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September 15, 1993

TO: John Wiles, Paul Davis
Project Officers
Agency for International Development
Room 6723 EUR/PDP/PD
Washington, D.C. 20523-0071

FROM: Margot E. Machol
President
Chesapeake Associates

RE: Fourth Quarterly and First Annual Progress Report
AID Cooperative Agreement EUR-0249-A-00-2073-00

I am delighted to report on the progress made by the Institute for Market Economics during the past quarter. They are really up and running; producing interesting and relevant studies, reports, and newsletters; running conferences and seminars; and becoming recognized as a major player in the policy process.

The Executive Board has been very involved in all aspects of the Institute's progress. It is finally up to its full complement of 12, having added 4 new members: Emil Hirsev, former Deputy Governor of the Central Bank, currently head of a consulting company specializing in international investments; George Vahariev, President of ICL-Bulgaria (largest high technology firm in Bulgaria); Agnes Ilieva, Senior Banker, Tourist Sport Bank; and Cyril Kalinov, Senior Banker, United Bulgarian Bank.

In addition, all of the staff has finally been hired. It has been difficult for the Institute to find exactly the right people to hire on a permanent basis. Consequently, they contracted out on a short-term basis for several articles this summer. For example, Kamen Atanassov, who is working on his PhD. at Princeton and was in Sofia for the summer, wrote a paper for the Institute on privatization. More recently, they have hired a new office manager, Mariana Arnaudova, an expert in computers; a macro economist from the Central Bank, Peter Boutousnarov; and a fairly recent graduate with an expertise in economics and social policy, Evelina Zheliakova. In addition, Krassen Stanchev and Ivanka Petkova continue to work 80 hours a week for the Institute; I am thrilled by their level of enthusiasm and commitment.

The Institute received its second U.S. trainer, a recent MBA, Peter Classen, who spent the last three months in Sofia, devoting 1-2 days per week to the IME. He assisted the office in budget and accounting practices, management techniques, and development of several newsletters and other mailings (see attached trip report).

Arrangements are now being made for the next U.S. visitors. Ken Juster, formerly Acting Counselor of the State Department, now a prtner at Arnold and Porter, will visit the IME from October 14-16, in conjunction with a trip he is making for his law firm to Budapest. Prior to his arrival in Sofia, he will let the IME publish 2 papers he is preparing, on privatization and dispute resolution mechanisms. These will be the basis for discussions he will have during his visit. In addition, Walter Stahr, from the Securities and Exchange Commission's General Counsel's office, and Susan Woodward, SEC's Chief Economist, are planning to visit the Institute the last week in October to discuss securities issues. (This trip will be paid for by the SEC.) I also plan to make my third visit at that time, to meet the new staff and assist them in planning for the next year, including the accomplishment of their goals in the securities area.

The Institute has started publishing a number of papers. I am attaching one of several they published on Bulgarian stock exchanges; two on privatization; and a draft of one they will publish soon on foreign direct investment.

They have also hosted or played lead roles in several seminars. I am attaching a copy of Krassen's remarks at a seminar on economic development in Eastern Europe. They also organized and translated material for, and participated in a conference on economics at the American University in Balgovgrad in conjunction with the Foundation for Teaching Economics. They also assisted the Institute for Policy Reform, through AID-Sofia, in the development of training for government advisors involved in multilateral negotiations. They were also asked to participate in the selection of participants for 2 World Bank seminars, as well as the selection for Fulbright scholarships and Pew fellowships.

The most significant activity they have been involved in has been on securities markets and stock exchanges. Following the June roundtable discussion led by Susan Woodward of the SEC, the IME has become a major player in this area. They were invited in July by the Economic Committee of the Parliament to develop a new securities law for Bulgaria (see attached letter). In this regard, they translated the CEELI (the American Bar Association's Central and East European Law Initiative) paper on securities law and have held discussions on it. They also have formed a working group of all the major players, including the Council of Ministers, CUBS (The Commission for Unification of Banking Standards), Finance Ministry, Central Bank, CEELI, etc., which is developing a concept paper on the principles of a good securities law. They have also obtained an agreement from the SEC to draft a securities law for Bulgaria based on the concept paper. CEELI has also agreed to translate the SEC draft law. Both the SEC and CEELI are doing all of their work pro bono. The working group is meeting to discuss a draft of the concept paper next week; the final draft is expected by month's end.

Another area in which the IME is doing exceptionally well is fundraising. In addition to the grants received last quarter from the Open Society Fund for rent and the Frederick Neumann Foundation for equipment, they have received money from the Foundation for Teaching Economics to help produce the economics course, and DM4500 (about $7,000) from the German Ministry of International Cooperation for a project on key local economic issues. Including in-kind donations of services and equipment, in the first six months of their operation, they generated $33,355 in non-Federal share. This is more than twice the $13,988 of AID funds used for operating expenses during this period. (See attached summary of expenses.) (I should note that the rate at which they are now spending has risen considerably, with the addition of extra staff and 30% new mandatory fringe benefits, so I believe their spending level is on target.)

The Institute has applied for funds from the Cultural Attache's office and the Foundation for Economic Education for funds to translate and publish Jim Guartney's book. They have also held discussions with RJR Nabicso regarding its Project Foundation Network in Eastern Europe.

The Institute will be very busy with the securities legislation during the next 2-3 months. They are also trying to plan major initiatives in banking privatization and in foreign direct investment, with the aim of both leading to conferences next year. They are working on a study on the economic impact of the restitution of private property and a study on joint stock companies registered in Bulgaria. In addition, they plan to keep publishing newsletters, articles, and studies, and to continue giving speeches and press interviews, participating in conferences and seminars, and meeting with policymakers.

In sum, in a remarkably short time, the Institute has established itself as a key player in the policy debate, as well as in research and education. They are becoming well known and well respected for the important issues they have tackled and the caliber of the work they produce. Although initially it took longer to get the IME set up than I had hoped it would, they have more than made up the lost time. They are now poised to make a major contribution during the next 12 months.

Attachments:

(1) IME-published list of activities
(2) Summary of Expenses of the IME
(3) Letter of invitation from Economic Committee of the Parliament on securities law
(4) Trip report from Peter Classen
(5) IME newsletter: "Stock Exchanges in Bulgaria; assessment and recommendations"
(6) IME paper presented to Privatization Agency, Cabinet and Parliament: "Note on Some Technicalities in the Mass Privatization Scheme in Bulgaria"
(7) IME paper: "Conventional and Voucher Versus Venture Capitalists Privatization"
(8) Draft IME paper: "Policies for Attracting Foreign Direct Investment in Market Economies"
(9) Excerpts from lecture by Krassen Stanchev: "Bulgarian Economic Affairs"

ACTIVITIES OF THE I.M.E.

During its first six months, the Institute of Market Economics has found fertile ground on which to begin operations. The IME can draw notice to its contribution to the following projects.

Legislative Development:

Recommendations made to Parliment on the structure of Securities and Exchange Law in June 1993.

Invited to structure an alternative model for Securities and exchange Law, July 1993.

Currently developing Securities and Exchange Law for tabling to the Cabinet and Parliament in October, 1993.

Commentaries:

Participation in Meeting of Environmental Ministers of the European Countries, USA, Canada, OECD, UN, Economic Commission and World Bank. Presented an assessment on Environmental Aid to Bulgaria. (April)

Participation at Oxford University on "Political Instability and Foreign Investments in East Europe." Presented assessment of political stability in Bulgaria. Lectured on Bulgarian economic affairs and opportunities for business in Bulgaria.

Commentary at Legal Committee Meeting of the Cabinent concerning the draft bill on Stock Exchanges in Bulgaria. Following the commentary, the IME received an invitation to assist the Economic Committee in drafting the Securities Act for Bulgaria.

Seminars & Round Tables:

Roundtable: "First steps of the Bulgarian Stock Exchanges" Invited 36 participants from Banking, stock exchanges, parliment, New York Stock Exchange.
Principal guest: Susan Woodward, Chief Economist of the SEC, Washington.

Lead special session on Economic Development at the Seminar: "Liberal Parties in Central and Eastern Europe." Presented: "Economic Platforms of the liberal parties of Central and Eastern Europe"

Lecture: "Bulgarian Economic Condition: Current Status" presented at the St.Cril and Methodios Foundation.

Courses:

Co-organized a seminar on "The Road to Economic Thinking" at the American University in Balgovgrad. Teamed with the Foundation for Teaching Economics, California and the Foundation for a Free & Democratic Bulgaria.

Publications, Books & Papers:

Book published by IME Program Director: "Securities: How to buy and sell with profit."

Paper: "Banking Privatization and Competition" published in Bulgarian Business Journal (not in English)
Paper: "Privatization of Commercial Banks in Bulgaria" (draft)
Paper: "First Steps of the Stock Exchange: Results of the Roundtable", presented to the Ministries of Finance, Justice, Central Government, and Parliament.
Paper: "Bulgarian Stock Exchanges: Assessment and Recommendations", published in two issues of MONEY Magazine.
Paper: "Note on Technicalities in the Privatization Scheme in Bulgaria", presented to Agency for Privatization, Ministry of Trade, Cabinet and Parliament.
Translation, Editing and Printing of Chapters of Paul Hayne's book: "The Economic Way of Thinking"
Translation of publication by the Foundation for Teaching Economic (Davis, California) "Test Simulations and Games
Paper: "Conventional and Voucher Versus Venture Capitalists Privatizations"
[illegible]

Interviews:

Providing regular interviews for Bulgarian national newspapers on: privatization, situtation in banking, foreign debt

Publication in weekly business journal for foreigneers: "Comparison of Bulgarian and Western Stock Exchanges."

Representations:

Selection of participants for World Bank Seminars in Vienna
Seminar: "Regulation of Natural Monopolies"
Seminar: "Enterprises in Transition"

Selections for the Fulbright Scholarship award.

Investigations:

Examiniation of the Bulgarian Stock Markets commenced (May)
Examination of the Economic Impact of Restitution
Case Study of Joint-Stock companies registered under corporate regulations in Bulgaria.

Future Projects:

Roundtable: "Impact of Restitution"
Roundtable: "

INSTITUTE OF MARKET ECONOMICS
SUUMARY EXPENSES

Direct Operations Expenses

	February	March	April	May	June	July	August	Totals & Cross Checks	
Salary Expense	932.77	675.47	675.47	863.68	938.44	915.75	0		5001.58
Legal Expense	120.1	0	0	18.78	0	0	0		138.88
Translation Expense	42.75	0	0	0	0	720.9	0		763.65
Accountant Expense	1.36	0	0	0	0	0	0		1.36
Total Direct Operating	1096.98	675.47	675.47	882.46	938.44	1636.65	0	5905.47	5905.47

Purchases

Office Supplies	0	11.92	27.77	116.13	175.67	44.07	?		375.56
Library Purchases	36.85	0	7.47	55.91	4.88	9.63	?		114.74
Computers / Equipment	0	0	0	167.93	15.58	102.56	?		286.07
Office Furniture	0	0	0	4464.48	92.98	0	?		4557.46
Total Purchases	36.85	11.92	35.24	4804.45	289.11	156.26	0	5333.83	5333.83

Facility Expenses

Renovations	0	0	0	167.93	305.75	0	?		
Telephone	0	0	0	18.02	?	na	?		
Electricity	0	0	0	1.43	?	na	?		
Total Facility Expense	0	0	0	187.38	305.75	326.5	0		819.63

Development Related Expenses									
Visas / Taxi / Other	0	36.04	350.02	0	0	4.8	?		390.86
Per diem	0	0	366	0	0	0	?		366
Travel Cumm. Account	0	0	0	412.05	0	0	?		412.05
Conference / Seminar	0	0	0	0	107.88	0	?		107.88
Entertainment	0	0	0	0	0	25.86	?		25.86
Postage	0	0	0	31.88	68.13	11.25	?		111.26
Publishing Expense	0	0	12.08	0	0	0	?		12.08
Total Development Related	0	36.04	728.1	443.93	176.01	41.91	0	1425.99	1425.99
Fees & Charges									
Bank Fees	1.03	0	1	1	0	0	?		3.03
Repairs	0	11.32	0	0	0	322.12	?		333.44
Installations	0	15.09	7.55	82.61	0	0	?		105.25
Insurance	0	0	0	0	0	60.37	?		60.37
Total Fees & Charges	1.03	26.41	8.55	83.61	0	382.49	0	502.09	502.09
Other Support Services									
Donated Services / General	116.6	0	1250	1597.16	2500	5000	5000		15463.76
Shipping / Travel	0	0	0	0	225	?	?		225
Lecturing / [redacted]	0	0	0	0	4277.39	?	?		4277.39
Donated Materials	0	6151.55	0	80	1696.89	0	?		7928.44
Facility Support Services									
Rent	205.99	200	200	650	500	500	500		2755.99

Office Use		617.96	600	600	448	243.99	194.14	?		2704.09
	Total Donations & Support	940.55	6951.55	2050	2775.16	9443.27	5694.14	5500	33354.67	33354.67
Salary Expense										
	Krassin	466.38	452.83	452.83	450.62	450.45	439.56			
	Ivanka	349.79	169.81	169.81	337.96	337.84	329.67			
	Toni	116.6	52.83	52.83	75.1	150.15	146.52			
		932.77	675.47	675.47	863.68	938.44	915.75			

NATIONAL ASSEMBLY

OF THE REPUBLIC OF BULGARIA

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9th July, 1993

Krassen Stanchev, P.h.D.
Executive Director
Institute for Market Economics
137 Rakovski Str.,
1000 Sofia

Dear Dr. Stanchev,

The Economic Committee of the Bulgarian Parliament received your paper, *"The First Steps of the Bulgarian Stock Exchanges"* describing the results of your round-table discussion.

It is a pity that only very few Committee members managed to attend the round-table but on June 10th, as you know, the Parliament was discussing the budget.

As you are aware, there are three initiatives to assist the emerging stock markets in Bulgaria. There is a German draft bill on stock exchanges which was discussed last week at the meeting of the Legal Department of the Council of Ministers. Your representative made a fair contribution to the discussion.

There is also the Concept Paper on "Securities Regulation for Bulgaria" developed by CEELI of the American Bar Association and a draft "Securities Act" initiated by the managers of the First Bulgarian Stock Exchange.

Different models to regulate the stock markets in Bulgaria have been proposed. I am confident that this question should be placed among the priorities of the legislature.

For this reason, I would like to invite the Institute for Market Economics to assist the Economic Committee of the Parliament in elaborating the following set of issues:

1. to assess the models which have already been proposed to the Parliament and the Government and to recommend the best structures for regulation policy to follow over both the short and long term;

2. to build a team of experts to draft regulations needed;

3. to propose regulations needed in order to improve competition and public confidence in the Bulgarian stock markets.

It would be excellent if you manage to set up a team involving different fields of expertise, professionals from different sectors, and managers from the stock exchanges.

My understanding is that as an ideal team should work with international advisors to prevent our country from repeating mistakes of the others.

For well known reason the Economic Committee is preoccupied currently with the hearings regarding taxation and bankruptcy regulations. I must inform you that because of these engagements, the Committee has no funds to cover your costs for working on this specific project but are nonetheless hopeful that you may be able to take on this task.

I hope the IME is able to make some valuable contributions in the near future.

Assen Michkovski
Chairman of the Economic Committee

Project Summary:

Report by Peter Classen on IME activities
September 10, 1993

As per our agreement, we were able to accomplish the following projects this summer at the MI in Sofia:

1) An accounting and budget review with reconciliation against bank transactions
2) Training of the Office Manager in basic western accounting for monthly reporting.
3) Training of the Office manager in word processing and database systems.
4) The design and completion of a database of possible sponsoring institutions.
5) The assistance with the Ministry of Economics regarding Exchange law development.
6) Development of newsletters, mailings and policy papers.
7) Implementation of the standard to-do-lists and project management techniques.

As the summer project evolved, we were able to develop a number of contacts at the various Ministries. One such contact has lead to the invitation by the Ministry of Economics, for the IME to prepare alternative Securities and Exchange legislation. This project is both high-priority and high-profile. It is considered by the staff to be one of the greatest successes of the summer.

As the Ministries have begun to recognize the contributions of the IME, they are now welcoming the policy papers that the IME executives have been preparing. The newsletters also seem to be "stirring" the policy formatting community. This is best seen in the new partnerships and invitations to participate with other not-for-profit think-tank operations in Bulgaria.

One success of the summer was the solicitation of assistance from professional not-for-profit managers to discuss the ongoing strategy and fund raising plans of the IME. The database that was jointly developed by myself and the Bulgarian office staff, now contains over 150 listings of the active not-for-profit foundations and institutions. This list will be instrumental in the fund raising mailing that should take place this fall.

I firmly believe that this was an enjoyable and educational project for all involved. I am glad that our efforts have led to some valuable contributions and that Bulgaria will benefit from this organization.

Respectfully submitted,

Peter R. Classen
[redacted]

IME

THE INSTITUTE FOR MARKET ECONOMICS

Stock Exchanges in Bulgaria: assessment and recommendations

On June 10th, the Institute for Market Economics (IME) hosted an important meeting concerning the development of Bulgarian stock exchanges. The purpose of the meeting was to evaluate and identify problems with the stock exchanges. One result of the meeting was the formation of a research group. This new group will draft securities law legislation and make recommendations to institutions concerning the development of Bulgarian new stock exchanges.

The IME invited specialists in the area of finance and economics. The principal guest of the round-table meeting was Susan Woodward, Chief Economist of the United States Securities and Exchange Commission. Other attenders were: Georgy Abadjiev („LEX"), Prof. John P. Bonin (Walsey University), Lutchezar Christov (HJP/Western Investment Group, NYSE), Andrey Evtimov (private consulting firm „Cresta"), Walentin Gotov (Commodities Exchange - Wratza), Prof. Jeffrey Miller (Delaware University), Nikolay Nikolov (Open Society Fund), Atanas Paparisov (National Assembly), Victor Papazov (Executive Director, First Bulgarian Stock Exchange) and brokers from the First Bulgarian Stock Exchange, Deyan Popov (Bulgarian Chamber of Trade and Industry), representatives of the Agency on Economic Coordination and Development, Ivan Tenev (First Private Bank), Radoslav Yonkov (Free Commodity Exchange „Dunav"- Russe), Martin Zaimov (Coopers & Lybrand), Press.

The main topics of discussion were, the trading conditions of the stock exchanges, payment and settlement for participants, rules and regulations concerning the stock exchanges and investor protection. The outcome of the meeting produced some very interesting results.

CONCLUSIONS:

1. There are many hopeful signs regarding the health of the Bulgarian stock exchanges. For one, there is a significant amount of trading. The degree of trading is high considering the age of the stock exchange and the size of the economy. Along with this, commissions are being paid to support the stock exchange and keep it functioning. The Bulgarian market is a real market, one which is viable without the assistance of government subsidizing. Additionally, trading activity is taking place in the absence of securities law. This means that the market participants are trusting each other.

2. The securities law has to promote the integrity of the market, to make the market feasible when unexpected events occur. The securities law, however, does not have to be a stock exchange law. A stock exchange must have its own rules. The securities law must specify the following:

> Agreements, rights and responsibilities between the broker/dealers and the customers. These agreements are formatted in standard contract form for example conformation slip.

A registered, non-profit organization in Sofia, Bulgaria. Reg# 831344929 Approved March 15, 1993, 729/XI/VI, p. 169
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Public information in the form of Income Statements, Balance Sheets and Fund Flows which is made available by companies to the market.

The minimum requirement of obligatory information for unquoted shares.

Laws regarding insider trading as a criminal matter.

3. The information market in Bulgaria is underdeveloped. Because of this, it is difficult to determine if company shares are being traded legally or if insider trading is taking place. As the information market becomes more sophisticated this problem of identification will be abated. Then the buyers will pay the right price for shares of industries being privatized. A group of auditors or a group of investment bankers, who are sought as advisors on the deal have to provide a balance sheet for the company.

4. Information is the background for market liquidity. It is better for the economy to have trading with little information available than not to have any trading. This is the current situation of the Bulgarian stock markets. As better information systems are being developed, a concern, is that fraudulent information is being spread. All players need to be informed publicly on trading, settlement and other stock exchange rules. There are cases of considering the rules of the stock exchanges or of stock exchange departments of the commodities exchanges as trade secret. This practice must be abolished.

5. It is difficult to understand the role of speculation. Some players are not familiar with this phenomenon. There is fear that shares from bankrupt companies can be traded. Investors who are knowledgeable in the area of speculation are certain in attaining a high return on their investment. Usually conservative investors avoid trading in a speculative bubble. Speculative bubbles, however, are a necessary part of the stock market. No one can remove the basic behavior of people which is inherent in all market participants. The speculative bubble phenomena may have a positive impact on the market. It can clean the market. It insures that players who are informed and conservative can buy stocks at the lowest price. Without speculation it is not possible to have a market. More dangerous are market manipulations and misleading statements.

6. There are two stock exchanges established in Sofia. One of them is out of operation. The other stock exchanges departments are part of the commodity exchanges located in Russe, Bourgas, Varna and Gabrovo. These departments are oriented towards the small investor. The main problem these departments are facing is that they have to set up trading rules that are similar to traditional principles. Specifically, these departments need rules on guarantees backing the deals.

7. Another area of concern when establishing a stock exchange is how to keep investor confidence. The stock market is not just a game. There are serious theories and rules which one must play by. It is necessary to distinguish between individuals who are educated in understanding the concepts of the stock market and those who are uneducated. Hungarian cases with the companies first floated bonds and with the IBUS tourist agency shares, considered as a speculative bubble. This is a typical example of loosing investor confidence. Many people have lost money in these buys and have left the market.

8. Stock exchanges do not need to be regulated by a state body. Regulation can be implemented by a non-governmental Institution. This Institution is responsible for checking the creditability of companies before they may issue securities. This can help instill investor confidence. Confidence is increased by requiring company's listing. The First Bulgarian Stock Exchange is in the process of requiring private companies to be listed. Companies that are not listed will not be allowed to be traded on the exchange. Information will be released in the form of Bulgarian standard accounting principles.

NOTE ON SOME TECHNICALITIES IN THE MASS PRIVATIZATION SCHEME IN BULGARIA

The most recent version of the privatization blueprint suggests that 8 investment funds be formed. Every citizen receives 8 points which he or she can exchange for shares in one or more of the investment funds. This note studies this scheme and suggests that it is technically very difficult to be accomplished, it has adverse effects on the operation of the stock market and gives wrong incentives to the investors, and last but not least, it has no economic justification.

Instead of this mechanism, in this note I take the stand that a much more simple and more effective mechanism can be used to accomplish the goals set in the privatization program.

To show the difficulties stemming from the blueprint I will use a numerical example which I will try to keep as simple as possible.

Assume that we have only two investment funds (or companies) whose shares are to be exchanged for "golden" points. The points are distributed freely to the consumers and each consumer receives two points. There are three consumers. Now, let's assume that the assets of the firms (Firm 1 and Firm 2) are valued at $6 for each firm.

The consumers have to choose where to invest their golden points. However, to solve the problem we also have to determine how many shares are issued for every firm. It is reasonable to assume that the number of shares is a multiple of 6, so that in case all golden points are claimed in one fund, the number of shares given against each golden point is an integer. Since all shares have to be given to the consumers, in case there are less than 6 golden points claimed in one fund, the consumers get a number of shares proportional to their participation in the fund (i.e. if 4 golden points are invested in Firm 1 and Consumer 1 has two of them, then it gets one half of the shares.)

One can already discern a problem. In terms of the example above, what happens if the other two points invested in Firm 1 belong to consumer 2 and 3, each investing one golden point. We have three shares to divide between two people, so each of them should be getting 1.5 shares. Though when we start working with 7-digit numbers (i.e. the number of consumers getting golden points), these divisions would cause even more headaches, I believe that this is a minor problem and there is a solution to it.[1] However, the solution would further complicate the already complicated model.

Further problems emerge when we start elaborating on the actual operation of the mechanism. To continue with our simple exercise, let's now assume that Consumer 1 and Consumer 2 invest all their points in Firm 1 and Consumer 3 all her points in Firm 2. The net worth which the first two consumers are receiving is $3 each (one half of the claims against assets of Firm 1). The third consumer is lucky - she gets $6! At first sight this outcome looks like a result from a market mechanism. But this is not a market. It is a pseudo-market which distorts the normal market incentives structure. Obviously,

[1] Try to think of privatizing a $1 billion enterprise which has 40 million shares claimed by 1,234,567 consumers; 1,000,000 consumers invest 1 point, 200,000 consumers invest 2 points, 30,000 - 3 points; there is no need to continue - it's already complicated.

Consumer 1 and Consumer 2 think (we assume, rationally) that the present value of the future income streams of Firm 1 is higher than that of Firm 2. But because of this, they get much less than Consumer 3. It seems that in this situation a hyper-rational agent would be not the ordinary investor who calculates present values and financial ratios, but the one who works on the speculative side of the market. This agent is trying to find where he would encounter the least number of investors. And since this behavior is rational we should assume that all consumers would easily adopt it. This in turn means that the pseudo-market would be purely speculative. And though speculation on financial markets is an inevitable feature of any market economy, it becomes a big problem when it is the predominant mode of operation. History and economic theory show that the overly speculative market may induce large disturbances in the real sector of the economy.

Another argument against this mechanism is based on the same issue: the differences between the values of the consumers' portfolios might be excessive when we start working with the real economy. And the problem is that this differences result purely from chance. This fact disqualifies fairness in the initial distribution of wealth as an argument for mass privatization.

A much more simple scheme calls for distribution of one share from each fund to every consumer. I don't see any economic justification of the preference for the current scheme compared to this one. In this simple scheme consumers, after getting their shares in the funds, can diversify their portfolios on the real stock market. The rational investment decisions are based on two major factors: the ratio between current stock price and expected future stock price (i.e. the expected capital gain) and the expected stream of dividends. Both schemes do not distort the evaluation of the dividend payments. However, the expected capital gain is significantly different. It is not sufficient to use economic arguments in order to calculate the expected capital gain under the current scheme. The reason for this is that the investor doesn't know the stock prices in terms of golden points. So, the evaluation of the opportunity costs and the capital gain is, if not impossible, at least very complicated.

Unlike this scheme, the simple mechanism described above has none of this problems - everybody is getting one share (i.e. an integer number); there is no conflict with the major goals of the mass privatization (moreover, it seems much faster since the stage at which consumers are claiming their shares is circumvented), investors follow the movements on the stock market and thus they can diversify their portfolios easily and rationally. In addition, the simple scheme contributes to the clarity and simplicity of the privatization process which in turn ensures much faster and effective transformation of property.

Ilian Mihov

Conventional and Voucher Versus Venture Capitalists Privatization

Kamen Atanassov

As the conventional kind of privatization is difficult for direct implementation in the post-socialist countries for a number of reasons, some economists have proposed other alternatives for mass denationalization. A commonly accepted structure of intermediaries, realizing a quick transfer of the ownership of the state sector to the public, are the holding companies or mutual funds. Expressing some reserves towards the predicted universal effectiveness of the mutual fund doctrine, I will propose a new specific form of a financial intermediary. I will put much weight on the impact it can provide over the approaching privatization in Bulgaria.[1]

1. The "roaring" period

After 1989, in Bulgaria started a process of political reorganization, soon followed by substantial economic changes. Almost all of the basic controlling mechanisms were totally destroyed.

Bulgaria lost almost 75% of its foreign markets. The almost totally freed prices started skyrocketing, reflecting rather chaos than efficient allocation of resources. The government started reorganizing the structure of the relations among the economic units, following an unclear demonopolization scheme.

So one can see that the state sector of the Bulgarian economy had to continue functioning in an absurd environment which some western economists qualify as 'the noisy period'.[2] I will call it "a roar". It's a result of a game with new but quite undefined rules. State enterprises were placed in a new competitive situation. They however remained under soft-budget constraints.

Bulgarian banks served not to allocate the credit resources to their best opportunities, but rather to organize direct investments under the decisions of the central board. Therefore, missing the basic incentives of profit maximizing agents, banks offered huge amounts of credit to state enterprises facing almost full bankruptcy. In fact that was a natural consequence that the state will cover all losses coming from the bad loans.

The state sector became the biggest borrower in the country. Only for the 9 months of 1992 the amount of credits from state banks to the state firms has reached 10 billion leva, which is almost 5% of the total Bulgarian GNP for the whole 1992. Obviously no one can say how much of the new debt obligations will be paid back. At the same time a new phenomenon has appeared the interfirm credit.

2. The privatization concept

There is no doubt that the private property along with market forces guarantees the best possible utilization of the available resources. And if that process is supported by a stable, well-designed legal system, it can unambiguously contribute to the well-being of the whole society. That's why most of the economic experts think that privatization is the only panacea for the East European economies.

From my perspective, when integrated in the process to a market-economy, the basic concepts of privatization go beyond the boundaries of the simple transfer of ownership. I think that the key task of an privatization mechanism should be to separate the viable from the non-viable capital stock. In Bulgaria huge investments were made under the control of the central boards. Under the decisions of the government people were forced to reduce their current consumption for the sake of huge investments, including substantial amounts of capital stock, investments in education, on-job-training, technologies etc. Therefore the role of any privatization model should be to pick up all elements of this huge pool of already accumulated resources which can directly, or more probably after a certain period of transformation, be successfully allocated to their most efficient uses. In fact the 'roaring period' in which privatization has to be started makes this task harder, placing more responsibilities over the eventual denationalization mechanisms.

Basically, there are two kinds of privatization schemes proposed by the western economic thought - the direct (or the so called conventional) privatization and a denationalization through intermediaries like holding companies or mutual funds.

2.1. The Conventional Privatization Scheme

The Bulgarian Parliament, has adopted a model of conventional privatization. I dare to express some reserves towards its effective implementation. From my perspective there are three basic reasons because of which the governmental privatization scheme will not achieve its goals.

First, the valuation process of state enterprises will be difficult and unprecise. The underdeveloped capital markets in Bulgaria do not reflect the current and the expected performance of the enterprises. Most of the assessing mechanisms proposed by some experts from the World Bank include complex signaling systems and require two basic conditions which don't exist in Bulgaria - enough time for their implementation and a stable economic situation.

Second, in a conventional privatization scheme there must be enough liquid capital. Neither is there an adequate credit system[3], allowing individuals to participate efficiently in the privatization. Boom of foreign investments hardly could be expected in Bulgaria.

Third, there is still no clear treatment of intrafirms loans and the state enterprises' obligations to the banks.

Imagine a potential buyer can choose investment from the big pool including all state enterprises. For convenience we can divide the state sector into three categories. The first one includes those firms which will remain state property forever (like the National Electric Company, the National Railroad Company, and others closely related to the state budget). The second group should consist of enterprises with quite unclear financial status and prospectives. The third group consists of state enterprises which bear all the necessary characteristics for a promising future performance. Obviously the most precise expertise, at least for the enterprises belonging to the third group, as they will attract buyers, can be achieved through a well designed auction system. What I expect is that their number will be quite small.

This means that under the already adopted scheme much of the existing resources will be neglected, i.e. will continue to be used inefficiently under the state management. There is a high probability that the misuse of these resources would lead to the waste of others. The possible result of a conventional privatization in Bulgaria will turn into a process of 'cream picking'.

2.2. The Holding Companies Method

A mass privatization is the one in which holding companies or mutual funds control over a big portion of the state enterprises while spreading their own shares among the public. The new intermediaries should have the total freedom to behave as actual owners of the privatized enterprises, including the right to close down the unprofitable companies. To define the incentive scheme of these intermediaries one should know the way in which the state firms are allocated among these intermediaries. In their paper 'Evolution and Design in the East European Transition' (*'Rivista di Politica Econmica'*, November, 1991), Roman Frydman and Andrej Rapaczynski have proposed an auction system. As they argue if the allocation is made administratively by the government, the new intermediaries won't have the incentive to keep the bad firms and will try to get rid of them as soon as possible. To define the 'viable' from the 'nonviable' capital stock, the two authors assert that if the intermediaries are offered the possibility to choose the firms they want to own, they will do their best to choose the good ones. What portion of the capital stock in Bulgaria can be defined as viable? What is the criteria for viability? Speaking about companies which would turn to be out of the scope of interest of the intermediaries, the two writers say the following: 'With respect to those left in its position, on the other hand, the state will be free to adopt a number of policies that will not lead to rapid destabilization or social unrest. It may decide to pay off the debts of some of the enterprises and attempt to auction them again later...' It seems that *a priori* Frydman and Rapaczynski consider viable firms with clear balance sheets, and if that's the criteria for viability, only a few Bulgarian state companies would fall into this group. At the same time the two authors don't exclude the possibility of some undesirable effects: 'To be sure, the funds might have made some mistakes, and consequently some of the enterprises might still be closed down. Also, some may have been acquired with an idea of liquidation in mind. But by any large, the state can adopt the position that the funds should be given full responsibility for the companies in their portfolios, and take the attitude of firmly refusing to subsidize them in any way.'

Having in mind the characteristics of the 'roaring period' in Bulgaria, I think that the chances for such a consequence are very high. The intermediary companies, although participating in auctions don't invest their own money, i.e. they don't buy the enterprises in the general meaning of the word. But even if betting with investment points or vouchers, after acquiring a state enterprise the holding company will have the right to behave as the actual owner. There would be strong probability that the intermediaries would try to attract more firms under their umbrella just for the purpose of liquidating them later. They would miss the incentives to do their best for the restoration of a currently nonviable firm.

Consequently, firms, having more unclear current status will either remain outside of interest of the intermediaries, or soon after their acquisition will be liquidated. In Bulgaria this new privatization scheme would be effective only in that portion of the state sector being in very promising current state. In other words, if this kind of privatization scheme had been adopted two or three years ago (during the more silent period), it would have achieved positive results. Under the new constraints, economists should search for new and more effective solutions.

It turns out that there is some kind of controversy between the two basic privatization models. On one hand, the conventional privatization, while preserving the basic enterprenuer's incentives for profit maximization and efficiency at any cost (and at any efforts, as the buyers of the state enterprises risk their own money), doesn't lead to an efficient solution for the broader portion of the Bulgarian state sector. It would be too risky for investors to use huge amounts of money to attain ownership of state enterprises facing some current hardships. On the other hand, if the holding companies approach is adopted, I think that the real incentives of enterprenuership will be missing, which in its turn won't provide a solution to the problems of the state enterprises, being in current nonviability.

3. The Venture Capital Firm - an alternative approach

Preserving the basic incentive scheme of the classic VCF, lets try to see if there is a way to integrate it in the privatization program for Bulgaria. As most of the problems come from the group containing enterprises with riskier status, I think the VCF model could be applied. An investment firm can offer funds and managerial skills to state enterprises facing current hardships and later when these firms become profitable, the investment group can get back their capital through a process of privatization. After the initial assessment of the state enterprise the new intermediary institution can get the right to receive a portion of the revenue, generated by the future privatization of this firm. By investing money and managerial skills, the new organization will buy the right to reorganize, prepare for privatization, and finally receive a percentage of the total sum, generated from the sale of the state firm, adequate to the amount of the initial investment (for example a percentage equal to the amount of the investments compared to the current value of the state firm's assets). Obviously, the extent to which the investment group controls the state enterprise will be crucial for the success of the new mechanism. The managerial functions can be provided by a board of managers, which should include a representative of the state, which is in fact the actual owner of the firm. With much less capital and risk (compared to those in the conventional type of privatization) investors can receive the right incentives to make the firm profitable. Of course one may argue that the investment group will use its power for direct embezzlement. From my perspective, a clause, guaranteeing that the intermediary can get back any capital only after the privatization of the state enterprise, will automatically eliminate an undesirable consequence, and one of the roles of the state representative in the board of managers could be exactly this - to control the rules of the game. This important constraint provides a self-enforcing mechanism, i.e. the investment group will do its best to fulfil the task faster and better - to put the enterprise on its legs and privatize it, because that will determine the amount of the profit. In fact I think that the basic advantage of this model is that it provides a satisfactory solution for the state enterprises which will remain unprivatised because of being more risky opportunities, but which can attract private enterprenuor's interest under a more flexible investment scheme.

As the eventual implementation of such an institutional structure will lead to the appearance of a new agent in the economic environment, I find it interesting to discuss what possible role and reaction is expected on the part of the other economic actors.

3.1. The State

The state will benefit from such an intermediary, because if the major part of the state sector remain untuoched in the adopted conventional type of privatization, the new VCF will provide quite a reasonable solution.

Under the new scheme the state will shift a considerable amount of its burden, in the form of controlling, inspecting, and reorganizing a large number of enterprises. Additionally, when the firms, under the control of the investment groups, are privatized, the government budget will receive the highest possible price for the state capital stock.

But in all cases the state has the unique opportunity to set the rules of the game. This naturally leads to the conclusion that the state officials should create all the necessary conditions for the effective functioning of the new mechanism. They are expected actively to participate in the process. For example, an important condition for a successful start of the new approach, should be the writing off of the bad loans of the state enterprises, that have attracted the interest of the new intermediaries. Most of the economists consider a state enterprise with a cleaned balance sheet won't have the right incentives to protect it from further contamination. State managers will continue to borrow without paying back, relying on the fact that the state will continue to cover the losses. In the new approach, from my perspective, such a possibility is excluded because the new boards of managers would do their best to protect the enterprises from any indebtedness, because that will be closely related with their interests of profit maximizing agents.

Therefore, the crucial role of the state in the proposed mechanism, should be expected in the form of cooperation, active participation, and even initiation of the new undertaking.

3.2. The Potential Investors

The source of funds has always been a hot issue and it doesn't make an exception in our case. But let's see why a VCF kind of intermediary should be a better alternative for people and organizations with some available capital. Under the new investment scheme (the VCF type) the potential investors will be offered the possibility to take more risks with less capital. At the same time, getting almost full control over the state enterprises, the private enterprenuors will have the opportunity to apply their knowledge and skills for their own benefit.

As the new intermediaries can organize investments in different state firms, that will give them a chance for risk diversification, which otherwise would be difficult in Bulgaria, because of the missing capital market. But trying to determine the basic incentive mechanism of the new proposal, I find it certainly more attractive than some of the other alternatives.[4]

Besides rich individuals and powerful private companies, the new mechanism should offer investment opportunities for other economic agents like banks, insurance companies, pension funds, and other financial institutions in which huge amounts of capital is concentrated. All major investors could easily control the soundness of their capital by having their representatives in the new boards of managers. The last, but by no means the less important source of funding, could be foreign capital. The new intermediaries will need lots of foreign assistance both in terms of consulting services and foreign trade relationships. I think it would be quite natural for foreign private investors to be interested in placing some money in profit maximizing organization, functioning under market criteria.

The role of this new approach can be viewed in the broader context of western financial assistance to the New Democracies. Many economists have advocated a New Marshal Plan, but financial support cannot be offered in the way it was done 50 years ago in Western Europe. According to them, the basic obstacle is that in the post socialist countries there are no democratic traditions, accompanied strong legal systems. There is a high probability for a misuse of an eventual large-scale financial support. Policymakers have to create those institutional structures to allow the efficient allocation of western support. If foreign aid is concentrated in special funds, which are directly invested in the economy through intermediaries of the VCF kind, then foreign governments will have more certainty in their actions. Therefore, the new mechanism can ease the process of direct financial assistance, guaranteeing the efficient allocation and use of the resources.

Conclusion Summary

Being far from the ambition to propose a panacea for the economic transformation going on in Bulgaria, in this paper I have tried to offer a different approach which reflects my understanding about the basic idea of the transition. Because of the specifics of the nowadays Bulgarian environment, (mostly as consequences of the tree-year 'roaring period') in this paper I have argued that a conventional privatization approach will

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affect only a negligible part of the Bulgarian economy. The holding companies approach also offers unsatisfying solutions, mostly due to the lack of a motivation scheme. Therefore, being mostly concerned about the great number of state enterprises which will remain outside the scope of the privatization program, mostly because of their high risk, I have proposed the VCF structure. For me, the most important characteristic of this mechanism is the fact that it engages private enterprenuorship and profit maximizing incentives into the reorganization of state enterprises. In the broader process of the transition, this is a way for an efficient transformation and reallocation of the already accumulated resources. And the basic task of policymakers should be, as Milton Friedman has stated in his inciteful article "The Role of Monetary Policy" (The American Economic Review, March 1968): '... to provide...a climate to the effective operation of those basic forces of enterprise, ingenuity, invention, hard work, and thrift that are the true springs of economic growth.' "

[1]While this proposal bears more general sense, I will concentrate the discussion more on the Bulgarian case, as both my interest and concern are more closely related to this place.

[2]The original thought comes from Jean Tirole's article 'Privatization in Eastern Europe: Incentives and the Economics of Transition.', 1990.

[3]Recently there has benn a proposal by the Prime Minister Berov, dealing with that problem.

[4]f course one should be clear about the fact that as long as there is no strong legal base, as is the case of Bulgaria, the underground economy will always be an alternative for people with money. Here I would like to use the opportunity to express my thanks to Mr. Valentin Chavdarov - expert at the Agency for Coordination and Development, for his helpful comments and assistance in the creation process of this article.

draft

"Policies for Attracting Foreign Direct Investment in the New Market Economies"

The following facts formed the basis of our decision:

1. Bulgaria is the country with the lowest volume of foreign direct investment as compared to other East European economies. During the last 12 to 18 months even the statistical data on their volume, industry structure, actors, and forms, etc.

2. Some politicians are making dangerous anti-foreign statements which repel rather than attract potential foreign investors, or at least make them feel insecure for the future of their business in Bulgaria.

3. The war to the West of Bulgaria, general instability serve as a strong disincentive. But at the same time, the absence of ethnic conflicts in the country and the relative political calm coupled with the functioning of democratic institutions make the discussion of the interplay of domestic and international determinants of country risk, both economic and political, quite interesting.

4. Given the size of domestic markets, transnational corporations and export-led recovery will be the engine of growth for the East European economies. The revival of intra-regional trade, in the absence of dominant national economies (like the former Soviet Union), to a large extent will be generated by foreign investment, and trade flows associated with it.

The conference on foreign direct investment should combine the general and comparative perspective, with country as well as industry and company case studies. It may include government decision-makers, corporate officials and representatives of international institutions who are qualified to shed light on the most recent and still little known experience. We have the agreement in principle of Dr. Karl Sauvant, the leading economist of the UN Center for Transnational Corporations that his organization is ready to participate in the preparation of the conference. IMF and World bank officials, OECD and EC representatives, members of the international lending community would also be invited to attend. With some lead time we may be able to interest some of the prestigious business publications in sponsoring the Sofia event.

The principal building blocs of the conference will be provided by the following topics:

1. Policies to promote foreign direct investment.

2. Successful strategies and models of attracting and promoting foreign direct investment.

3. Foreign direct investment in the world economy.

4. The role of transnational corporations in Central and Eastern Europe.

5. Comparative study of investment flows in Central and Eastern Europe.

6. Policies of host countries to attract foreign direct investment:

- legal and institutional structures;
- barriers to entry;

7. Home country policies:

- foreign direct investment from the Triad (USA, Western Europe and Japan);
- NICs investment in Central and eastern Europe;

8. Transnational corporations and transnational banks in Central and Eastern Europe:

- regional and national comparative advantage and foreign direct investment;
- TNCs and TNBs and privatization;
- TNCS and industrial restructuring;
- TNCs and export performance of Central and East European economies.

9. Policy responses of newly emerging democracies to the challenges of globalization and foreign direct investment:

- economic transition and foreign capital;
- anti-foreign, xenophobic and populist reactions to TNCs in the regional economy;
- policy and institutional accommodation;
- cultural barriers to internationalization and re-integration with the world economy

This is just a crude review of some of the major themes. Policies of host and home countries, both macro- and microeconomic should be at the center of our deliberations. Th adoption of a common pattern of data gathering and conference paper structures will create an invaluable information tool for policy makers both in Central and east European economies, and capital-exporting countries.

We'd be delighted to hear your comments as early as possible with view of preparing a proper organization for the conduct of this unique conference.

BULGARIAN ECONOMIC AFFAIRS

(Excerpts from the Oxford Lecture, Oxford, Merton College, 20 May 1993)

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I. Grounds

1. Political Background

1.1. Reform aiming at transition to market economy has started in February 1991 when coalition government was elected by the Constituent National Assembly.

1.1.1. The main economic reform targets were, and to great extent still are as follows:
a) financial stabilization, inflation curbing, money aggregates and budget deficit regulation;
b) changing patterns of economic behavior through prompt privatization;
c) exercising pressure on enterprises to adjust to the changing economic environment and setting up fundamental market economy institutions in the country;
d) attempting to follow coherent economic policy.

1.2. In March 1991 nominal interest rates jumped from 2 to 47 % for all credits, including those already given. (Exceptions from this rule were very few: for the loans to build private flats, the loans for young families, and for environmental loans with an incentive for the latter to realize respective projects before the end of the year.) Since then nominal interest rates have been floating around the figure of 57 % in annual calculation. (Currently there is a public discussion on possible reduction of the summer 1993 nominal interest rate; the value expected is under or around 40 %.)

1.3. Between March and July 1991, Bulgaria was the first country in Eastern Europe to adopt an entirely new Constitution which established the basic rights to private property and provided the possibility to avoid political clashes similar to those which, for instance, Russia is encountering currently. Although there is good constitutional prospective for market economic performance, one exception proved to be an obstacle to foreign investments: the Constitution prohibits purchasing of agricultural land by foreigners. Due to the constitution making process, just after the economic changes has started two months of 1991 were completely lost in terms the legal preparation of the reform.

1.4. Necessary for political reasons, general elections in the fall 1991 have postponed economic changes. The new government redefined to certain extent economic priorities, mainly through giving advantages to the full restoration of the old property as it existed in late 40's.

1.5. Aiming to tackle anti-market resistance of ex-communist "nomenclatura", the new non-communist leadership of the country, which had dominated in the economic and political decision making since fall of 1990 missed the right time for choosing right priorities for economic reconstruction. Understandingly, leaders concentrated on classical (or "historical") market formative entities - small trade, small enterprises and (small) farming, which were viewed as hard to control by the *ancient regime* or, at least, were considered as its opposition. This view was supported by the restored old (late 30's and 40's) parties which were more important in Bulgaria than in the rest of CEE countries. Vast area of accumulated know how was abandoned as unimportant and "socialists' field of influence". High technology, in which Bulgaria used to play as the role of the biggest supplier to the Comecon market, is just the most shocking example - when Comecon was dissolved the whole sector collapsed overnight.

2. Current economic situation

2.1. Recession has reached 22 % as compared to the previous year when the government foresaw it to be twice less. Budget deficit equals 8,5 billion leva and thus amounts about 20 % higher than expected. 1993 official forecast is that recession will not exceed 4 % of the GDP, and budget deficit will reach 8 % of the GDP.

2.2. The 1992 inflation rate is about 80 %, reaching highest price rise level in Healthcare Commodity Group (111 %) and Clothes-and-footwear Group (110 %); Foodstuffs have risen 88 %; The end-of-1991 official inflation rate forecast (63 %) which served as a basis to draft 1992 budget was exceeded, being at the same time considerably less than 1991 rate (400 %). There are few prices still controlled by the government some of which (energy, electricity, communications) are almost artificial. 1992 passed without their significant marketization what proved to be an obstacle on the way to economic reconstruction. Two price shocks have been scheduled for this year, first already having taken place.

2.3. Bad foreign investment climate is created to a great extent by the Bulgarian foreign debt situation; the net weight of external dept is 11,5 billion US $. (GDP according to the official statistics is a little bit less than 84 bn.) General solution of the debt problem depends on negotiations on a 9,273 bn debt to the London Club of commercial bank creditors, as was reported recently. (To make a comparison, Poland foreign debt used to ashared around 20 % to the London Club, owing the rest to the official creditors.) Other factors are: collapse of the East European market, Gulf War and Balkan Crisis, high interest rates, so called "bad credits", missing regulations, bureaucratic barriers and some political instability. As a result foreign investments in Bulgaria are 26 times less than in Hungary and 6 times less than in Rumania. (At the same time one should take into account that 55 % of all foreign investments in CEE countries went to Hungary.)

2.4. The pace of Bulgarian privatization is among the slowest in Eastern Europe, having just one big facility privatized so far. The process was postponed due to the restoration (or restitution) of old property which was nationalized in late 40's. 70 % of the urban property has been restituted. Around 50 % of 51, 300 applications to restore old property in the cities were fulfilled by the end of 1992. The average face value of the restituted assets per unit property (shops, flats, buildings and so on) is 153,000 leva; the market value is several times higher.

2.5. Having something in common with privatization from legal point of view, restitution hardly can be considered economically as a substitute for the former. It causes social tensions and diminishes incentives for the market behavior of the vast majority of people who believed in the reform few years ago. Established on the basis of the public suspicion about "who is to buy the enterprise", "at what price", and "from where are the money", the legal procedure of the Bulgarian privatization is too administrative.

2.5. GDP per capita, according to the incomplete National Statistics Institute (NSI) data, is 980 US $ a year. Most of the state-owned enterprises, accounting totally about 90 % of the GNP, are in financial distress due to the disintegration of the former markets and to the uncompetitiveness of products on the new ones. Most of these enterprises have negative returns for 1992 and the positive ones vary around 1 %. Returns on comparatively riskless investments are about 60 % annually. But a combinational impact of the high interest rate, although the Central bank attempted twice to decreased it in 1992, and the expectations of increasing inflation do not provide a proper investment climate. Nevertheless, in 1992 the private sector managed to become an economically significant factor. It accounted for about 10 % of GDP (in the first half year; some sources ("FT") witness that private sector's share in the overall 1992 GDP has reached 20 - 25 % which means increase of 4-5 times), 50 % of the retail trade turnover, and 20 % of households income.

2.6. According to the NSI March-1993 report almost 12 % of the agricultural land has been given back to its former owners; the progress in this respect before the end of the coming summer is scheduled to overcome 50 % threshold and to reach by the fall of the year 70 %. Agricultural production has drastically decreased. This forced the government to establish Farmers Concessionary Credits Fund.

2.7. Official unemployment forecast for the current year is 17 %. Trade unions, however, say it is around this figure today. At the same 2,4 ml Bulgarians (of 8,5 ml population according to the census of December 1992) are on retirement. Pension funds are not separated from the state budget. In 1992 52,3 % of the unemployed are women, over 46 % are below 30 years; 47,5 % of the overall number of unemployed were unskilled workers, 31 % - skilled ones; the share of "white collars'" unemployed is falling down; unemployment among minorities (Gypsies, Muslims, Turks) is very high reaching in some "hot spots" 40 % of the local population in the rural areas or 80 % among the Gypsies in the big cities.

2.8. At the starting point of the reform Bulgaria used to have economic structure almost identical to those of ex-Czechoslovakia (47 % industry, 36 % agriculture, and the rest services - source: Komerzbank) but in the West Bulgarian products were less competitive than Czech and Slovak ones due to the internal Comecon member-countries' specialization. For example, Bulgarian high technology had to compete with Japanese. The overall volume of the Bulgarian export to the EC for the 1989 - 1992 period is 3,5 to 5 times less than that of Hungary, Poland and Czechoslovakia, and it has not improved at all since 1990.

3. <u>Legal deficits</u>

3.1. Although attempted, the tight monetary policy was not followed by stimulating production which could drive the country out of recession. In a sense such moves were impossible without preliminary legislative work done by the Parliament and the government. Legal gaps gradually eroded or, in an optimistic vision, made softer the original and rather successful monetary policy.

3.2. Delayed privatization and implicated problems could be tackled through switching on alternative market approaches in order to support emerging private sector and to motivate broader range of individual investors. But such economic policy is almost unthinkable because of legal deficits:
a) taxation and taxation administration are absolutely out of date, VAT regulations with low taxation rate is necessary in order to provide an incentive for the emerging private sector to improve;
b) last part of the Commercial Law (first was adopted in May 1991) which deals with bankruptcy regulation has hardly been submitted to the Parliament;
c) banking supervision and banking sector interference in the real estate and privatization issues, and especially rules for tackling "bad credits" are required;
d) emerging stock exchanges, a process which is going simultaneously in CEE countries, needs special protective regulations;

e) social security funds should be legally separated from the state budget and regulated;
f) inadequate non-profit corporate and regulative law blocks the possibilities to take the burden of healthcare, social security, education etc. off the state budget.

3.3. The requirement to fill some of the above listed gaps has been pointed out by IMF and the World Bank, other requirements have been proposed by the private and banking sector. Some of the bills have been drafted and/or submitted to the legislature (taxation and bankruptcy bills, for instance).

3.4. It seems, however, that the implementation of the existing legislation still is a significant problem. Because of the time shortages the same problem should occur even after the recognized gaps would be overcome. The courts are overloaded and although alternative dispute resolution methods (arbitration, mediation etc.) are authorized by law, they are in a dormant state. Enforcement procedures are inefficient.

PATTERNS OF UNDERGROUND PRIVATIZATION IN BULGARIA

1. The redistribution of company portfolios along holding structures allowed them to attract profit-bearing assets to the newly-formed companies and direct liabilities to holding umbrella. Joint ventures lacking in capital, as well as joint partnership, are being set up with a minimum private stake. Sanctions are impossible because such incorporations are legally-grounded.

2. The sale of shares and equity does not conform to the legally-stipulated maximum amount of 5% of company assets (under Article 10, Paragraph 2 of the Transitional and Concluding Provisions in the Law of Privatization) and its exceeding entails no sanctioning.

3. Joint-stock companies sell shares to pay the debts of the staterun shareholding companies, thereby reducing the government stake in them. This type of privatization is highly unprofitable as government shares are sold at their face value.

These patterns of underground privatization is facilitated by the lack of a legal and institutional framework of state ownership management. The provisions for control over the distribution and sale of shares by the bodies under Article 3 of the Law on Privatization are not observed. The clauses on institutional control over incorporation are also expected to be rescinded. The Council of Ministers enforced decentralized regulations on incorporation instead of creating a special body as stipulated in the Law on Privatization.