The Rebirth of Capitalism in Bulgaria*

Roumen Avramov and Kamen Guenov**

The first years of transition in Eastern Europe were generally seen as a period of shock macroeconomic stabilization. Gradually (and unobtrusively) this dominant issue gave way to the recognition of the genuine essence of transition as an unprecedented in scope redistribution of the national wealth.

The Redistribution of the National Wealth

The public debate has been concentrated on the forms this process assumes. Its focus on individual cases, however, has painted a fragmentary and chaotic general picture, which, in our view, should be put in order.

Noneconomic Aspects

First and foremost, it should be presumed that the Bulgarian economy does not consist of two complementary and clearly differentiated segments.
Four years after the onset of transition, it is impossible to discern a clear dividing line between the state and private sectors in the economy. It is much more accurate to speak of a complete diffusion of ownership with a much wider "private" penetration than official figures suggest. (According to the National Statistical Institute - about 20% of GDP at the beginning of 1994).
Both state and private property are loosely outlined. After the demise of central planning the state did not divest itself of the ownership rights but lost its capacity to protect them effectively.
The private sector, in turn, is not clearly defined due to its specific origins and development. They extend from sheer embezzlement to legal transfers of assets. Some of the most typical forms we could cite are:

- Transfers of part of the value added from state1 owned to private enterprises.
- The emergence of financial holdings, conglomerates, partially state-owned banks and other "hollow" financial structures which underlie the appearance of parallel markets. "Shadow" forex, credit and capital markets emerged on the background of a general lack of control.
- The network of inter-firm debt and credit dependence, entangling state-owned and private enterprises and serving as a bridgehead to open or hidden privatization.
- "Spontaneous" private sector generation in the numerous "get-rich-quick" niches of the transitional societies.
- By capitalizing property and intangible assets which, under the previous regime, were not subject to economic turnover or were exclusive state ownership (mainly by restitution, but also by the economic liberalization itself).

---

* This study was published first in Bank Review, 4/1994, it is reprinted here with kind permission of the authors. The study was written when Roumen Avramov, Senior Research Associate, was Vice President of the Agency for Economic Coordination and Development (AECD) and Kamen Guenov was an economist AECD. The study is a part of a project, partially supported by the European Commission, PHARE - ACE Programme 1992, Research Grant 92-0098-R (Financial Intermediation during Transition). The authors wish to thank Jerome Sgard (C.E.P.I.I„ Paris), Mariella Nenova-Amar (the author of the Subsection "From the Banking System to Households " of this paper) and Nikolai Gospodinov for helpful comments and discussions.

** Currently, Roumen Avramov is now a Programming Director of the Center for Liberal Strategies (www.cls-sofia.org and Kamen Guenov is an Head of the Budget Department of Sofia Municipal Bank.

- Finally, the "organized" forms of legal privatization that still play a minor role. They either legalize the transfer of assets *ex post,* or (through mass privatization) pave the way for a secondary redistribution of assets towards already existing wealth poles.

A rational attitude towards the redistribution of the national wealth should take into account a few historically inevitable circumstances.

- Assuming the Bulgarian transition to be a radical but *peaceful* change of the political and economic regime, we should agree that it involves a redistribution of wealth whereby the initial advantage is inevitably enjoyed by individuals and groups which exercised the real economic power under the previous regime. A model of transition involving their violent ousting is possible, but only in a revolutionary context. In the Bulgarian case, the first steps of the transition were sufficiently well-controlled in order to protect the former holders of effective economic power against threats to their position.
- The initial (well-targeted) "money-laundering" and the subsequent emergence of private businesses clearly indicated that the transfer of capital is matched in importance by the proximity to real power structures (connections, information networks, resources for exerting pressure over suppliers and competitors), i.e. to the intangible assets of society.
- Under a radical liberalization of the economy the spontaneous redistribution of state-owned assets simply cannot be avoided. It gained strong impetus from the intentionally passive economic policy in 1990. The process, though, was made irreversible with the introduction of a very liberal legislation (particularly the Trade Law) in the con text of a still predominating state ownership. Alongside other liberalization measures, this "coexistence" opened a number of legal loopholes for asset siphoning-off.
- The major economic problem of transition lays not so much in the difficulties related to the emergence of new economic agents, as in their ability to function as *authentic* market agents. Recent experience casts serious doubts on this possibility. Budget constraints on the private sector remain too loose, and are easily overcome by ensuring uncontrolled access to financial flows and/or the creation of parallel structures.
- Sidestepping the budget constraints presents no difficulty for the state sector either. The dominant form of state-owned enterprise management has become the "private management" of state assets reflecting the lack of control on the part of the principal. The so-called state-owned economy is thoroughly parcelled out to interest groups which privately capitalize its profits and part of its intangible assets, at the same time preserving the legal "shell" of enterprises. The convenient position of managers (free of any outside control), and the however, has proved that ethical recognition of a wide-scale redistribution of national wealth has never been possible. The economy recognizes only *faits accomplis* and its functioning is based on the existing agents. Assertions that in parts of Eastern Europe (i.e. the Visegrad four) this process is enfolding smoothly and on "moral" grounds are sheer demagogy. It is highly inappropriate to refer it to the moral values of "good" and "evil". Only two conclusions can be drawn with certainty, *First,* each step towards the legitimization of private capital and a clear regulatory framework is making society more "normal". *Second,* what is "good" for the economy is what leads to noninflationary and "non-debt" growth. In this sense, there is no better legitimization of private capital than its contribution to such kind of growth.

Economic Aspects

In economic terms, there are two channels for wealth redistribution: legal/illegal capital transfers (financial, tangible or intangible) or reduction of liabilities; changes in relative real incomes through uneven price dynamics.

In a market economy it is natural to cover incurred losses (negative savings) by liquidating financial or nonfinancial assets, by running-down cash balances or by increasing liabilities. Under the loose ownership structure in Bulgaria, however, economic agents are not fully

liable for losses by their capital. Instead, they may relatively easily transfer them. Thus, the unclear property rights are turning from legal to a major macroeconomic problem.

The fact that losses may not be covered by those who generate them does not mean they are eliminated. They are either transferred onto some other (definite) agent, or are dispersed ("socialized") into the economy. The second case is the typical one, with two institutions formally engaged in the "socialization" of losses: government (through the budget) and the central bank.

In practice, however, there is no choice as long as the taking-on of losses by the government increases the budget deficit. In case it is not financed by tax revenues (the possibilities for which are limited) or by the banking sector, the deficit is inevitably monetized by the central bank through inflation. Thus, "socialized" losses are eventually taken on by households and creditors who bear the burden of inflation tax.

In a macroeconomic context, the generation of chronic negative financial results (losses) by an economic agent or institutional sector (households; enterprises; the financial system; government) implies inability to generate positive saving. According to the definition of the System of National Accounts[1] (SNA) saving is the balancing item after the secondary income distribution and the use of disposable income. For enterprises it corresponds to the net disposable income, and for households - to that part of disposable income that is not spent on goods and services.

Saving is the link between the current and capital account in the SNA framework. That is why negative saving leads to the decapitalization of the respective economic agent or sector: instead of increasing, its net worth declines, thus undermining its own potential for accumulation and growth. In a broader sense, this also undermines the potential of the economy at large.

The persistent decapitalization problem becomes a crucial issue of the economy in transition. In this context the main sources of losses acquire particular importance. They are mainly linked to those state-owned enterprises that were most dependent on the past (now extinct) specialization of the country within CMEA. The capital invested in them is economically obsolete with no prospects of regaining its former value. In other words, their decapitalization is a fact, and their operating losses only bring their net worth in line with economic reality.

However, some viable enterprises can also be erroneously identified as apparent sources of losses in the public sector. In fact the difficulty to assess share of the officially recorded losses in the state sector has been due to income transfers to private firms where part of the value added is realized. Thus the decapitalization of state-owned enterprises does not necessarily reduce *national* saving.

However, some viable enterprises can also be erroneously identified as apparent sources of losses in the public sector. In fact the difficulty to assess share of the officially recorded losses in the state sector has been due to income transfers to private firms where part of the value added is realized. Thus the decapitalization of state-owned enterprises does not necessarily reduce *national* saving.

This transfer has two possible final uses; to be a vehicle for a direct private sector capitalization; to increase personal consumption. Since a large segment of the private sector in Bulgaria consists of small noncorporate businesses, in many cases the transfer of value added from state-owned enterprises boils down to a simple transfer of income for consumption. The corporate sector of the economy is underdeveloped, and *the dividing line between households and the private noncorporate sector is extremely thin. Hence the fusion of personal consumption, current consumption and investment, which obscures the actual stance of the economy and biases the agents' behaviour.*

[1] EC Eurostat, IMF, OECD, UN, WB - System of National Accounts, 1993, p. 206.

Regardless of the concrete channels for profit and loss transfers, the following fundamental identity holds true:

Saving (Households + Private Sector Enterprises + +Public Sector Enterprises + Primary Budget Balance) = Gross Investment + Current Account Balance[2] .

This basic identity shows that aggregate saving can take three forms: investment in domestic capital; purchase of wealth from foreigners (current account surplus); purchase of domestic government debt.

The increase in aggregate saving in the economy is conditional on the growth in the saving of households and/or of enterprises in the public and private sectors (positive disposable income), and/or a rise in the primary budget surplus. Combinations are possible with one of the elements growing, offsetting the negative growth of the others.

In a dynamic perspective, this identity may have different configurations. Three of them are of practical interest to us:

- If the total volume of saving falls, there is a need for investment cuts and/or increased deficit in the current balance-of-payment account. The larger the negative saving in the real sector, the greater the saving generated by households in order to prevent the overall decapitalization of the economy. (The primary budget balance is assumed to remain unchanged).
- In the absence of direct foreign investment and the existence of a primary budget deficit (as in 1993), households and the private (and/or state) enterprises remain the only possible sources of growth in saving. As many of them are being decapitalized, the main burden will be shifted onto households and the overlapping private sector.
- In order to offset a rising primary budget deficit (under unchanged real sector performance), a larger volume of household saving or a decrease in investment and/or in the current account balance are needed.

These configurations put the problem of transition in the broader perspective of the ability of different institutional sectors to ensure noninflationary growth of the national economy.

The present paper examines the macro economic aspects and consequences from restructuring the national wealth and "socializing" losses in the economy. These two processes are intrinsic to the transition to a market economy in Bulgaria.

Some of the issues were tackled in the annual AECD report for 1993[3] where the decapitalization of state-owned enterprises was identified as a major problem. This paper carries the analysis further on, based on a wider approach and more extensive and detailed information on 1992 and 1993.

Sources of Decapitalization

There are three major sources of negative saving in the Bulgarian economy: the state-owned enterprises in the real sector; the banking system; the government budget (in 1992 and 1993).

No effective measures for changing the structure of ownership in the *nonfinancial sector* were taken until 1993, and not a single state-owned enterprise was closed down. The share of profit-making enterprises continued to fall. Whereas overall before-tax losses amounted to 15.3% of GDP in 1992, in 1993 they rose to 17.6% of GDP. The worst financial performance was registered in the manufacturing sector, which accounted for 71.7% of overall losses and only 33.6% of profits.

State-owned enterprises slightly improved their financial performance in the first half of 1994, without, however, any radical positive breakthrough.

---

[2] "+ " in case of surplus and "-" in case of deficit.

[3] AECD, The Bulgarian Economy in 1993. Annual Report, December 1993.

Government generates negative saving under a negative (or falling positive) primary balance. Since 1991, there has been only one instance of a primary budget deficit (-2.13%) in 1993. Conversely, the emerging primary surplus in 1994 is making the budget contribution to saving positive.

During 1993 *the banking system* turned into a major source of negative saving. Whereas net profits of commercial banks (after-tax profits less losses) amounted to BGL 129 million in 1992, by the end of November 1993 interest payments of banks exceeded interest revenues by about BGL 9.5 billion (3.3% of GDP). By including the accounting effect of the bad debt bail-out, net bank losses at the end of 1993 were formally reduced to BGL 5 billion (1.7% of GDP).

We should not overlook the fact that the banking system generates losses by the very rules of its behaviour. Undoubtedly, part of the losses stem from lavish and irrational expenditures, and from corruption.

Special attention should be paid to the decapitalization of state-owned enterprises in the real sector.

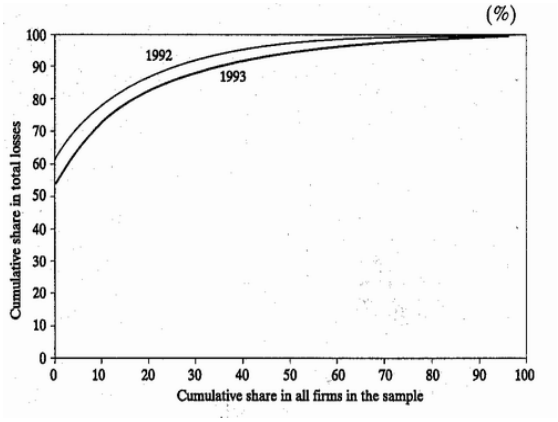
As shown on the Table 1, aggregate net disposable income[4] (the term closest to the common notion of enterprise savings) turned negative for the nonfinancial state sector in both 1992 and 1993. The revaluation of long-term tangible assets was the only source of increase in the net worth of state-owned enterprises. (In 1993 its contribution, after the conclusion of most revaluations, was substantially lower).

The overall negative financial results do not reveal a strong differentiation between state-owned enterprises. Their distribution according to profitability rates is extremely concentrated. (See Figures 1 and 2). By the end of 1993, the top 94 firms (out of 9,298 recorded firms) had generated over 46% of overall losses. Despite their relatively low number, they account for about 36% of total assets and are thus decisive for the national economy. In the first quarter of 1994, the top 100 firms registered 61.9% of the overall losses of the recorded 5,964 firms.

The financial statistics indicates a drastic deterioration in the financial conditions of the above- mentioned 94 firms during 1993. Their sales revenues grew by a bare 13%, while operating costs increased by 20.9%. On the other hand, their financial expenses rose by 35%, and their wage bill - by 46.3%. Clearly, these firms do not (or cannot) respond adequately to market signals. In case their privatization is impossible, the government should tighten control on their activity.

Figure 1

Distribution of Loss-making Firms* (in the total number of firms)

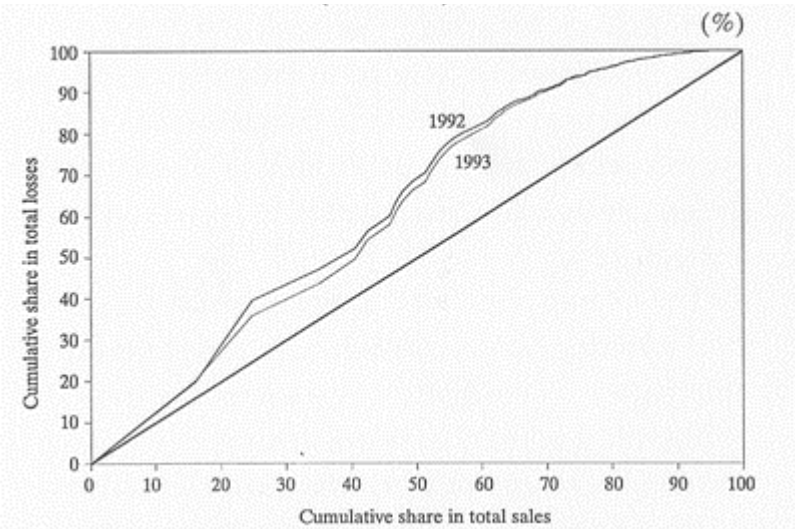


Cumulative share in all firms in the sample
*Firms in the sample with recorded losses of:
a) Greater than BGL 600,000 in 1992;
b) Greater than BGL 1,650,000 in 1993.

Source: NSI, AECD.

Figure 2

Distribution of Loss-making Firms* (in sales)



*Firms in the sample:
a) 2,652 in 1992;
b) 3,438 in 1993.
Source: NSI, AECD

At the same time, in the state sector there is a *"viable core"* of enterprises, which show signs of adequate adjustment to the changing environment.

The tentative discrimination between "good" and "bad" firms was based on a synthetic indice incorporating indicators for the degree of debt servicing and the current financial condition of the firms[5]. Excluding small firms and those with near-zero values of the synthetic indice (61.8% of the total number), two distinct groups are obtained:

group A - 30.6% of the sample[6]- firms that have adjusted most successfully to the new environment;

group B - 7.6% of the sample - firms with continuously deteriorating financial conditions and a growing share of credit arrears.

Well-performing firms are concentrated in manufacturing, transport and trade. Group "A" firms account for 69.7% of trade sales and 74.5% of manufacturing sales. Group "B" firms belong mostly to branches like ferrous metallurgy, mechanical engineering, metal processing, electrical and electronic engineering, glass and textile industry. Firms in nonferrous metallurgy, clothing, food, printing and chemical industries perform better than the average. Such a distribution is relatively indicative of the comparative advantages of the Bulgarian economy, but it is also strongly influenced by the inherited branch structure of the economy.

The two groups display clear differences in their behaviour and financial patterns.

- Tax collectibility in "A" considerably exceeds that in "B".
- Arrears to suppliers in "A" are considerably lower than in "B". The same holds true for overdue sales receivables. Clearly, "B" firms resort more to inter-firm credit to manage their liquidity.
- "B" firms account for the larger part of short-and long-term credit arrears.
- The interest paid/due ratio of "A" firms exceeds that in "B".

[5] The following indicators are included: profitability, liquidity, ratio of interest paid to interest due, indebtedness to suppliers, the budget, the Social Security Fund and employees, relative share of credit arrears.

[6] A panel sample was used throughout the surveyed period, allowing for a more accurate assessment of the changes in enterprise behavior.

25	Profits tax (accrued)	8,615	6,051
26	Profits tax (paid)	6,961	3,854
27	Other taxes (accrued)	2,021	2,120
28	Other taxes (paid)	3,961	1,047
29	Gross disposable income I (23 - 25 - 27) (accrued)	-13,607	-25,442
30	Gross disposable income II (24 - 26 - 28) (paid)	9,792	-5,755
31	Depreciation of fixed assets	12,658	24,782
32	Net retained incomes I (29 - 31) (accrued)	-26,265	-50,224
33	Net retained incomes II (30 - 31) (paid)	-2,866	-30,537
34	Revaluation of fixed assets	370,630	114,423
35	Increase in net worth I (32 + 34) (accrued)	344,365	64,200
36	Increase in net worth II (33 + 34) (paid)	367,764	83,886
37	Fixed assets	466,897	593,740

Source: NSI, AECD.

	Indicators	1992	1993
1	Sales revenue	364,467	424,541
2	Inventory growth	21,246	19,758
3	Production costs (4 + 5 + 6)	281,431	320,318
4	Input costs	169,553	185,277
5	Input services costs	32,705	45,703
6	Input goods from outside	79,173	89,339
7	Inventory decrease	6,869	8,508
8	Value added (1 + 2 - 3 - 7)	97,413	115,473
9	Labor costs	50,033	65,901
10	Social security and other benefits	19,851	26,909
11	Gross trading profits (8 - 9 - 10)	27,528	22,663
12	Interest accrued	33,491	42,998
13	Interest paid	9,807	26,582
14	Dividends paid (15 + 16)	190	332
15	- from sales	69	213
16	- from depreciation	121	119
17	Rents paid	6,033	6,317
18	Interest earned	3,787	3,945
19	Dividends received (20 + 21)	525	515
20	- from dividends and revaluation	390	411
21	- from repurchase	134	104
22	Rents received	4,903	5,253
23	Gross total profits I (11 - 12 - 14 - 17 + 18 + 19 + 22) (accrued)	-2,970	-17,271
24	Gross total profits II (11 - 13 - 14 - 17 + 18 + 19 + 22) (paid)	20,714	-855
25	Profits tax (accrued)	8,615	6,051
26	Profits tax (paid)	6,961	3,854
27	Other taxes (accrued)	2,021	2,120
28	Other taxes (paid)	3,961	1,047
29	Gross disposable income I (23 - 25 - 27) (accrued)	-13,607	-25,442
30	Gross disposable income II (24 - 26 - 28) (paid)	9,792	-5,755
31	Depreciation of fixed assets	12,658	24,782
32	Net retained incomes I (29 - 31) (accrued)	-26,265	-50,224
33	Net retained incomes II (30 - 31) (paid)	-2,866	-30,537
34	Revaluation of fixed assets	370,630	114,423
35	Increase in net worth I (32 + 34) (accrued)	344,365	64,200
36	Increase in net worth II (33 + 34) (paid)	367,764	83,886
37	Fixed assets	466,897	593,740

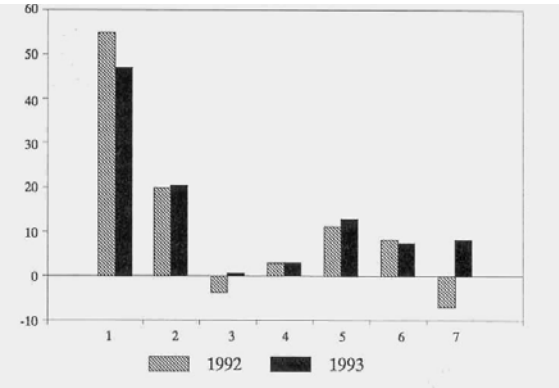
Source: NSI, AECD.

[7] We should be aware of the fact that part of **the** data is intentionally distorted so that the accounts barely represent the actual financial conditions of firms. As biases are systematically oriented to "hide" assets, they can only transfer some enterprises from "B" into "A ".

How Are the Losses of the Nonfinancial Sector Financed?

As we already pointed out, negative savings require one (or all) of the following measures: liquidation of financial or nonfinancial assets, running-down of cash balances or increase in liabilities.

Figure 3
Financing of Losses



1. Interest arreas
2. Short-term credit
3. Payable less receivables
4. Unpaid wages
5. Liabilities to the government budget
6. Liabilities to the State Social Security Fund
7. Disinvestment

Source: NSI, AECD

Internal Sources

In 1993, non-financial state-owned enterprises covered only 9.2% of their losses[8] by own resources: 3% by past-retained earnings, 4% by reserves, and 2.2% by their capital.
In 1992 and 1993, wage arrears covered 3% of enterprise losses.
Net disinvestment[99], which leads to capital reduction, is the extreme way to cover losses. It represented 8.3% of enterprise losses in 1993.[10]
As Table 2 shows, disinvestment has been a chronic phenomenon in the Bulgarian economy since mid-1992. It was particularly pronounced in 1993, amounting to 16.1% of the value added.
To sum up, state-owned firms cover only a small part of their losses by own resources. Wage arrears come only as a last resort. If loss-making state-owned enterprises are allowed to sell part of their assets, they can draw on internal sources to a larger extent, and thus speed up privatization. Despite the inevitable allegations about "low-priced" sales and "unfair" redistribution of property, any privatization procedure for persistently loss-making enterprises is a step in the right direction which will eliminate some obvious irrationality.

[8] The estimates are based on NSI financial statistics. The 1992 figure was 9.8%.
[9] A negative difference between investment and depreciation allowances
[10] In 1992, net investment in loss-making state-owned firms was positive, amounting to BGL 1.4 billion. Note, however, that till the IV quarter of1992 depreciations were accrued on a capital stock not revalued since 1990. Accruing them on revalued capital will probably produce disinvestment in 1992 as well.

External Sources

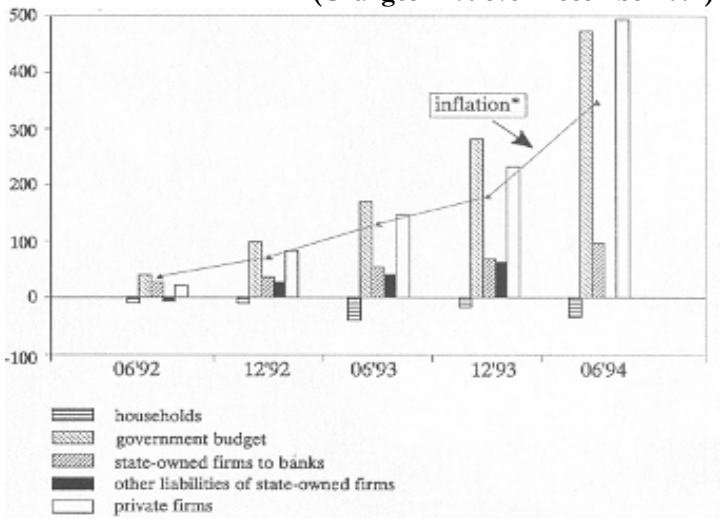
Next to their own capital, which is a very restricted loss-covering resource, enterprises have more attractive and accessible sources at their disposal, i.e. debt accumulation in different forms.

The debt of state-owned enterprises grew on a lower rate than government debt. (Partly due to the bail-out of bad debts by the budget). In its major part, however, the debt of the real sector will not be serviced - a fact of which both debtors and creditors are aware. Thus, payment arrears become the main instrument for the transfer of losses.

Figure 4

Changes in Indebtedness - Households, Government Budget, Real Sector

(Changes in *%* over December 1991)

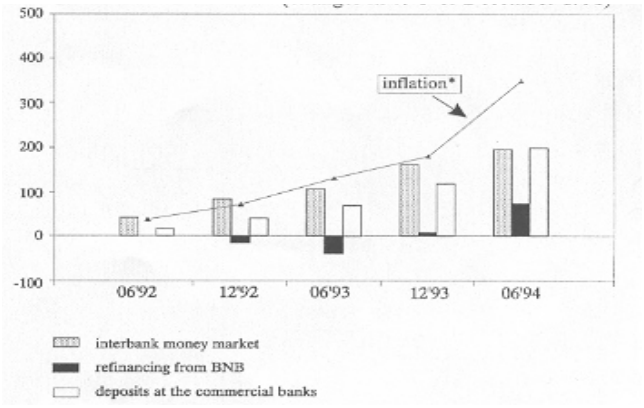


**Consumer Price Index*
Source: BNB, AECD

Figure 5

Changes in Indebtedness -the Banking System

(Changes in % over December 1991)



*Consumer Price Index
Source: BNB, AECD

Table 2

Dynamics of Gross and Net Fixed Investment

(million BGL on an accruals basis)

Indicators	1992				1993				1994
	I	II	III	IV	I	II	III	IV	I
1. Gross Investment	2367	3194	4273	4335	5239	5916	6454	8299	5678
2. Depreciations Allowances	1390	2625	4598	11077	5108	10800	16328	22979	6395
3. Net Investment	968	569	-326	-6742	130	-4884	-9874	-14680	-717
4. Value added	10545	33601	50993	74687	13251	34048	61065	91247	34301
3/4	9.3%	1.7%	-0.6%	-9.0%	1.0%	-14.3%	-16.2%	-16.1%	-2.1%

Source: NSI, AECD

Figure 4 and figure 5 illustrate the debt dynamics by institutional sector in the Bulgarian economy.

Debt to the Banking System

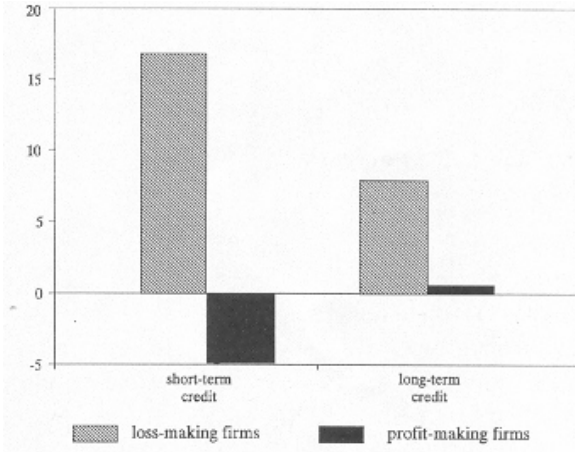
The sharp reduction of government subsidies in 1991 was followed by mounting arrears of state-owned enterprises to the banking system. The restrictive policy and widespread insolvency, though, made high nominal interest rates gradually lose their economic relevance, as the *price* of credit became less important a problem than the *ways for obtaining* it. The large delay in solving the bad debts problem additionally slackened the financial discipline and reduced creditor pressure on state-owned firms.

The growth in liabilities to the banking system has become the major source of covering losses in the nonfinancial state sector. Short-term credit and arrears in interest payments covered 67.6% of the losses produced by loss-making firms in 1993, against 74.6% in 1992 (Figure 3).[11]

During 1993, state-owned enterprises in the nonfmancial sector increased their credit arrears by BGL 28.5 billion. This figure, however, does not account for net credit flows. In order to determine the real activity on the credit market, the volume of newly extended credit[12] (credit growth net of capitalized interest) was assessed. The results indicate that loss-making firms have received BGL 24.786 billion in new credits, while the new credit extended to profit-making ones was BGL 4.362 billion less than paid-off amounts.

Figure 6

Distribution of New Credits Extended to the State-owned Nonfinancial Firms



Source: NSI, AECD

[11] The estimates are based on NSI's financial statistics.

[12] The overall credit turnover is estimated as the volume of partially or fully paid-off credits extended over the period. Newly-extended credit is assessed by deducting the credit outstanding at the end of 1992 (plus the amount serviced during 1993) from the credit outstanding at the end of 1993. The interest arrears accumulated during 1993 are added.

These credit flows have been largely predetermined by the structure of credit outstanding. (At the end of 1992, loss-making enterprises accounted for 74.6% of short-term, and 83.5% of long-term credit outstanding). This has been due to the commercial banks' practice to extend rollover credits to insolvent debtors in order to cover at least their interest payments on old debts. In this way loss-making enterprises have been piling up liabilities, while profit making ones have been repaying their loans and rarely drawing new credits. Thus, solvent debtors from among private firms and profit-making state-owned enterprises are crowded out of the credit market or burdened with sizable costs.

Inter-firm Credit

The dynamics of inter-firm credit is assessed by comparing the receivables on sales and the payables to suppliers, as well as the respective arrears.[13]

In 1993, the net growth in payables to suppliers accounted for only 0.7% of the losses of loss-making enterprises (Figure 3).). Overall, the nominal inter-firm credit fell from BGL 5.4 billion to BGL 3.4 billion during 1993, with much larger decline in real terms. The falling importance of inter-firm credit is evident in its ratio to the banking debt: from about 1/2 in 1992 it fell to 1/3 in 1993.

The figures above relate to the *overall* volume of payables and receivables. *Arrears* indicate BGL 4.8 billion growth in inter-firm credit. They remain a big problem for a relatively small group of firms: 15% of the industrial firms account for 49% of overdue sales receivables, and 41.4% of payable arrears.

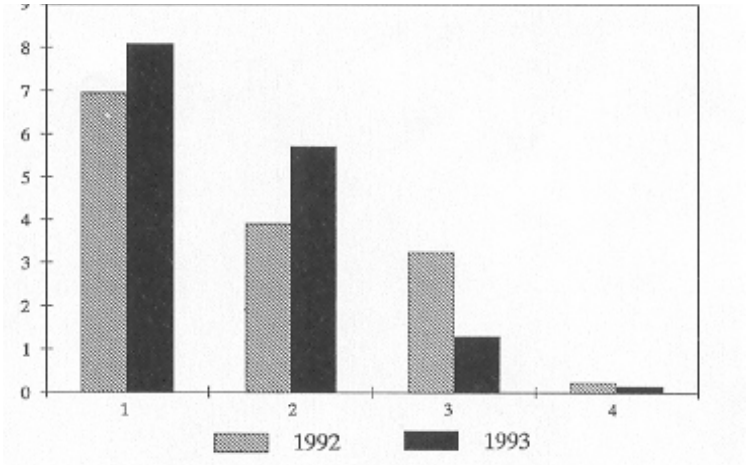
As we consider the state sector *as a whole,* rising arrears indicate a growing indebtedness to the private sector. (The growth is partly due to the increase in external liabilities.) This trend reflects the expansion of the private sector itself, as well as the growing inter-firm debt between state-owned and private enterprises.

In a structural context, data on receivables and payables clearly identify the manufacturing industry as a net debtor: at the end of 1993 outstanding payables exceeded outstanding receivables by BGL 9.5 billion. Overdue payables exceeded arrears in receivables by BGL 6.1 billion. The other major sectors in the economy are net borrowers (BGL -5billion, and BGL -0.1 billion, respectively).

Figure 7

Inter-firm Credit of State-owned Industrial Enterprises

(billion BGL)



[13]The estimates are based on NSI financial statistics.

1. Payables less receivables of loss-making firms
2. Overdue payables less overdue receivables of loss-making firms
3. Payables less receivables of profit-making firms
4. Overdue payables less overdue receivables of profit-making firms

Source: NSI, AECD

The problems with inter-firm credit relate to a relatively small group of firms and usually have to do with arrears in payables and receivables. Proposals for debt swaps for certain large state-owned enterprises were made in 1994, obviously seeking control over attractive sectors of the economy. Actually, this is turning into a new stage of hidden privatization.

A comprehensive arrangement of inter-firm arrears requires a clearing house to net the outstanding payables and receivables. Securities issues may cover remaining debts. Their offer and demand will set the market price of the inter-firm debt, while creditors will be able to collect part of their receivables.

Transfer of Income, Losses and Capital

This section gives an account of the channels for transfer of income, losses and capital in the economy. These are the flows that redistribute the burden of transition among different sectors and groups.

Table 3
Payables and Receivables*

	Arrears in Payables		Arrears in Receivables	
	Total	**Industry**	**Total**	**Industry**
1992				
January- March	22.35%	32.78%	30.87%	31.63%
January-July	29.03%	41.21 %	36.56%	48.39%
January- September	33.14%	40.65%	37.55%	44.77%
January- December	31.05%	33.44%	32.77%	28.90%
1993				
January- March	27.01%	33.92%	18.45%	26.01%
January- July	32.75%	39.99%	18.36%	24,14%
January - September	39.27%	52.51 %	42.25%	42.05%
January - December	31.29%	40.22%	19.34%	29.32%

*Per cent of total payables and receivables

Source: NSI, AECD.

From State-owned Enterprises to the Private Sector

The transfer of value added from state-owned to private enterprises decreases the net worth of the former. The transfer is channelled into several directions:

To households, since part of it is transformed into consumption expenditures of the employed in the private sector.

Private sector capitalization. The transfer is partly "materialized" in the growing GDP share of this sector. It is invested in construction and trade, which provide a relatively better protection against inflation.

Capital flight from the country. The volume of capital flight (or nonrepatriated capital) is sizable. It is invested in both real estate and financial assets abroad.

Indirect indicators of the scope of capital flight are the statistical discrepancies between NSI and BNB data on the trade balance. In 1993, they amounted to 5.5% on the imports side, and to 29.3% on the exports side. (BNB assessments are higher in both cases.) This leads to a huge "unaccountable" difference in the recorded trade balance, amounting to USD 828.6 million in 1993 (8% of GDP).

Part of the difference is due to a double accounting in the banking system, while the other part may be attributed to an inflow/outflow of foreign exchange through "unofficial" channels. Short-term capital inflows are attracted by interest rate differentials (nonexistent through most of 1994) between lev and foreign currency deposits. Capital outflows, in turn, are determined by unclear currency regime prospects, political instability and the lack of profitable investment opportunities (of large-scale privatization, in particular).

Under a limited volume of foreign exchange reserves, capital flight leads to financial destabilization and chronic forex market crises, i.e. to revenues depreciation. Capital flight (in the absence of large direct foreign investments) burdens the balance of payments and eventually raises the external debt. This is yet another method for the diffusion and subsequent "socialization" of losses.

Capital outflow can be cut down only by an overall improvement in the business climate, attractive investment opportunities and an effective financial and banking supervision. In particular, there is a need for stricter control on the cash foreign exchange operations of nonbank financial institutions. They are the major channels for bypassing the foreign currency regime restrictions for capital transactions.

The transfer of value added from the state to the private sector takes on an impressive variety of forms. We will only highlight the mechanisms of macroeconomic significance.

- *Redistribution of value added to employees and satellite private firms.* The actual control in most enterprises is in the hands of managers and workers' councils. The formal owner (the state) and the creditors are not able to protect effectively their interests. Under pressure from trade unions and lobbying groups, labour costs have diverged from labour productivity, increasing their share in value added. Wages' share grew from 71.7% in 1992 to 80.4% in 1993,[14] The slight improvement in the financial conditions of state-owned enterprises in early 1994 brought the wages/value added ratio down to 66.2%.

In most firms depreciation allowances have only been accrued without being actually used for overhaul and new investment. In 1993, allowed depreciation costs exceeded fixed capital investment by some BGL 5.4 billion. In fact this amount was doled out in wages, depriving the enterprises from revenues, and the budget - from taxes due.

The direct transfer from the state to the private sector has important statistical consequences as well. Part of GDP produced in state-owned enterprises is realized outside them, i.e. outside the firms where statistical accounts are most reliable. Hence, the undervaluation of the official income-side estimates of GDP, and the large differences between them and final expenditures-side estimates. The final expenditures approach is far more reliable in transitional economies, since it provides a more accurate assessment than the one based on income statistics.

- *Satellite private firms that supply or buy from state-owned enterprises transfer revenues by changing the overall price level'. Using the difference between the levels of administered domestic and world prices is another channel for substantial income redistribution.*

Since 1991, CPI growth far exceeded the growth in producer prices. This gap can be partly attributed to methodological differences in calculating the two indexes. Yet, it reflects the wedge between the levels of input and output prices for state-owned enterprises.

This process is supported by the top executives of state-owned enterprises and private businessmen (who often are in close relationship). The difference in price dynamics results in lower growth rates of revenues compared to expenditures in state-owned enterprises. This,

[14]The estimates are based on NSI financial statistics.

in turn, leads to the accumulation of losses, to a growth of debt to suppliers, to the banking system and the budget. At the same time, the private sector is directly capitalized at the expense of the state sector and the consumers.

- *An "organizational" asset drainage.* The delay in the official privatization has facilitated the incorporation of firms with the aim of transferring assets to joint ventures, holdings, subsidiaries or new "clean" structures bare of old liabilities. This process has been complemented by selling "revalued" shares thus reducing the stake of the state.

The only way to narrow the aforementioned channels of income transfer from state-owned enterprises is the clear outlining of ownership rights. In this context, mass privatization may be seen as a relatively quick (and hence useful) legalization of already privatized enterprises.

From State-owned Enterprises to the Budget

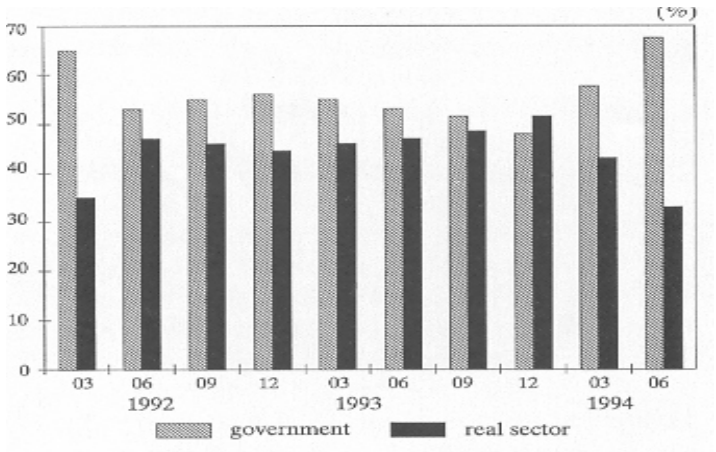
Most financial problems of state-owned enterprises are transformed into a larger budget deficit.

The bad debt bail-out by the government and the primary budget deficit in 1993 substantially raised the domestic debt. Its servicing is almost entirely dependent on credits from the banking sector, leading to three negative side-effects:

- The increasing importance of the claims to the government sector within the growth in total domestic credit has crowded out the nongovernment sector and has led to misallocation of credit resources.
- Consistent fiscal policy has been practically blocked by the growing domestic debt servicing. A steadily falling share of budget revenues has been allocated for noninterest expenditures.
- Part of the budget deficit has been monetized, spurring inflation, thus forcing the central bank to raise the interest rates

Figure 8

Nominal Growth in Domestic Credit*



*Contribution to the tola! rate (on annual basis).
Source: BNB, AECD.

The problem has yet another aspect: partial payment (or arrears) of accrued budget taxes and contributions to the State Social Security Fund (SSSF) are an important source for covering losses (Figure 3). The reported unpaid budget tax revenues and SSSF contributions due amount to 4.2% of GDP.

The erosion of the direct tax base in 1993 forced the government to lay greater stress on indirect taxation that burdens consumers. There was a large restructuring of accrued taxes,

with the share of profits tax plunging from 40% in 1992 to less than 20% in 1993. Excise tax collectibility rate rose sharply at the expense of turnover tax.

From State-owned Enterprises to the Banking System

With a certain lag, the problems of state-owned enterprises are transferred to the financial sector as bank losses.

According to NSI estimates, state-owned nonfinancial enterprises paid only 42.6% of interests due in 1993. According to bank statistics, interest arrears amounted to BGL 13.6 billion and BGL 9.5 billion respectively on lev and dollar credits.

There are two distinct groups among state-owned firms; about 2/3 of them pay all taxes due, while 1/5 - 1/4 have paid nothing. The second group capitalizes interests, thus increasing the volume of credit outstanding.

Insolvency and high nominal interest rates have substantially raised the amount of credit arrears. Their relative share in the overall lev credit increased from 15% at the end of 1991 to 41.3% at the end of 1992, exceeding 61% in February 1994.

As a partial solution, the Law on Bad Credits Contracted prior 1990 (adopted in late 1993) provided for bond issues for BGL 26.383 billion and USD 1.807 billion. The major part of the bonds is still "frozen" in several commercial banks, inflicting heavy losses on them. The market price of bad debt lev bonds would hardly run at more than 35 -40% of their face value. However, by law, the BNB imposes a minimum price which is now twice higher.

The difference between the equilibrium and the fixed price, as well as the relatively restricted privatization opportunities prevent these bonds from being traded. The expansion of trading may improve the banks' liquidity and deepen the securities secondary market. This holds true mainly for the foreign currency bonds that are very attractive instrument.

In the last few months, only limited amounts of bad debt bonds were traded on the secondary market.[15] Privatization by bonds will be profitable for potential investors since any price below the face value will reduce their costs. In June 1994 alone, BGL 520.7 million worth of bonds were used in 9 privatization deals, reducing the overall government debt by the same amount. The rising demand raised the average bond price from BGL 690 (per BGL 1,000 of face value) in May to BGL 987 in July. However, this trend is hardly representative. It is based on just one large privatization deal, in which the buyer and the bondholder bank are too closely linked.

Bond privatization has incurred losses on the budget since it writes off liabilities serviced at 1/3 of the base interest rate while direct payment would bring in fresh money. Clients and banks reap the benefits since they share the difference between the actual price and the face value of the bonds.

The transfer of losses from state-owned nonfinancial enterprises to commercial banks may be limited by actually enforcing and simplifying the existing bankruptcy procedures, by allowing the financial institutions to acquire shares in the enterprises and permitting state-owned firms to sell part of their assets.

---

[15] See **Government Loans and Securities** newsletter

Table 4

Tax Collection Rate in the Government Sector

Indicators	Paid/Due Excise		Paid/Due Turnover Tax		Paid/Due Profits Tax	
1992						
January-March	71.94	87.53	58.62	57.99	41.15	32.0
January-July	78.80	88.53	67.63	69.49	51.65	43.2
January - September	84.76	85.02	73.21	71.99	68.93	63.3
January- December	87.73	87.47	77.02	74.97	66.33	56.1
1993						
January- March	78.29	85.78	52.01	48.60	53.21	61.2
January - July	48.44	43.74	59.76	54.89	73.61	60.0
January - September	98.94	99.13	66.22	63.29	78.67	66.1
January - December	96.47	96.19	70.84	67.02	71.18	67.9
1994						
January- March	79.58	79.79	49.87	45.82	35.19	39.8

Source: NSI, AECD.

From the Banking System to the Private Sector

In their relations with the budget and the banking system, private firms fall in the pattern of state-owned ones: they do not pay taxes, fall into arrears and pile up bad debts.

Beside state-owned enterprises, commercial banks are the other source of direct income transfer to the private sector. Most private firms strive to get credits (uncollateralized if possible) at whatever interest rates.

The credits to private firms collateralized by state assets (extended until 1993) served as a channel for direct}capitalization of the private sector. The discrepancy between the lev credit outstanding for the *public* nonfinancial sector as reported by the BNB and the NSI is a very rough indicator of the scale of the process. At the end of 1993 it amounted to BGL 35.5 billion.[16]

A sizable part of these liabilities will add to the amount of the so-called "bad" credits, while the remaining private firms (even if they are solvent debtors) will use the implicit privilege to avoid covering their liabilities by their assets.

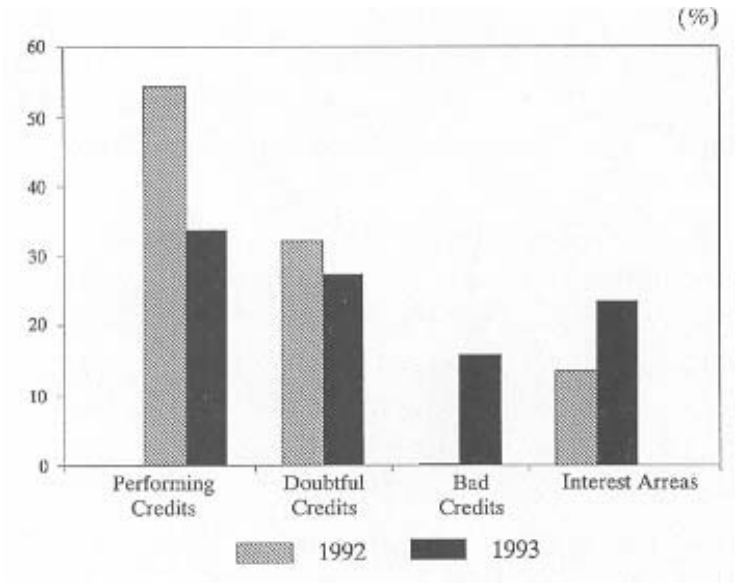
Another form of direct transfer from the banking system to the private sector are the well-known instances of establishing banks (and other financial institutions) with borrowed funds. BNB was too late in reacting to this obvious decapitalization of the state-owned commercial banks.

The distribution of the credit outstanding among the state-owned and private firms was largely restructured in 1993. Despite the crowding-out of the nongovernment sector, private firms already accounted for 39.6% of the lev credits to the real sector versus 24.6% in 1992.[17] This was due, on one hand, to the government bail-out of the credits extended till the end of 1990, and on the other hand -to the sharp increase of nonperforming and bad credits to the private sector.

[16] Part of the difference is due to recording capitalized interest in the "other liabilities " item in NSI financial statistics. (This, however, can account for just BGL 7 billion of the difference). BNB's monetary surveys put the claims to the private sector at BGL 31,8 billion at the end of December 1993, while the annual bank statistics recorded BGL 53.1 billion. For obvious reasons, commercial banks record credits to private firms collateralized with state assets as liabilities of the state-owned firms, while the latter do not show these amounts on their balance sheets.

[17] BNB **Monthly Bulletin, 6/1994**

Figure 9
Distribution of Lev Credits to the Private Sector



Source: BNB, AECD

Clearly, the structure of the lev credit outstanding for *the private nonfinancial enterprises indicates that regular claims are quickly transformed into doubtful and bad debts.* Moreover, the share of interest arrears (23.3%) of private enterprises almost levels up with that of state-owned enterprises (25.5%).

Uncollateralized loans are the main reason for the large growth in bad credits and interest arrears. At the end of 1992, only 60.7% of the lev credit were collateralised.

The comparison with the structure of the *foreign currency* credits outstanding is quite revealing. In 1993, arrears of interests on foreign currency credits to private firms represented only 1.8% of the outstanding amount. Over the year, the number of granted loans exceeded that of paid-off ones by 1,492, while the credit outstanding grew by some USD 381 million. Unlike lev loans, over 80% of the foreign currency ones were collateralized. Note that due to the lev real-term appreciation, foreign currency credits in 1992 and 1993 (especially in the first and third quarters) were extremely profitable to debtors.

Since, financial institutions cannot dispose of state-owned firm assets (even in cases of proven insolvency), the banks seek other means for reducing (or retransferring) the losses transferred to them by the real sector.

The easiest way out is the subsequent transfer onto depositors (mainly households). This is inevitable since households remain the major net creditor in the financial system. (The net flow "deposits less credits" from households to the financial sector amounts to about 18% of GDP).

The transfer of losses from the banking system to depositors goes along the following channels:

- Sustaining negative real interest rates on time lev deposits. In 1993, the cumulative negative real interest rate was about -7% (-11.7% in 1992). This incurred losses amounting respectively to 3.8% and 2.8% of GDP in 1992 and 1993. In the eight-month period of 1994, the cumulative real interest rate on deposits was negative once again (-18.4%).

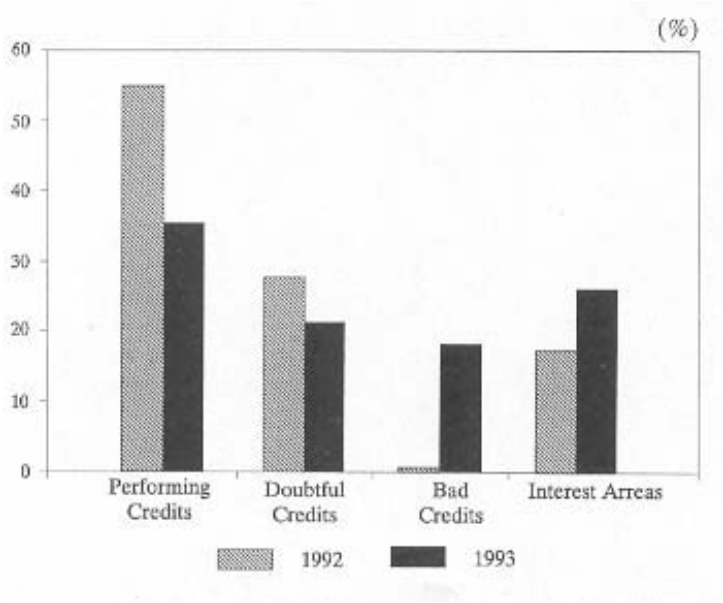
From 0.26 percentage points on a monthly basis at the end of 1992, the difference between the base interest rate and the interest rate on one-month deposits rose to 0.94 percentage points at the end of July 1994. The main goal of commercial banks is to sustain an interest rate level that, on one hand, does not reduce the deposit base, and, on the other hand, minimizes their financial costs.

- Financial institutions adjust their interest rates on current deposits disproportionately to the base interest rate changes. Thus, for instance, 14.5%, 14.6% and 15.4% average weighted interest rates on current accounts corresponded to base interest rates of 41%, 52% and 62%.
- Pressed by the growing share of nonperforming loans, commercial banks have been steadily increasing the interest differential between new credits and deposits. From 17.9 percentage points at the end of 1992 (on annual basis), the spread between interest rates on short-term credit and time deposits reached 33.2 percentage points at the end of July 1994.

The abovementioned measures were successful in transferring part of the losses onto depositors and borrowers. However, commercial banks do not dispose of sufficient internal resources to face mounting losses, since Parliament and BNB have not yet authorized them to increase their capital, while the official bank privatization has not yet begun.

Figure 10

Distribution of Lev Credits to the State Sector



Source: BNB, AECD

Table 5

Lev and Foreign Currency Claims and Liabilities of Commercial Banks

Indicators		Nonfinancial Private Firms		Nonfinancial State-owned Firms	
		1992	1993	1992	1993
Total claims/	Lev	216.5	245.2	384.3	286.3
Total liabilities	Foreign currency	74.8	162.6	222.6	248.2
Regular claims/	Lev	54.2	33.6	55.3	34.6
Total claims	Foreign currency	81.9	46.9	62.1	12.6
Doubtful claims/	Lev	32.1	27.2	25.6	20.9
Total claims	Foreign currency	16.8	44.4	31.0	38.6
Bad credits/	Lev	0.2	15.8	0.6	19.0
Total claims	Foreign currency	0.0	6.9	0.0	31.4
Interest arrears/	Lev	13.5	23.3	18.5	25.5
Total claims	Foreign currency	1.2	1.8	6.9	17.4
Collateralised	Lev	60.7	71.7	84.5	79.8
Total claims	Foreign currency	83.3	86.1	52.1	43.6

Source:BNB

In order to reduce the risk component in their portfolios, commercial banks have reoriented their lending policy, buying BGL 11,998 billion of government securities on a net basis (about 4.2% of GDP) in 1993 (compared to a token amount of BGL 90 million in 1992). Nevertheless, the net credit flow to state-owned enterprises (credits net of deposits) grew from 2.8% of GDP in 1992 to 5.3% of GDP in 1993, mainly due to the capitalization of interest arrears. At the same time, net credit to private firms plunged from 3.8% to 1.7% of GDP.

Since 1993, the budget deficit has been financed by government securities issues mainly. Most of the securities are purchased by the financial institutions, mainly the SSB. The Ministry of Finance and the BNB introduced different incentives to stimulate the interest of the nonbanking sector. Despite its small share (9.3% of the debt on government securities at the end of August 1994), nonbank financing is gradually increasing.

Commercial banks use deposits to acquire government securities. The main buyer is the SSB that accumulates both household and private sector money. The other commercial banks participants in the auctions also get lev resources from the SSB. In this way, households (with bank intermediation) finance the budget deficit in the last resort. The difference between direct and indirect financing from households lies in income distribution: if they purchase the securities directly, they receive an annual income from 3 to 10 percentage points higher than the interest on one-month time deposits. Thus, the expansion of direct financing may, to a certain extent, curb the losses transferred onto households by the banking system.

From the Banking System to the BNB and the Budget

The next stage in the transfer of problems concerns the relation of commercial banks with the central bank.

Several state-owned banks are in an extremely difficult situation, with 60 - 80% share of arrears in lev credit at the end of February 1994. They will continue to register losses even at an average spread of 40 percentage points.

The financial situation of these banks further deteriorated in the wake of the foreign exchange market crisis at the end of March 1994. The ratio between their foreign currency denominated assets and liabilities is favourable. (At the end of February 1994, they amounted respectively to 55 - 85% of total assets, and to 40 - 55% of total liabilities). Nevertheless, the losses incurred by dollar denominated credits and the depreciation of the lev require fresh money. Provided such resources are not available, the current operations of these banks will be severely disrupted. This is a grave problem since they cover 28.2% of commercial bank assets.

Several options seem possible:

- *BNB could refinance the commercial' banks.* This may be done only by issuing new money which will increase the inflationary pressure. The bulk of the lev "bad debt" bonds have already been lodged for Lombard credits which (at *60%* margin) pushed refinancing by 69% in January - July 1994. Most of the increase resulted from the refinancing of problem banks that generate enormous operating losses.
- *The banks could acquire the necessary resources at the interbank money market.* As the BNB was ever trimming refinancing in the last two years[18], the interbank money market turned into the prime source of resources for the banking system. At the end of July, overall credits and

[18] The BNB ceased holding interbank deposit auctions in early July 1994. The announced intention is to gradually stop granting uncollateralized discount loans and short-term deposits. The interest on overdrafts was sharply raised on several occasions in the wake of the forex market crises

deposits outstanding in the interbank money market were twice larger than outstanding BNB refinancing. The main player in the interbank market is the SSB which supplies over 70% of deposits. The SSB does not finance the real sector, so it rechannels the bulk of household savings to commercial banks and the budget.

In the last few months, however, the growth in lev household deposits sharply fell, and even turned negative in March and early April. The March 1994 forex market crisis led to a loss of confidence in the lev and a steady trend for currency substitution. This dampens the growth of SSB funds supply as the bank prefers the lower risk of the Treasury bills. The commercial banks' share in the interbank money market grew by only 6.9% from late December 1993 till early June 1994.

- A *liquidation procedure could be initiated for troubled financial institutions.* Due to the close interdependence between the commercial banks, this may trigger off a destabilizing "domino effect". Such an event would arouse deep public concern. The only way Parliament and BNB could go would be to compensate depositors which would raise demand sharply and initiate a new inflationary cycle.

On the other hand, the "demonstration" effect of a bank bankruptcy (with depositor compensations) would be very strong and force depositors into a much more careful consideration of future risky steps.

- *The transformation of losses into government debt.* At the end of 1992, for instance, the Economic Bank (jointly with other commercial banks) set up a consortium that extended BGL 1.6 billion credits to the energy sector. In the wake of this move, the BNB wrote off some BGL 7 billion bad debts of the Energy Committee from the bank's balance sheet at the expense of BNB own reserves. This was immediately followed by discount loan refinancing of the consortium banks to the amount of the credit extended. This resulted in a transfer of BGL 7 billion nonserviceable assets to the BNB, and injecting fresh money into the Economic Bank.

The Law on Bad Credits generated an even bigger problem. The troubled state of the Economic Bank having become obvious, at the end of July 1994 the BNB took a compromise decision for its "rescue", purchasing 80% of the bank's bad debt bonds (about BGL 9 billion).

In this way the problem was taken on by the BNB and the budget. Having purchased the bonds, the central bank has to choose among several possible ways to deal with them:

- The BNB can keep the bonds. This purchase actually blocked BGL 9 billion which will generate some BGL 1 billion in interest income for the BNB from the budget by year-end. If the same amount was used for refinancing, the interest income accruing to the central bank would reach about BGL 2.9 billion.
- If the BNB sells the bonds, they will be used mainly for privatization swaps. This would be the only profitable investment under their artificially high fixed prices.
- Assuming that the central bank sells the bonds at the fixed minimum price (BGL *666* per BGL 1,000 of face value), it would receive about BGL 3 billion less in profits, and hence its transfer to the budget would decline by some BGL 2.2 billion.[19]

The first and third options would reduce BNB revenues, hence its transfer to the budget. The central bank and the budget will take on the full amount of enterprise liabilities, while commercial banks dispose of low-revenue assets.

The second option is also unprofitable for the budget. The BNB disposes of the bonds, which, however, are used as face-value disbursement in privatization deals and are thus written off as claims to the budget. In this way, commercial banks get back the full amount of their claims to enterprises, whereas the budget disposes of securities on which it pays only

[19] The BNB is legally bound to transfer the surplus of revenues over expenditures to the budget after deducting the amounts for its reserve and other special funds. A definite target is set in the annual budget act.

1/3 of the base interest rate, but is forced to issue Treasury bills and bonds at interest rates above the base one.
Clearly, after their purchase from the Economic Bank, over 1/3 of the lev bonds (issued under the Law on Bad Credits) go to the BNB (and possibly to the budget), thus largely invalidating the initial scheme of burden-sharing of the bad credit bail-out between the budget and the commercial banks. The bulk of weight is once again taken on by the central bank and the government.
Any similar BNB decisions vis-a-vis other commercial banks will inevitably result in a new transfer of losses from commercial banks (through the BNB) to the budget. *Actually, this is a transfer to households:* the rising budget deficit either has a direct inflationary impact, or restricts fiscal policy in transferring revenues to households.

From the Budget to Household

Under certain conditions, budget deficit financing may directly generate inflation; hence transfer part of the problems onto households. The assessment of these transfers is related to two key concepts:

- *seignorage* - the net revenue derived by the money-issuing institution and collected by the government on the ground of its concession of this exclusive right.
- *inflation tax,* representing the capital losses of holders of money balances due to inflation.

With seignorage, the transfer is from the issuing institution (the central bank) to the budget and represents the net budget revenues from the BNB (when the inflow is positive). With inflation tax, the "transfer" takes the form of pressure on households to increase their nominal savings in order to sustain their real value.
In case inflation is a product of a deliberate policy of budget deficit financing through money printing and/or direct central bank credits, the abovementioned transfers may be regarded as an intentional shifting of the burden from the state onto households. This is an inflationary method of deficit financing, since, under equal conditions, it raises the amount of reserve money and hence, the money supply.
The scope of seignorage as a budget revenue source was narrowed in the last few years. It may, however, gain prominence in case the ideas for "unleashing" inflation turn into reality.
Seignorage may be assessed by deflating the nominal monthly change in monetary base by the monthly CPI. It has two components: the inflationary one and the real change in reserve money demand.
The initial inflation surge following the February 1991 price liberalization manifested itself as a one-time inflation tax, after which the seignorage level remained almost unchanged. Seignorage grew at higher rates after the adjustment of administered prices in May 1992 till the end of the year.
According to AECD estimates, direct central bank credits and the transfer of BNB "profits" to the budget in 1991 did not increase monetary base in real terms. The restrictive monetary policy in the early reform period, the lower credit demand by the nongovernment sector as well as the slump in real household incomes and consumption allowed a budget deficit financing without any inflationary money growth.

Table 6

Change in Seignorage and Its Components

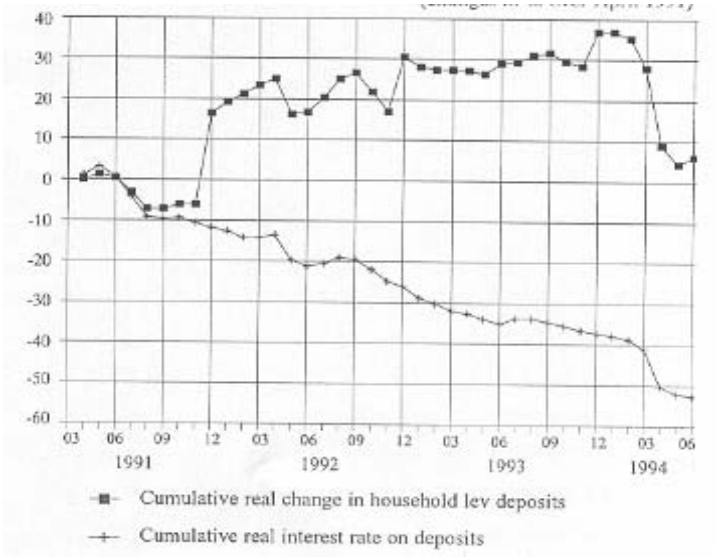
(billion BGL)

Indicators	1991	1992	1993
Seignorage	6.4	2.8	- 0.3
Inflationary Component	6.7	0.6	0.3
Real Reserve Money Demand	- 0.3	2.2	-0.6

Source: AECD.

Figure 11

Real Interest Rate and Real Change in Household Lev Deposits



Source: BNB, AECD.

In 1992, real monetary base grew as a result of the replenishment by the BNB of foreign exchange reserves (which accounted for 58% of monetary base growth) and of direct BNB financing of the deficit (accounting for the remaining 42%).

1993 saw a fall in real monetary base demand due to the intense issuing of Treasury bills and the surplus of BNB sales of foreign currency over purchases.

The total amount of direct or indirect budget financing through seignorage decreased in 1992 relative to 1991, and turned negative in 1993.

As for the impact of inflation on households, their behavior is fully compatible with an implicit taxation (the inflation tax). In the last three years, their constant aim was to increase their nominal savings in order to maintain their value in real terms. As the Figure 11 shows, households' attempts were successful until the beginning of 1994. The forex market crisis in early 1994, however, set off an active currency substitution and loss of confidence in the lev, which translated into falling growth rates of real-term savings.

Outlook

The Figure on page 23 summarizes some of the cycles of generation and transfer of problems in the Bulgarian economy. The post-communist reality is a continuous struggle to shift the burden of transition onto the capital and revenues of other sectors or individuals, thus "bailing out" the ones that are the source of the problem. "Decapitalizing the other one" is the

basic behavioural rule of economic agents.[20] "The other one" may be an enterprise, the banking system or the state, but the greatest burden of the seemingly diffused problems is eventually taken up by enterprises and mostly by households. This occurs through two channels: inflationary redistribution of wealth; increasing tax pressure in order to limit budget deficit growth and ensure resources for external debt servicing.

The transfer of the burden onto households has sparked protective responses for its redistribution. The forms they take are income transfers from the public sector, obliteration of the dividing line between households and the private sector, a distortive blending of current consumption, personal consumption and investment. As a result, larger fields of economic behaviour "sink" into the underground economy.

In a social aspect, these protective reactions nurture organized crime, corruption and chaos. Thus, the secondary redistribution of "losses" results in a new social stratification, creating new wealth poles.

The revival in the first half of 1994, the expected near-zero growth in 1994 and the slight improvement in some global financial indicators bring only partial changes in the above assessment. They concern mainly the fact that growth leads to the distribution of gains instead of losses. On the other hand, the situation remains practically the same since the ongoing diffusion between private and state-owned capital and the lack of clear financial discipline will only reproduce the existing problems and even reinforce the urge for their transfer.

In a more general context, everyone wants to be "on the right side" of inflation. Being a powerful distributor of the national wealth, inflation generates losses to creditors and benefits for debtors.

The figures show that the state and the private sector register the fastest debt growth (Figures 4 and 5). State-owned enterprises do not record such a large increase in liabilities to the banking system, but the bulk of them has been transferred onto the budget.

Bank deposits and the refinancing of commercial banks grow at slower rates. However, we have to take into account that the banking system underwent a massive recapitalization through the Law on Bad Credits.

Finally, only households are pressed to reduce their debt, since only they face real budget constraints. Being the sole net creditor in the economy, households are the most vulnerable to inflation. Some of their gains as debtors (for instance in their capacity of taxpayers to the budget) are too small to offset their losses as creditors.

The capacity of inflation to wipe out debt always tempts to turn it from a *result* to an *instrument* of economic policy. The economic deadlock strengthens this temptation so that the idea for using *hyperinflation* as a *means* for solving the problems is gaining ground.

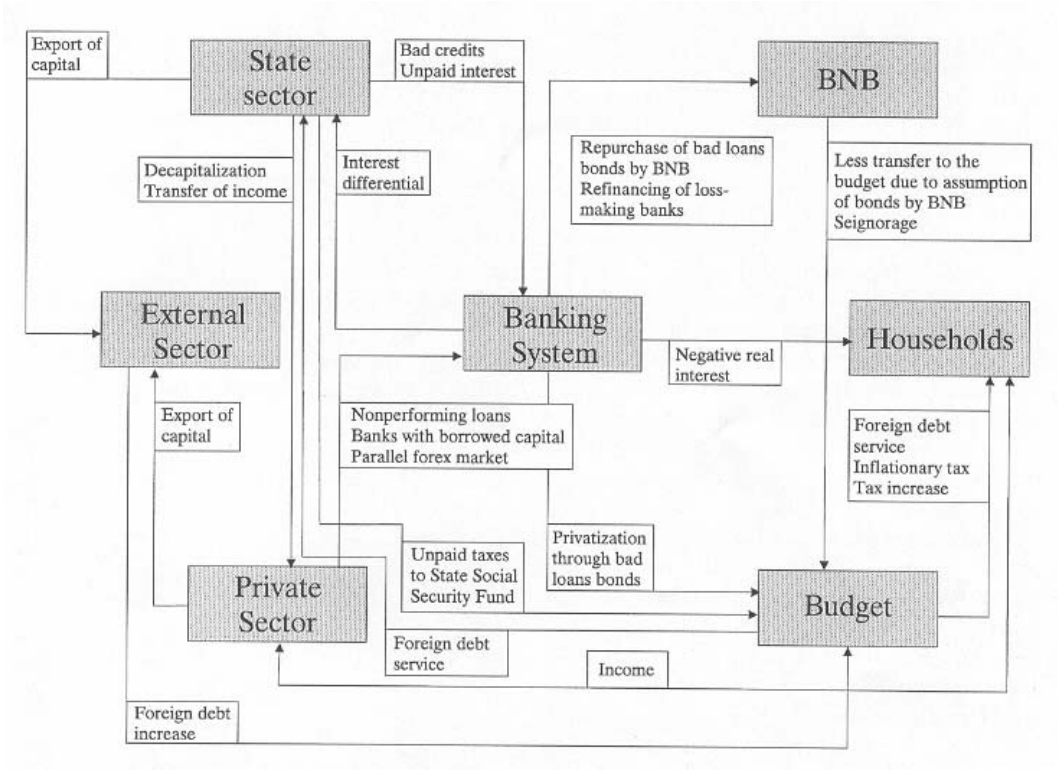
Doubtless, the advantage of hyperinflation is in the radical solution of debtors' problems and the transfer of the burden from the budget to households (through seignorage), simultaneously facing society with a choice which can no longer be put off. Hyperinflation has an enormous social cost and is therefore one of the few challenges that require unconditional economic policy consensus.

At the same time, it should be noted that although the "unleashing" of hyperinflation may eventually put a drastic end to price growth, it will not solve any of the deep structural problems of the Bulgarian economy. So, it seems unproductive to seek costly economic solutions when political consensus may bring the same results.

---

[20] This is the basic rationale in any economy. However, it is the degree of "taming" this economic instinct that discriminates the economy of the primitive accumulation from the mature market economy.

Transfer of Income, Losses and Capital



In the present situation of undefined ownership rights, underground privatization, unclear "rules of the game" and practically nonenforced state power, all attempts at solving the domestic debt problem remain palliative and generate inflation.

The major source of negative savings (hence, of debt) in the economy is a relatively limited but identified segment in the state sector. As already mentioned, there is a "viable core" of enterprises, which adjust successfully to the changed environment. If the restructuring of the main debt sources does not begin at once (by privatization, liquidation and bankruptcies), they will inevitably continue to reproduce all the distorted financial flows.

The problem of domestic debt and the sources of its growth can be solved only under clearly defined ownership rights and a "tough" but narrowly targeted economic dimension of the government. Experience clearly shows that such a situation will become possible only when the initial redistribution of the economic space becomes stable enough, and the lack of rules turns more "expensive" for the main players than their availability. The reaching of this point is not only economic, but a political and social problem as well.

Despite the urgent need for a quick privatisation, the present political and social background makes its outcome ambivalent. As already shown, many private economic agents enjoy the well-known freedom to act and the lack of control of the state-owned ones, so they too, become a source of bad debts. The reproduction of this situation is pointless.

This does not mean, however, that the preservation of state ownership should be the answer to the problem. The main objective of economic policy should be the legitimization of all forms of capital under clear regulative rules. It is not the statistical predominance of the private sector, but clear rules of behaviour for *both* private *and* state-owned capital that will bring the Bulgarian economy close to the market type.

At present there are two main sources of instability in the economy: the large volume of "vagrant" capital, operating (practically uncontrolled) on the quickly developing shadow forex, credit and capital markets; the loss of credibility in economic policy and in the newly-established market regulative institutions.

Such a situation, almost four years after the onset of transition, is the result of an intentional backout from exercising power (judicial, financial, supervisory), a deliberate postponement of urgent measures, and half-way economic policy decisions.

The lack of confidence in the economic policy has, in turn, had a negative impact on the lev and has led to risky household and enterprise behaviour, undermining the financial system.

Overall instability and inappropriate measures push capital out of the country which eventually leads to the accumulation of new foreign debt. The transfer of losses along this channel is possibly the most dramatic long-term effect from the slowdown in genuine structural reforms. If this slowdown continues (and no conditions for capital inflow are created), the Bulgarian economy will enter a new debt spiral that will lead it back to the well-known initial point of transition.