug-95	38.59	49.65	66.37	39.23	44.11	38.59	41.81	38.48	52.07	25.32	11.62	39.00
Sep-95	38.59	49.65	66.37	39.23	43.85	38.59	41.16	38.48	53.15	25.33	11.20	41.15
Oct-95	38.59	49.65	66.37	39.23	43.42	38.59	41.16	38.48	51.56	25.33	11.09	42.13
Nov-95	38.59	49.65	66.37	39.23	44.75	38.59	41.16	38.48	52.06	25.27	11.12	42.34
Dec-95	38.59	49.65	66.37	39.23	43.90	38.59	41.16	38.48	51.43	25.29	10.83	42.73
Jan-96	38.59	49.65	66.37	39.23	42.69	38.59	43.71	38.48	50.96	24.98	10.64	42.17
Feb-96	49.09	61.65	79.59	49.77	54.37	49.09	53.61	49.65	60.54	29.36	12.08	53.88
Mar-96	58.76	72.86	91.93	59.47	64.10	58.76	61.61	60.10	71.60	35.25	13.66	61.26
Apr-96	85.79	105.50	127.33	86.59	72.45	85.79	89.00	90.12	78.80	37.75	14.20	63.56
May-96	160.14	199.87	262.66	161.17	140.25	160.14	164.27	178.70	163.38	67.80	20.53	127.53
Jun-96	160.14	199.87	262.66	161.17	190.43	160.14	164.27	178.70	205.51	78.81	24.58	133.42
Jul-96	160.14	199.87	262.66	161.17	189.69	160.14	164.27	178.70	203.87	78.40	24.72	152.98
Aug-96	160.14	199.87	262.66	161.17	189.58	160.14	164.27	178.70	202.76	78.46	24.62	174.70

1. Exceeding one month.
2. Against gold or convertible currency collateral.
3. Against government securities collateral.
4. Discount loans (to prime-rate borrowers).
5. Average yield of all issues in the respective month; short-term (up to one year).

Source: BNB.

BASIC STATISTICS:

INTERNATIONAL COMPARISONS

BASIC STATISTICS: INTERNATIONAL COMPARISONS

	Units	Reference period[1]	Australia	Austria	Belgium	Canada	Denmark	Finland	France	Germany	Greece
Population											
Total	Thousands	1994	17 840	8 031	10 124	29 251	5 206	5 088	57 960	81 407	10 430
Inhabitants per sq. km	Number	1994	2	96	332	3	121	15	106	228	79
Net average annual increase over previous 10 years	%	1994	1.4	0.6	0.3	1.6	0.2	0.4	0.5	2.9	0.5
Employment											
Total civilian employment (TCE)[2]	Thousands	1994	7 680 (93)	3 737	3 724 (92)	13 292	2 508	2 015	21 781 (93)	35 894	3 790
of which: Agriculture	% of TCE	1994	5.3 (93)	7.2	2.6 (92)	4.1	5.1	8.3	5.1 (93)	3.3	20.8
Industry	% of TCE	1994	23.7 (93)	33.2	27.7 (92)	22.6	26.8	26.8	27.7 (93)	37.6	23.6
Services	% of TCE	1994	71 (93)	59.6	69.7 (92)	73.3	68.1	64.9	67.2 (93)	59.1	55.5
Gross domestic product (GDP)											
At current prices and current exchange rates	Bill. US$	1994	331.6	198.1	227.9	544	146.7	97.2	1 328.5	1 832.3	73.1 (93)
Per capita	US$	1994	18 588	24 670	22 515	18 598	28 181	19 106	22 944	27 826	7 051 (93)
At current prices using current PPP's[3]	Bill. US$	1994	327.9	162.3	204.2	596.7	107	82.5	1 111.8	1 601.7	118
Per capita	US$	1994	18 382	20 210	20 166	20 401	20 546	16 208	19 201	24 325	1 450
Average annual volume growth over previous 5 years	%	1994	2.2	2.5	1.6	1.1	1.9	–1.6	1.1	2.6	1.4 (93)
Gross fixed capital formation (GFCF)	% of GDP	1994	21.4	24.8	17.4	18.7	14.8	14.3	18.1	18.5	17.4 (93)
of which: Machinery and equipment	% of GDP	1993	9.8	8.7	7.8	6.2	7.2	5.90	8.10	7.5	7.8
Residential construction	% of GDP	1993	5.2	6.3	4.6	6.1	2.9	3.7	4.9	6.5	3.6
Average annual volume growth over previous 5 years	%	1994	0.8	3.7	0.4	–0.1	–2.8	–12.9	–1	0.8	2.7 (93)
Gross saving ratio[4]	% of GDP	1994	16.8	25.3	22	16	17	16.6	19	21	15.5 (93)
General government											
Current expenditure on goods and services	% of GDP	1994	17.5	18.8	15	20.2	25.3	22.4	19.6	17.7	19.1 (93)
Current disbursements[5]	% of GDP	1993	36.9	48.4	55.3	49	61.1	58.9	51.5	45.6	51.2
Current receipts	% of GDP	1993	33.5	48.6	50.1	43	58.3	52.5	46.8	45.7	40.2
Net official development assistance	% of GNP	1993	0.34	0.31	0.41	0.46	1.03	0.76	0.66	0.44	..
Indicators of living standards											
Private consumption per capita using current PPP's[3]	US$	1993	10 803	10 546	12 090	11 863	10 042	8 814	11 395	10 733	6 367
Passenger cars, per 1 000 inhabitants	Number	1990	430	382	387	469	311	386	413	480[8]	169
Telephones, per 1 000 inhabitants	Number	1991	464	432	410	586	577	544	511	420[8]	413
Television sets, per 1 000 inhabitants	Number	1991	480	478	451	639	536	501	407	556[8]	197
Doctors, per 1 000 inhabitants	Number	1993	2.2 (91)	2.3	3.7	2.2	2.8 (92)	2.6 (92)	2.8	3.2 (92)	3.8 (92)
Infant mortality per 1 000 live births	Number		6.1	6.5	8	6.8	5.4	4.4	6.5	5.8	8.5
Wages and prices (average annual increase over previous 5 years)											
Wages (earnings or rates according to availability)	%	1994	3	5.5	3.7	3.3	3.5	4.8	3.5	5.2	14.6
Consumer prices	%	1994	3	3.4	2.8	2.8	2.1	3.3	2.5	3.3	16.2
Foreign trade											
Exports of goods, fob*	Mill. US$	1994	47 363	44 881	137 259[7]	165 358	41 850	29 514	235 337	422 243	8 958
As % of GDP	%	1994	14.3	22.7	60.2	30.4	28.5	30.4	17.7	23	11.5 (93)
Average annual increase over previous 5 years	%	1994	5	6.7	6.5	7.1	8.3	4.9	5.6	4.4	3.4
Imports of goods, cif*	Mill. US$	1994	49 731	55 071	126 006[7]	148 297	35 932	23 091	220 508	376 566	21 111
As % of GDP	%	1994	15	27.8	55.3	27.3	24.5	23.8	16.6	20.6	30.1 (93)
Average annual increase over previous 5 years	%	1994	4	7.2	5	5.4	6.1	–1.3	3.5	6.9	5.4
Total official reserves[6]	Mill. SDRs	1994	7 730	11 523	9 505[7]	8 416	6 203	7 304	17 986	52 994	9 924
As ratio of average monthly imports of goods	Ratio	1994	1.9	2.5	0.9	0.7	2.1	3.8	1	1.7	5.6

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. Gold included in reserves is valued at 35 SDRs per ounce. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Refers to the public sector including public enterprises.
10. Including non-residential construction.

Sources: Population and Employment: OECD, *Labour Force Statistics*. GDP, GFCF, and General Government: OECD, *National Accounts*, Vol. I and *OECD Economic Outlook*, Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators*. Foreign trade: OECD, *Monthly Foreign Trade Statistics*, series A. Total official reserves: IMF, *International Financial Statistics*.

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period[1]	Iceland	Ireland	Italy	Japan	Luxembourg	Mexico	Netherlands	New Zealand
Population										
Total	Thousands	1994	267	3 571	57 190	124 960	398	93 010	15 382	3 526
Inhabitants per sq. km	Number	1994	3	51	190	331	153	47	377	13
Net average annual increase over previous 10 years	%	1994	1.1	0.1	0	0.4	0.8	2	0.6	0.8
Employment										
Total civilian employment (TCE)[2]	Thousands	1994	138	1 168 (93)	20 152 (93)	64 530	162 (91)	32 439	6 631	1 560
of which: Agriculture	% of TCE	1994	9.4	12.7 (93)	7.5 (93)	5.8	3.7 (91)	25.8	4	10.4
Industry	% of TCE	1994	26.1	27.7 (93)	33 (93)	34	31.5 (91)	22.2	23	25
Services	% of TCE	1994	65.2	59.7 (93)	59.6 (93)	60.2	64.8 (91)	52.1	73	64.6
Gross domestic product (GDP)										
At current prices and current exchange rates	Bill. US$	1994	6.2	52	1 017.8	4 590	10.6 (92)	371.2	334.3	51.2
Per capita	US$	1994	23 199	14 550	17 796	36 732	27 073 (92)	3 991	21 733	14 513
At current prices using current PPP's[3]	Bill. US$	1994	5.1	54.3	1 068.4	2 593.7	11.7	673.3	285.9	57.3
Per capita	US$	1994	19 271	15 212	18 681	20 756	29 454	7 239	18 589	16 248
Average annual volume growth over previous 5 years	%	1994	0.6	4.7	1	2.1	4.1 (92)	3	2.3	2.5
Gross fixed capital formation (GFCF)	% of GDP	1994	15.2	15.1	16.4	28.6	20.4 (93)	20.7	19.3	20
of which: Machinery and equipment	% of GDP	1993	3.9	6.3	7.4	11.5	..	9.4	8.6	9.3
Residential construction	% of GDP	1993	4.4	4.1	5.3	5.4	..	4.9	5.1	4.9
Average annual volume growth over previous 5 years	%	1994	–4	1	–2.3	1.4	6.5 (92)	7.7	0.4	5.8
Gross saving ratio[4]	% of GDP	1994	16.9	19.5	18.8	31.2	60.2 (92)	15.1	24.4	20.7
General government										
Current expenditure on goods and services	% of GDP	1994	20.6	16	17.1	9.8	17.1 (92)	11.8[9]	14.2	14.7
Current disbursements[5]	% of GDP	1993	34.9	..	53.2	26.9	..	..	55.4	..
Current receipts	% of GDP	1993	35.9	..	47.1	32.9	..	..	54.5	..
Net official development assistance	% of GNP	1993	..	0.15	0.42	0.27	0.34 (92)	..	0.88	0.22
Indicators of living standards										
Private consumption per capita using current PPP's[3]	US$	1993	11 546	7 750	11 029	11 791	15 545	4 853	10 726	9 266
Passenger cars, per 1 000 inhabitants	Number	1990	464	228	478	282	470	85	356	440
Telephones, per 1 000 inhabitants	Number	1991	527	300	400	454	511	70	477	436
Television sets, per 1 000 inhabitants	Number	1991	319	276	421	613	267	148	485	443
Doctors, per 1 000 inhabitants	Number	1993	3	1.7 (92)	1.7 (91)	1.7 (92)	2.1 (92)	1	2.5 (90)	2
Infant mortality per 1 000 live births	Number		4.8	5.9	7.3	4.5 (92)	8.5 (92)	18	6.3	7.3
Wages and prices (average annual increase over previous 5 years)										
Wages (earnings or rates according to availability)	%	1994	..	4.6	5.9	2.4	..	5.3	3.2	2.1
Consumer prices	%	1994	6.3	2.7	5.2	2	3.1	16.1	2.8	2.5
Foreign trade										
Exports of goods, fob*	Mill. US$	1994	1 628	34 125	189 802	396 149	..	60 882	155 084	12 169
As % of GDP	%	1994	26.3	65.7	18.6	8.6	..	16.4	46.4	23.8
Average annual increase over previous 5 years	%	1994	2.7	10.5	6.2	7.6	..	21.7	7.6	6.5
Imports of goods, cif*	Mill. US$	1994	1 464	25 812	167 690	274 916	..	79 346	139 800	11 859
As % of GDP	%	1994	23.6	49.7	16.5	6	..	21.4	41.8	23.2
Average annual increase over previous 5 years	%	1994	0.7	8.1	1.9	5.5	..	25.5	6.1	6.1
Total official reserves[6]	Mill. SDRs	1994	201	4 189	22 102	86 214	..	4 301	23 655	2 540
As ratio of average monthly imports of goods	Ratio	1994	1.6	1.9	1.6	3.8	..	0.7	2	2.6

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. Gold included in reserves is valued at 35 SDRs per ounce. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Refers to the public sector including public enterprises.
10. Including non-residential construction.

Sources: Population and Employment: OECD, *Labour Force Statistics*. GDP, GFCF, and General Government: OECD, *National Accounts*, Vol. I and *OECD Economic Outlook*, Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators*. Foreign trade: OECD, *Monthly Foreign Trade Statistics*, series A. Total official reserves: IMF, *International Financial Statistics*.

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period[1]	Norway	Portugal	Spain	Sweden	Switzerland	Turkey	United Kingdom	United States
Population										
Total	Thousands	1994	4 337	9 900	39 150	8 781	6 994	60 573	58 375	260 651
Inhabitants per sq. km	Number	1994	13	107	78	20	169	78	238	28
Net average annual increase over previous 10 years	%	1994	0.5	–0.1	0.2	0.5	0.7	2.1	0.3	1
Employment										
Total civilian employment (TCE)[2]	Thousands	1994	1970 (93)	4 372	11 760	3 926	3 772	19 664	25 044 (93)	123 060
of which: Agriculture	% of TCE	1994	5.6 (93)	11.5	9.8	3.4	4	44.8	2.2 (93)	2.9
Industry	% of TCE	1994	23.1 (93)	32.8	30.1	25	28.8	22.2	26.2 (93)	24
Services	% of TCE	1994	71.3 (93)	55.7	60.2	71.6	67.2	33	71.6 (93)	73.1
Gross domestic product (GDP)										
At current prices and current exchange rates	Bill. US$	1994	103.4 (93)	87	482.4	196.6	257.3	130.7	1 019.5	6 649.8
Per capita	US$	1994	23 984 (93)	8 792	12 321	22 389	36 790	2 157	17 468	25 512
At current prices using current PPP's[3]	Bill. US$	1994	95.3	122	531.7	153	167.4	319.3	1 030.2	6 649.8
Per capita	US$	1994	21 968	12 335	13 581	17 422	23 942	5 271	17 650	25 512
Average annual volume growth over previous 5 years	%	1994	2.1 (93)	1.4	1.5	–0.3	0.5	3.6	0.8	2.1
Gross fixed capital formation (GFCF)	% of GDP	1994	22 (93)	25.7	19.8	13.7	22.8	24.5	15	17.2
of which: Machinery and equipment	% of GDP	1993	..	..	5.7	5.7	7.5	10.3	7.3	7.7
Residential construction	% of GDP	1993	..	..	4.1	4	14.9[10]	9.1	3.1	4
Average annual volume growth over previous 5 years	%	1994	–3.93	2.7	–1.2	–7.6	–0.4	5.1	–2.1	4.6
Gross saving ratio[4]	% of GDP	1994	21.9 (93)	24.2	18.8	13.7	29.3	22.5	13.5	16.2
General government										
Current expenditure on goods and services	% of GDP	1994	22.1 (93)	17.2	16.9	27.3	14.1	11.7	21.6	16.4
Current disbursements[5]	% of GDP	1993	..	..	43.7	67.3	36.7	..	42.7	35.8
Current disbursements[5]	% of GDP	1993	..	..	40.1	59	36	..	36.8	31.7
Current receipts	% of GDP	1993	1.23	0.36	0.32	1.33	0.49	..	0.34	0.19
Net official development assistance	% of GNP	1993	9 826	7 780	8 412	9 240	13 730	3 617	10 942	16 444
Indicators of living standards										
Private consumption per capita using current PPP's[3]	US$	1993	378	260	307	418	441	29	361	568
Passenger cars, per 1 000 inhabitants	Number	1990	515	273	340	687	603	143	445	553
Telephones, per 1 000 inhabitants	Number	1991	423	187	400	468	406	175	434	814
Television sets, per 1 000 inhabitants	Number	1991	3.2 (92)	2.9	4.1	3	3	0.9	1.5 (92)	2.3 (92)
Doctors, per 1 000 inhabitants	Number	1993	5	8.7	7.6	4.8	5.6	52.6	6.6	8.5 (92)
Infant mortality per 1 000 live births	Number		4	..	7.2	5.4	..	..	6.7	2.8
Wages and prices (average annual increase over previous 5 years)										
Wages (earnings or rates according to availability)	%	1994	2.7	9	5.6	5.7	3.9	73	4.6	3.6
Consumer prices	%	1994	34 645	17 072	73 129	61 122	70 467	18 456	205 170	512 627
Foreign trade										
Exports of goods, fob*	Mill. US$	1994	30.9 (93)	19.6	15.2	31.1	27.4	14.1	20.1	7.7
As % of GDP	%	1994	5	6.1	10.5	3.4	6.4	9.5	6.1	7.1
Average annual increase over previous 5 years	%	1994	27 345	25 967	92 182	51 730	68 126	22 976	227 026	663 256
Imports of goods, cif*	Mill. US$	1994	23.3 (93)	29.9	19.1	26.3	26.5	17.6	22.3	10
As % of GDP	%	1994	2.9	6.6	5.2	1	3.2	37.9	2.8	7
Average annual increase over previous 5 years	%	1994	13 033	10 627	28 475	15 929	23 790	4 911	28 094	43 350
Total official reserves[6]	Mill. SDRs	1994	5.7	4.9	3.7	3.7	4.2	2.6	1.5	0.8

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. Gold included in reserves is valued at 35 SDRs per ounce. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Refers to the public sector including public enterprises.
10. Including non-residential construction.

Sources: Population and Employment: OECD, *Labour Force Statistics*. GDP, GFCF, and General Government: OECD, *National Accounts*, Vol. I and *OECD Economic Outlook*, Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators*. Foreign trade: OECD, *Monthly Foreign Trade Statistics*, series A. Total official reserves: IMF, *International Financial Statistics*.

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