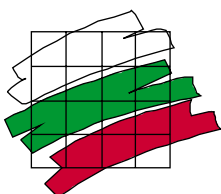


WORKING PAPER SERIES

MANAGEMENT OF CAPITAL INFLOWS IN BULGARIA

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1. OVERVIEW

Increasing capital inflows have been an important element of Bulgaria's successful stabilisation and transformation toward a market economy in recent years, although its openness to foreign investment dates back to the beginning of 1990s. The Bulgarian experience in dealings with capital flows during the last decade could generally be divided into four sub-periods.

First, just before the financial liberalisation in the beginning of 1990s Bulgaria was crossed out from the road of world's capital flows mainly due to the moratorium on external debt payments following dubious economic policy in the end of the previous decade and the absence of a basic legislative framework for foreign investment. At that time, market institutions in the country emerged in vigorous political dynamics surrounded by completely depleted foreign reserves, full state control on the interest rates, monetary overhang and precipitous dollarisation, which soon after the collapse of traditional CMEA ties brought the country to the edge of hyperinflation.

Second, in the first half of 1990s capital inflows were limited to some speculative influx and the fragile macroeconomic stabilisation was funded primarily by loans from international financial institutions. The first Law on the Business Activities of Foreign Persons and Protection of Foreign Investment passed in the beginning of 1992 granted equal rights to both foreign and Bulgarian citizens and legal persons to acquire shares or participating interest in commercial companies. It could not itself offset the negative effects on foreign investor's credibility in the country fuelled primarily by the unclear and not transparent strategy of the initial economic and financial liberalisation. The inadequate legislative, accounting, information and institutional framework for market reforms and the slow progress in the negotiations with Bank Advisory Committee of Paris and London Club of Creditors¹, further exhausted the investors' confidence. These allowed the fast changing governments to pursue populist policies, notwithstanding external shocks, which imposed an environment of soft budget constraints, large-scale budget deficit (financed primarily through the banking system dominated by state banks), time inconsistent monetary policy under floating exchange rate regime, and an opaque privatisation.

¹ *The agreements were signed in mid-1994.*

Third, the acute financial and political crisis in the second half of 1996 and the beginning of 1997 caused by the liquidity problems of the financial system, the destabilisation of monetary policy and a lack of people's credibility with the central bank following the bank runs. These not only stopped temporarily all capital inflows to the country, including previously agreed financial support by the international financial institutions (IFIs), but the sharp turmoil in the domestic financial markets brought Bulgaria almost to the edge of hyperinflation once again in this decade. The processes led to new elections in the spring of 1997, when a right oriented political party was empowered with a strong, international financial institutions supported, program to impose macroeconomic stability and carry out long delayed structural reforms. The introduction of the currency board arrangement in mid-1997 and the fast and transparent to the most possible extent privatisation, aiming to restore the confidence of international capital markets in the country were the core of 1997 stabilisation strategy.

Fourth, the period after 1996-1997 crisis is characterised with increasing capital inflows mainly from IFIs and world-recognised private investors. The successful turn in capital inflows can primarily be attributed to the abrupt changes in capital flow management and the sharp rearrangement of legislative, accounting, information and institutional framework targeted to meet EC membership criteria before the end of 2006. The main factors behind all investment decisions in favour of Bulgaria are the political and economic stability, the credible economic and financial policy supported by a medium term stand-by arrangement with IMF, and the established liberal trade and investment climate in spite of the continuously unfriendly external environment associated mainly with the armed clashes in former Yugoslavia. As a result, the growth potential of the domestic market was strengthened while the advantages of labour resources, in terms of productivity, skills and costs, were proven. In recent years, Bulgaria has succeeded in both attracting and effectively absorbing foreign investment, constantly maintaining the highest GDP growth rate in Europe at the end of millennium.

Net capital inflows have amounted to about 800 mln USD per annum since 1997 and have contributed to the sharp increase of exports, further changing their geographic and commodity structure. In addition to their impact on exports, capital inflows helped to narrow the gap between domestic savings and investment. They have also provided a source of finance for the balance of payments deficit and play a vital role in the post-crisis restructuring of the financial sector, which is crucial for the efficient operation of a market economy².

In the decade of transition, investment opportunities in Bulgaria have shifted from greenfield investment to privatisation investment and vice versa, exhibiting a trend

² Fully aware of the importance of foreign investment the new government, elected in mid-2001, drafted a program to increase capital inflows even further – to 1.1 bln USD per annum during its term of office.

to equalise in the last two years. Privatisation investments have been made in virtually all sectors while greenfield ones have been concentrated primarily in the heavy industries and other highly indebted industrial giants inherited by central planning era. Reflecting the increasingly stable climate, investment projects in Bulgaria recently benefited considerably from the support of IFIs (like EBRD and IFC) and special incentive packages from some multinational companies. Without the same level of investment inflows from privatisation, the emphasis of investment policy gradually shifts to greenfield projects in public infrastructure, reinvestment, and joint ventures. The government is particularly committed to assign domestic companies thereby allowing them integrate better into competitive environment of the single European market.

EU countries, particularly Germany, Belgium, Italy and Greece, are the main sources of foreign investment in Bulgaria. Investor's list shows that small to medium-sized multinationals account for a large portion of the total investment volume in spite of the fact that the statistical data are absent. Investors from other industrial countries have entered the country more gradually. Capital inflows from Russia and CEE countries have demonstrated a stable growth pace in the recent years.

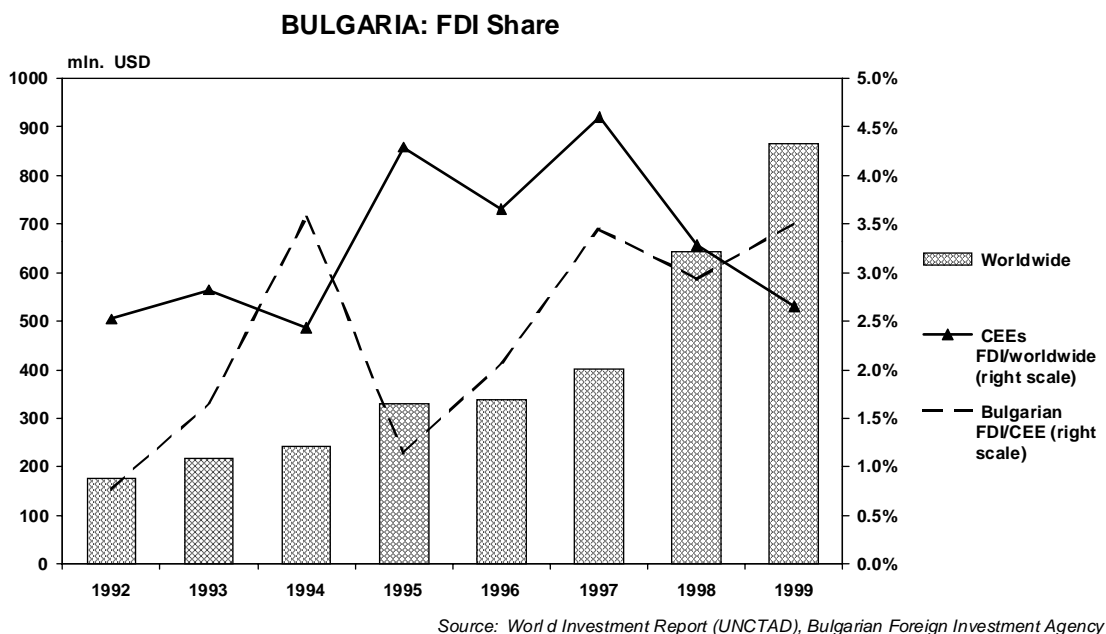
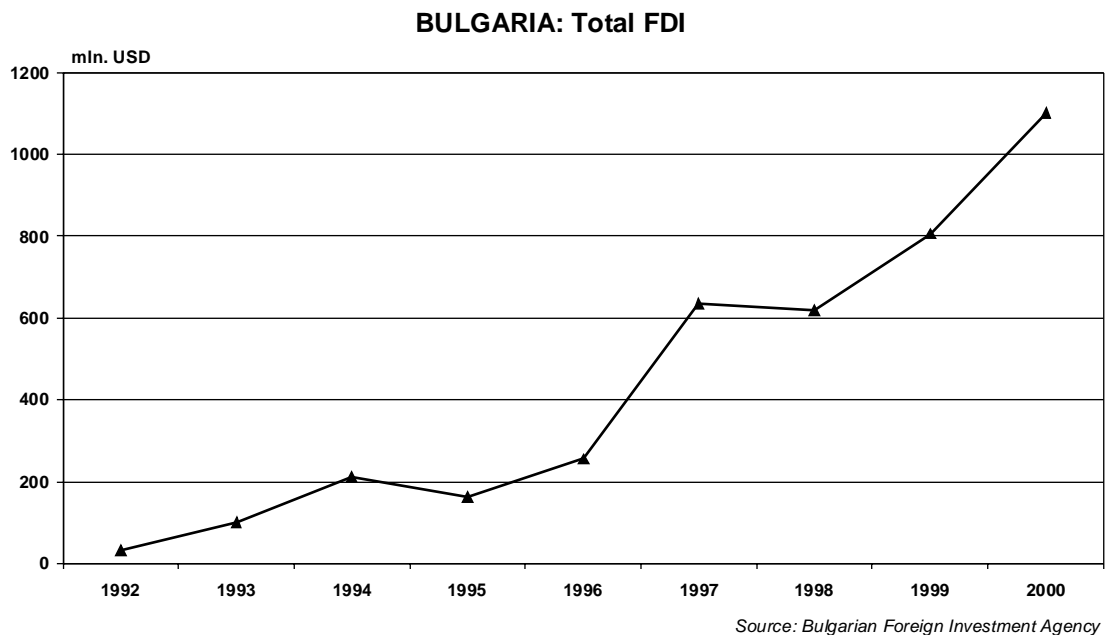
Investors' motivations have varied over the years as a function of the timing, size, and even the origin of the project and company in question. Only few investors had discontinued their previous business relations in Bulgaria, due to the protracted privatisation process and the incoherent changes in the legislative and policy incentives framework during the transition. Foreign investors' opinion on the investment climate in Bulgaria has varied. The majority of them are generally satisfied, but some have certain concerns regarding the stability and transparency of the legislative framework, the time consistency of government policy, and the administration's commitment to improve bureaucratic procedures for the business and investment.

Bulgaria has continued to liberalise its foreign investment regime in line with its efforts to become a EU member in the medium term. Recently adopted laws on the Foreign Exchange Regime and Public Offering of Securities as well as the liberalisation of the foreign trade regime are fully correspondent to this strategy. Only few restrictions remain, namely on the right of foreigners to possess real estate and land in Bulgaria. Although the liberal policies have contributed to the substantial increase of foreign investment, a part of policy-makers and economists are still concerned that backward linkages and technology transfers to local less competitive industries have remained below expectations.

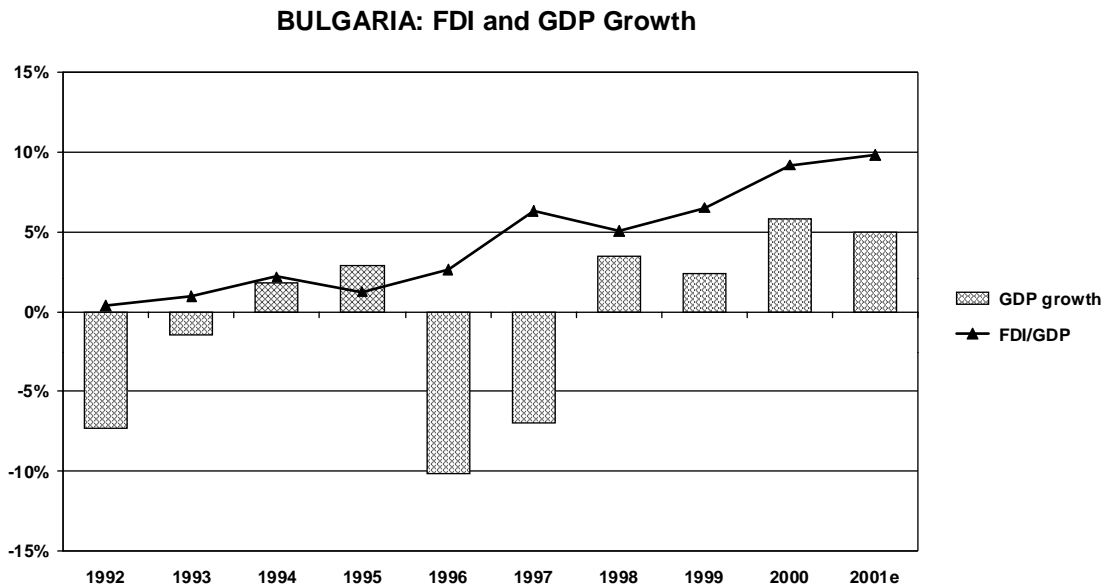
Outward flows from Bulgaria have been very small because of the relatively low standard of living and the strict capital transaction control exercised by the state during most of the observed period. These flows were mainly targeted to countries with favourable tax regimes. After the recent liberalisation of the capital transactions, Bulgarian banks increased their money balances abroad because of their cautious regard on economic development in times of substantial structural changes.

2. CAPITAL FLOWS AND RECENT MACROECONOMIC DEVELOPMENT (MID-1997 - 2000)

Bulgaria's macroeconomic performance has witnessed a remarkable turnaround after the crisis in spite of the complicated external environment. Bulgaria's share as a user of worldwide direct investment follows a steady upward trend, registering the highest GDP growth rates in Europe. During the 1997-2000 period, some 3.2 bln USD were invested in the country, accounting for 80.5% of the total amount of foreign direct investment during the last decade. On a per capita basis, recent foreign investments in Bulgaria almost touched the highest levels in Central and Eastern Europe. In the recent years, the growth rate of FDI in Bulgaria has exceeded the average for CEE and, consequently, the Bulgarian share in CEE' foreign investments increases.



Foreign investors have participated in more than 33 000 projects since 1992. The average volume of a single investment is around 0.12 mln USD. The average volume per project varied significantly over the years with the peak of 0.23 mln USD reported in 1999. Foreign investments successfully fill the gap between the scarce domestic savings and gross fixed capital formation ratios. Foreign direct investment to GDP ratio increased gradually to reach around 10% in 2000 contrasting with the negligible levels reported in the first half of the 1990s.



Source: National Statistical Institute, Bulgarian Foreign Investment Agency

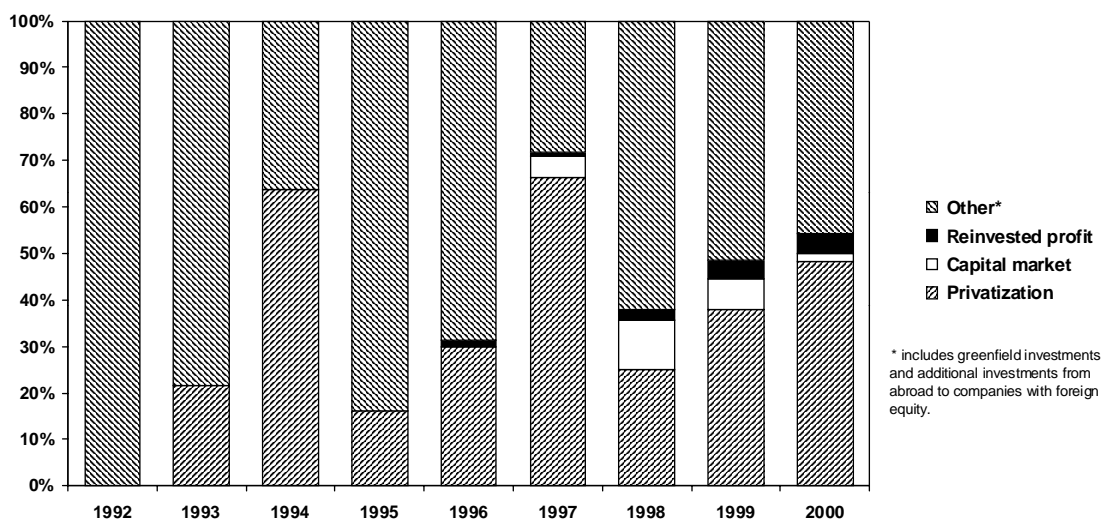
2.1. Structural Characteristics of the Capital Flows

a) Distribution by type

The Foreign Investment Agency of Bulgaria classifies capital inflows in four categories on the basis of the main channel through which they come – privatisation deals, stock market, reinvested profit and others, where greenfield investment and additional investment from abroad into companies with foreign equity are included. „Other“ category is dominated by greenfield investments, which account for more than 90%.

The total value of the so-called „other“ investments in Bulgaria reached almost 2 bln USD. They have been the predominant part in the structure of capital inflows during the period 1992-2000. Greenfield investment prevailed not only in the periods when the privatisation process was only on paper, but also constituted a large portion in the times of accelerated ownership transformation. The inherited high indebtedness of Bulgarian enterprises sector and the necessary renewal of old-fashioned technologies of production both contributed to this effect. Capital inflows through privatisation represent the second largest inflow channel. A substantial volume of investments through privatisation was centred on the strategic projects, viz. the so-called „large scale privatisation“.

BULGARIA: FDI by Type



Source: Bulgarian Foreign Investment Agency

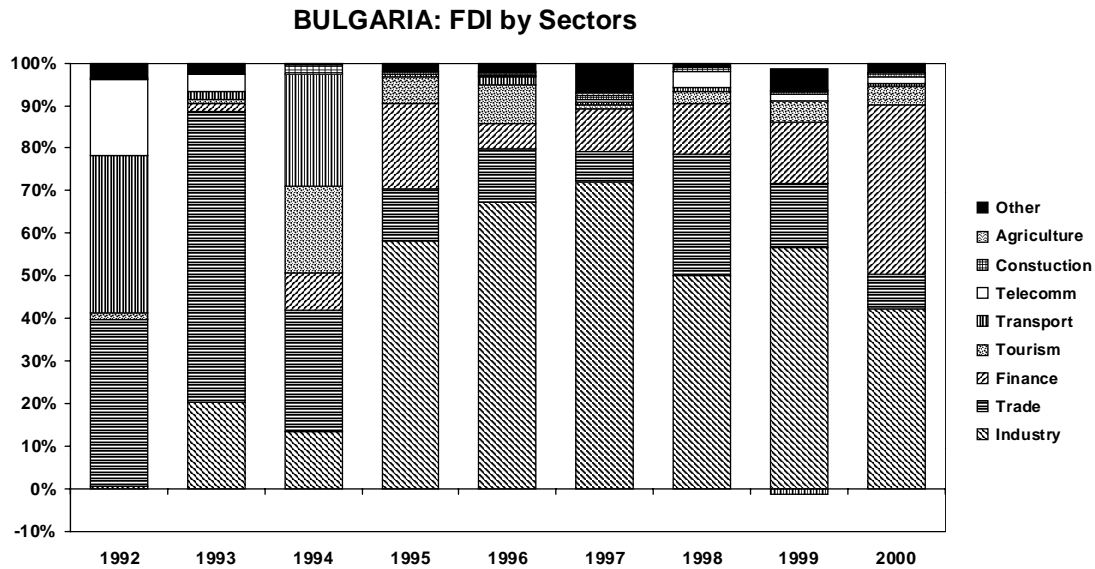
In the whole period of analysis, the inflows through the domestic stock market and reinvested profit remained less important channels of foreign investment. Unfortunately, the Bulgarian capital market is still underdeveloped and does not fulfil the important economic and social functions, typical for the developed economies. The recent slight increase of portfolio investments (both in and out) could be attributed, at the face of it, to the switch from a managed floating to a strong peg of the lev to the DEM under the currency board arrangement.

Although the Bulgarian stock market operates in a well-determined legal and regulatory environment, especially in recent years, it still does not attract free domestic and foreign portfolio investors in an expected manner. In 1999, a special segment for the public offering of state-owned „packages“ of securities was established on the Bulgarian Stock Exchange. It has proved to be a transparent method of privatisation, but unfortunately, it is not used in large-scale privatisation. Since 1996, reinvested profit in Bulgaria by the foreign investors has amounted to less than 100 mln USD.

b) Sector distribution

The sectoral breakdown of capital inflows shows a remarkable dynamics. During the 1992-1994 period, trade and transport were the sectors wherein the main portion (61.4%) of the total amount of investments was concentrated. The following years witnessed a shift to the various industrial sectors, which accommodated 68.8% of the volume of foreign investment in 1995-1997. After the introduction of the currency board arrangement, a remarkable foreign investors' interest was monitored in the financial sector. Foreign investors have privatised five of the seven largest Bulgarian banks in the last four years. The total amount of these deals ran at about 550 mln USD. After the recent introduction of modern legislation and regulations in insurance, world known investors also recognised the banking sec-

tor. Thus, the capital inflow to the financial sector is currently estimated at 17.7% of total capital inflows in Bulgaria.



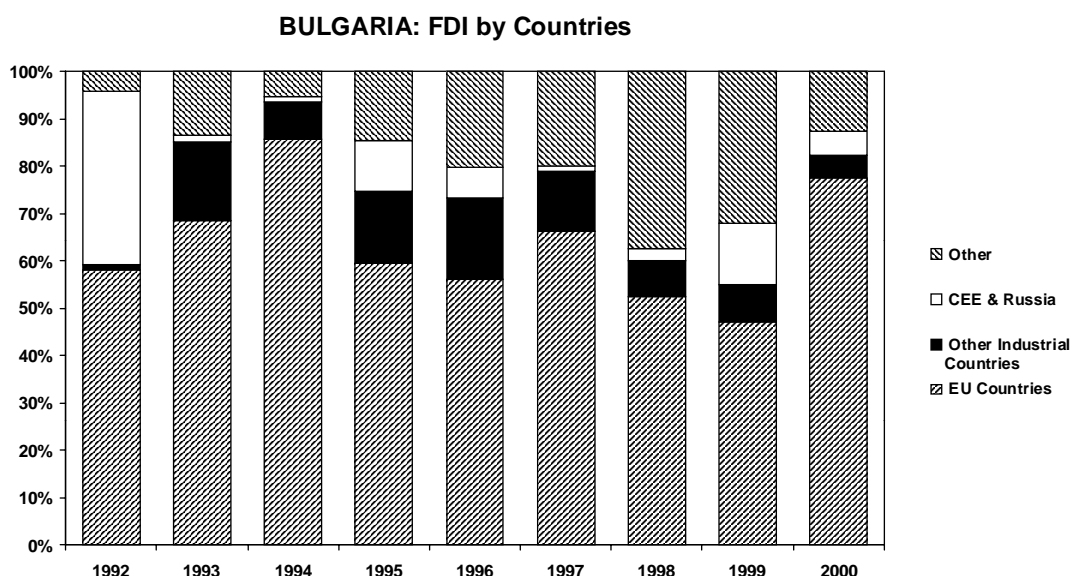
Source: Bulgarian Foreign Investment Agency

At the earlier stages of transition, consumer goods businesses, having established markets and brands (food industry, breweries, vine production, clothing and textile), as well as international transport attracted the principal foreign investor interest. The debt service reduction agreement with the Paris and London Club of Creditors in mid-1994 slightly opened the door for a further acceleration of capital inflows. Unfortunately, the low credibility of economic policy and the unstable investment climate associated with the turmoil at the domestic financial markets in 1994-1996 as well as the later emphasis on management buy-outs privatisation prevented to give a new lease of life to the existing sectors or to create entirely new industries.

A shift towards more high tech and high value-added products and sectors is still below expectations and no significant research and development facilities have been established in Bulgaria. Over the last few years, textile, clothing, footwear and furniture industries were the sectors steadily reporting a sustainable growth rate of production and foreign investment, not susceptible to the drastic changes in the international business environment. In 2000, exports of knitwear stepped up by 32%, while footwear and furniture exports increased by 6% and 13% respectively. The strong performance of light industries had to do with Bulgaria's comparative advantages in the relatively labour-intensive sectors of the economy, mainly in view of the lower level of wages in comparison to labour productivity. Foreign investors (mostly Greek and Turkish) also played an important role in the sustainable export growth in these sub-industries, providing machinery, equipment and market outlets.

b) Countries of origin

The leading investors in Bulgaria come from Europe. In the 1992-2000 period, foreign investment inflows from EU member countries accounted for 63.5% on average of their total volume. Although their share varied on a year-to-year basis, it has remained above 50% throughout the whole period. Another important portion of the capital inflows to Bulgaria comes from the so-called other industrial countries (USA, Japan and Switzerland). The role of non-EU industrial countries as a source of foreign investment remains far from the initially expected one. The increasing volume of investments in Bulgaria coming from Central European countries in the second half of the observed period can be seen as a sign of the recovery in this zone. Among the largest foreign investors in Bulgaria are PRAMET (Czech Republic; electrical engineering), VIDEOTON (Hungary, electrical engineering), INTRELICHTER (Hungary, transport), ADUT_ADOX SKALICA (Slovak Republic; paper industry), and EASTROCAPITAL (Czech Republic; banking).



Source: Bulgarian Foreign Investment Agency

However, the available data should be interpreted carefully as they cover only the country of direct origin. As evident from the data, the share of the so-called „other“ countries rose significantly in the second half of the 1990s' owing to the fact that multinationals often channel their investments through their foreign affiliates or offshore zones for tax or other reasons. Available statistics are likely to underestimate the role of countries such as USA and Russia (and, to a less extent, of some other industrial countries) as the ultimate source of capital inflows. The increasing inflows from offshore zones, some of which being subject to suspicions for money laundering, recently forced the Bulgarian government to revise the bilateral agreement for mutual protection and promotion of investments with Cyprus.

2.2. Role of the Banking Sector and Capital Markets

The strategy of the post-crisis economic reforms aimed to introduce an appropriate legal and institutional environment for the development of a modern financial system and capital markets in line with the primary goal of Bulgaria to prepare for EU accession. Decisive steps have been taken since 1997 to achieve these goals. The banking system and capital market gradually overcame the consequences of the 1996 financial markets collapse and, therefore, financial intermediation has improved significantly. In the end of 2000, the degree of financial intermediation in Bulgaria remained below the EU and CEE countries levels.

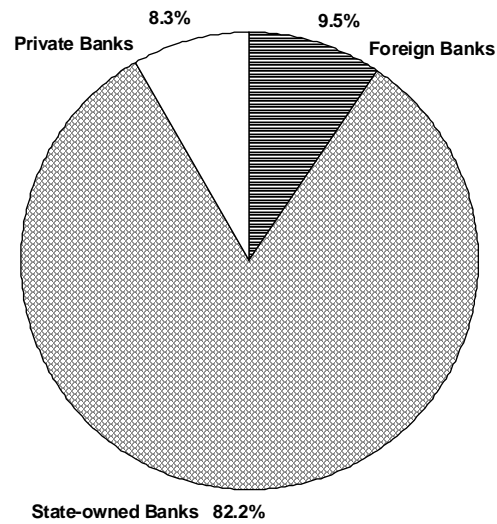
The banking sector has accumulated a significant part of capital inflows in the form of FDI through swift bank privatisation, especially in 1999 and 2000. Both strategic investors (Uni-Credito Italiano, NBG) and institutional ones (Regent, ALICO, EBRD) have been shown interest and participated in bank privatisation. In recent years, Bulgaria has received more than 550 mln USD in cash from bank privatisation.

In the 1997-2000 period, the privatisation of 5 out of the 7 largest state owned banks, dominating the banking sector, was accomplished. In end-2000, only the majority stake of the third and the fifth largest banks in Bulgaria according to the volume of assets (DSK BANK and Biochim Bank) remained under government control. Currently, the government holds the majority stake in Business Promotion Bank, a bank with a negligible share in the bank market, established in 1998 to encourage the development of small and medium private enterprises, and is minority holder in the small Central Cooperative Bank. The bank privatisation is expected to come to an end in 2002.

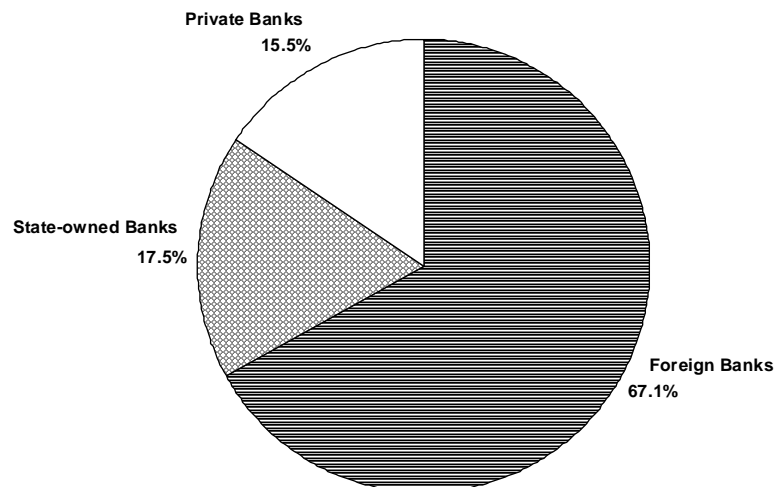
The structure of the Bulgarian banking system has sharply changed since 1997, however the sector remains small and concentrated. In the end of 2000, there were 35 banks in Bulgaria. The total assets of the banking system amounted to less than 40% of the annual GDP in 2000. At present, foreign investors already exercise control over commercial banks, accounting for more than 67% of the banking system's total assets. The participation of foreign investors in the Bulgarian banking sector has also increased through the establishment of local branches or affiliates of foreign banks. In this way, leading banks such as Citibank, BNP-Paribas and Commercial Bank of Greece have entered the Bulgarian market since 1997.

The business volumes of foreign bank branches or affiliates in Bulgaria reported a remarkable growth. The total amount of their assets has increased 3.7 times since 1997, to reach 661 mln USD in end-2000. In the end of 2000, eight branches and four affiliates of foreign banks operated in Bulgaria.

The confidence of depositors in the banking system seems to have been restored in late-1999, and it took much longer than initially expected by the policy-makers.

BULGARIA: Structure of the Assets of Banking System (1996)

Source: Bulgarian National Bank

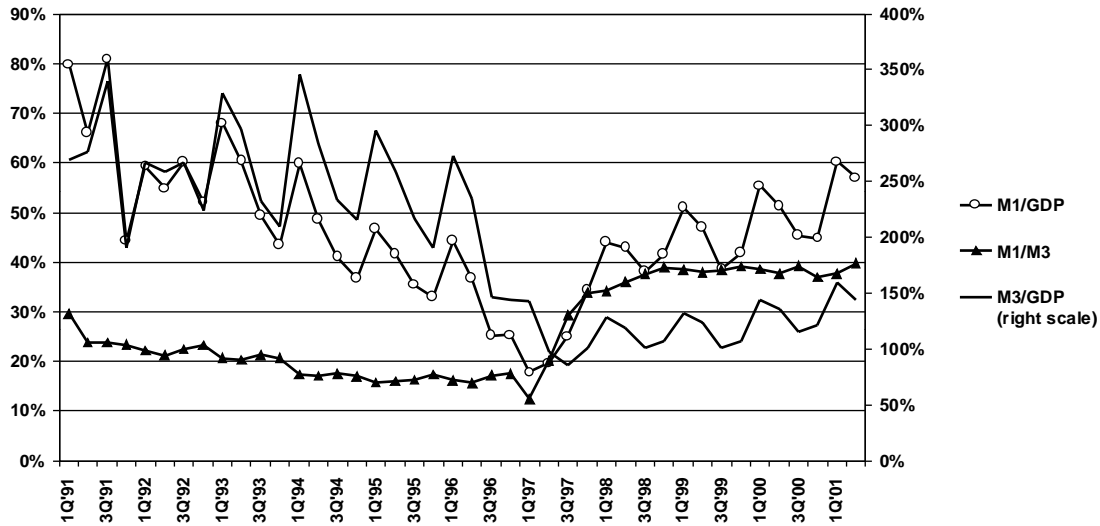
BULGARIA: Structure of the Assets of Banking System (2000)

Source: Bulgarian National Bank

The various indicators of the degree of financial intermediation have proved the gradual improvement of the banking sector. The ratio of M3 to GDP rose gradually from 85.6% in mid-1997 to 121.5% in the fourth quarter of 2000. At the same time, M1 to GDP ratio increased from 25% to 45%, which could also be regarded as an important sign of the relatively high volume of cash transactions in the Bulgarian economy. Bulgarian money multipliers have continued to be far from the levels in Germany, whose currency is used as a reserve currency.

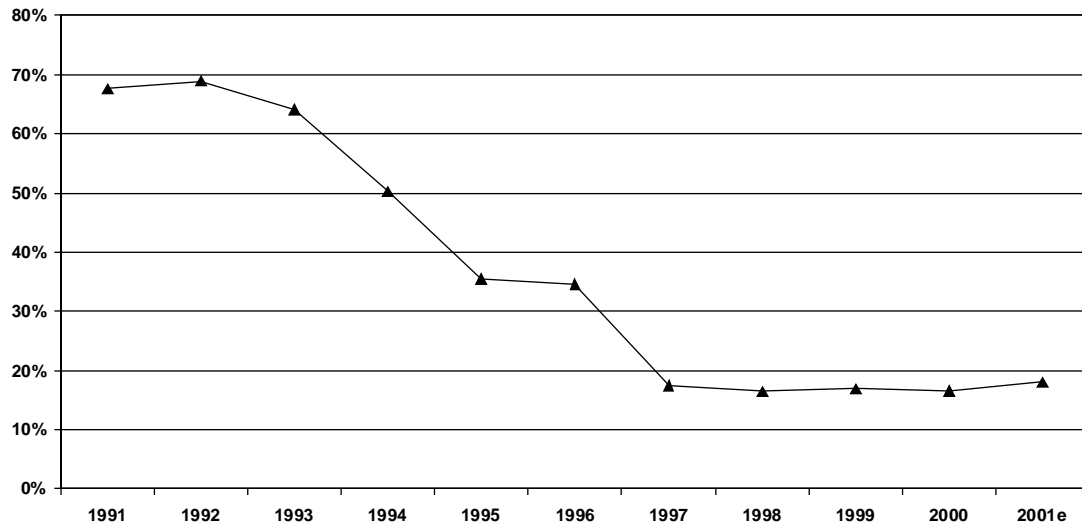
The banking sector continues to focus its activity on intermediating short-term deposits into low-risk liquid assets. At the end of 2000, loans to the non-financial sector accounted for some 30% of the total bank assets or less than 20% of GDP,

BULGARIA: Money Supply



Source: National Statistical Institute, Bulgarian National Bank

BULGARIA: Bank Claims on Non-government Sector to GDP

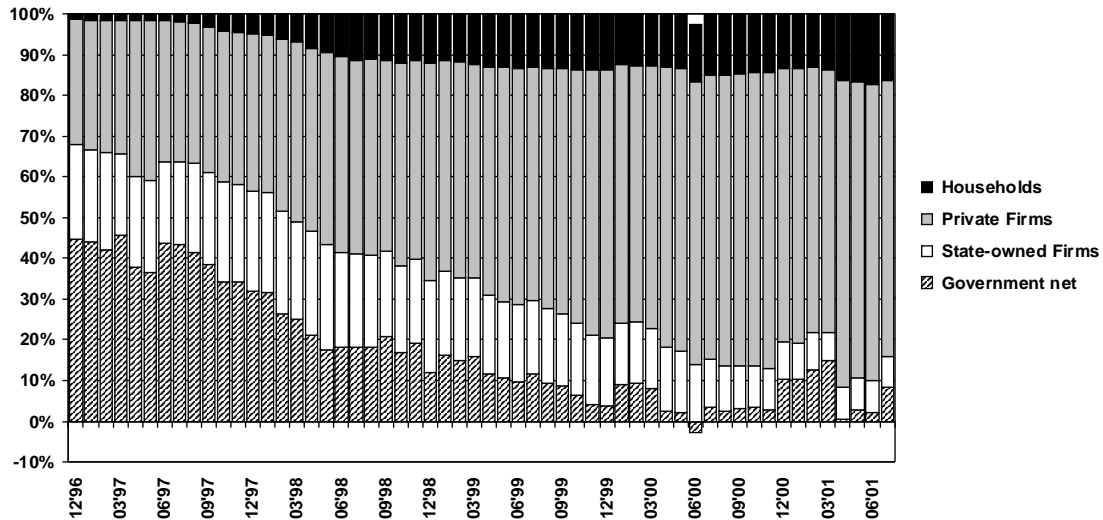


Source: National Statistical Institute, Bulgarian National Bank

while deposits with financial institutions – almost entirely denominated in foreign currency – and securities comprised over one half of total assets. This conservative asset management strategy is, in part, a response to the 1996-1997 banking crisis and the relative dearth of good domestic opportunities, but it also reflects the sector’s dependency on foreign currency and short-term deposits as its main source of funding. The composition of bank assets and liabilities has been stable since the end of the banking crisis, while the upward trend in credit to private enterprises as a share of total domestic credit is likely to continue.

An improvement of the quality of the banks credit portfolio is also visible. The share of sub-standard loans in the banking system portfolio decreased from 33.2% in the end of 1996 to 5.3% in the end of 2000. It is worth mentioning that the improvements in the quality of bank loans in Bulgaria have been achieved with a

BULGARIA: Structure of Domestic Credit



Source: Bulgarian National Bank

very limited financial support by the government. Successful financial restructuring in 1997-1998 allowed banks not to experience pressure in maintaining their liquidity and to concentrate on operational restructuring.

The banking sector earnings and cost base are stable, but the preference for allocating assets in low-risk instruments and short-term instruments dampens profitability. In 2000, net interest income and net income from commissions and fees accounted for 70% of total banking sectors operating income. Operating expenses of the sector remained high at almost 55% of operating income in 2000.

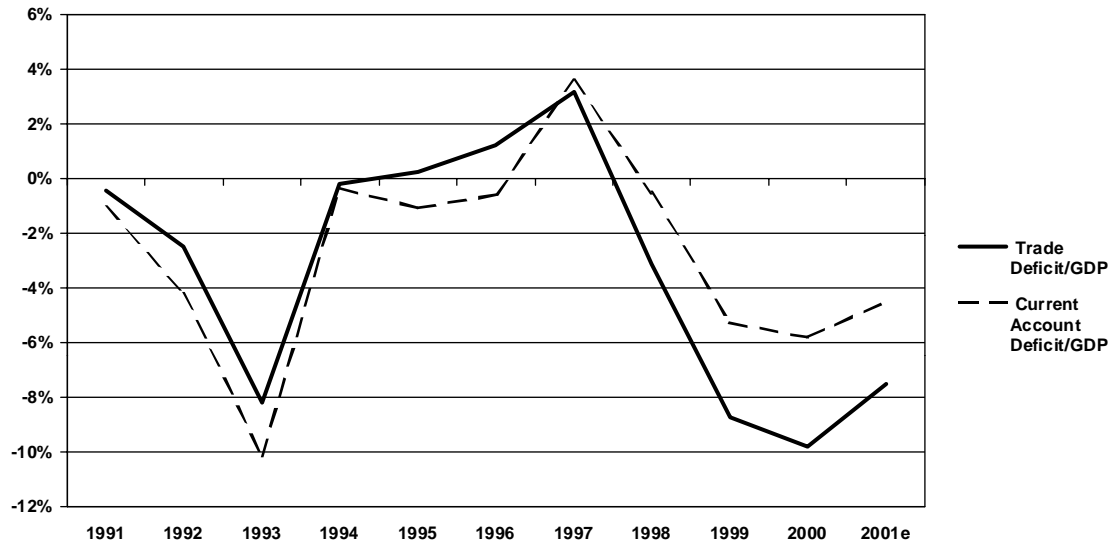
In the last three years stock trading was launched on the Bulgarian Stock Exchange – Sofia. The main efforts were concentrated on developing and stabilising Bulgaria's capital market infrastructure. As a result of the implementation of remote electronic trading, the capacity of this structure went further to meet the requirements of the more developed stock markets. These positive developments notwithstanding, the capital markets are still underdeveloped.

The trading volumes on the Bulgarian Stock Exchange remain very low and most of the trading takes the form of secondary exchange of company stocks from the Mass Privatisation. Trading on the Stock Exchange reached its peak in 1999 with some 21.2 mln shares traded to the total amount of 133.8 mln DEM and 18.8 thousands of corporate bonds to the amount of 472.2 thousand DEM. In 2000, the number of shares traded as well as the total turnover reported a slight decrease. The number of companies listed on the Stock Exchange as of end-2000 remained very small, falling to only 361 against 625 companies registered in 1998. The majority of them are small or medium-sized, which makes them unattractive to the leading international investors. The residual packages of shares of foreign owned companies remain among the most actively traded stocks because many investors prefer to push out minority shareholders that have acquired interest through the regular rounds of Mass Privatisation.

2.3. The Relationship between Capital Flows and Structural Reforms

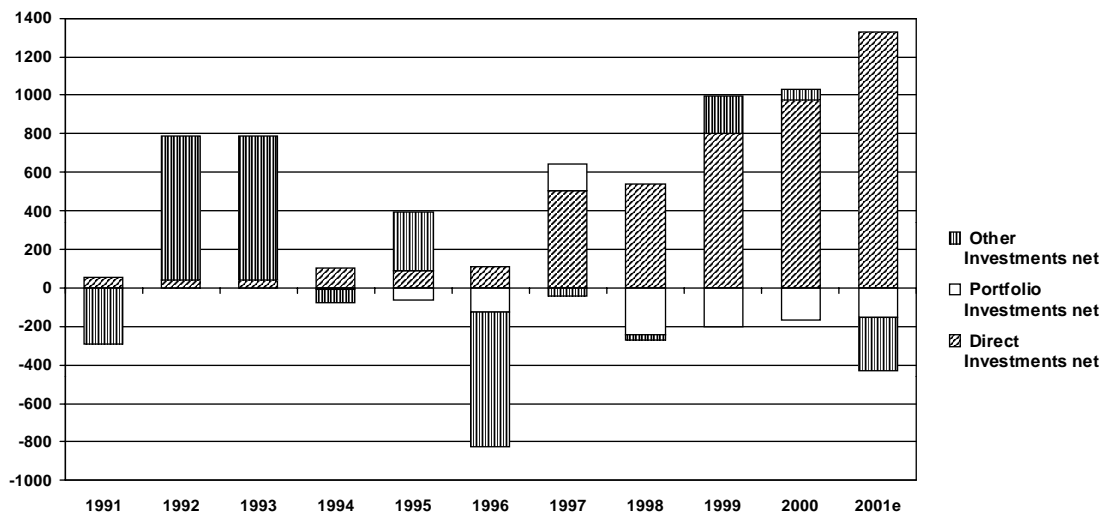
The Bulgarian experience during transition is a proof of the close interrelation between the trends of foreign investment inflows and the pace of structural reforms. However, it also raises some questions concerning the „bottle-necks“ of the reform process. First, Bulgaria has recently witnessed an increase of capital inflows, given the presence of sustained structural reforms and a credible economic policy, regardless of the continuous external shocks³. Second, capital inflows, together with IFIs loans, represent an indispensable financing for the current account deficit during the transition period.

BULGARIA: Trade Deficit and Current Account Deficit



Source: Bulgarian National Bank, National Statistical Institute

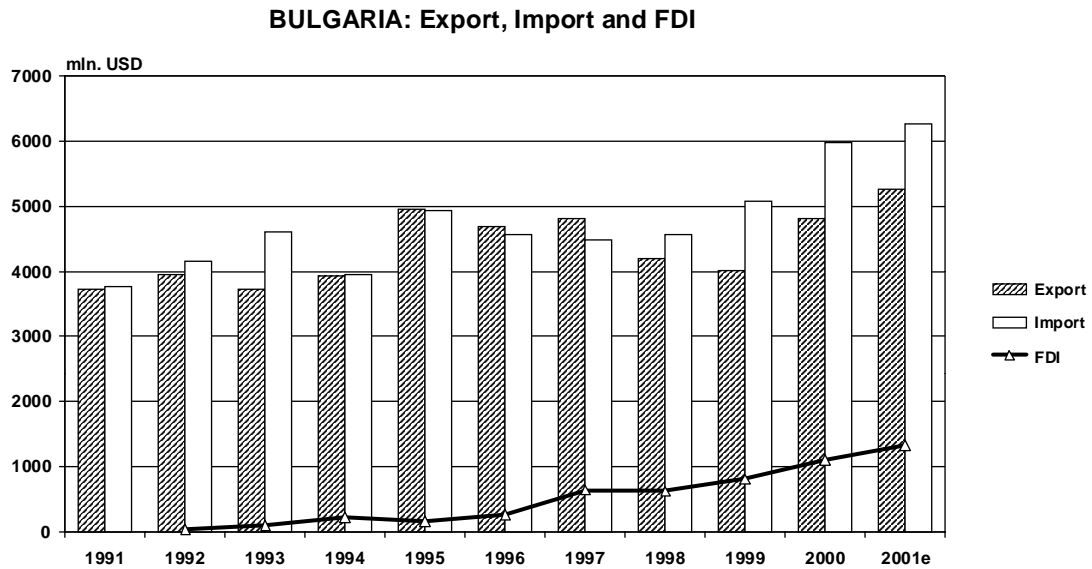
BULGARIA: Financial Account



Source: Bulgarian National Bank

³ Such as the regional conflicts in 1990s, the UN embargoes on Serbia, the fluctuations of the Brady bond market, international financial crises, etc.)

Third, the faster changing industries, most of them being export-oriented, attracted a substantial portion of the increasing capital inflows. The recent trends of exports in certain industries, namely the textile, footwear and clothing industries, and to a lesser extent pharmaceutical, chemical and petrochemical industries, mechanical and electrical engineering as well as metallurgy, followed closely the dynamics of foreign investments. The most important exporting companies and export products in 2000 were those of the textile and clothing industries. At the same time, these sectors accounted for more than 20% of Bulgarian exports.



Source: Bulgarian National Bank, Bulgarian Foreign Investment Agency

Fourth, undoubtedly foreign investments have already played an important role in the Bulgarian economy yet backward linkages with the local economy remain below expectations. The performance of domestic companies and that of firms with a predominant foreign participation tend to vary considerably in certain areas such as wage levels, gross value-added, net sales, capital base and export orientation. This has given rise to fears among economists, that a „dual economy“ could live in Bulgaria together with a more successful „external sector“ operating in isolation from the other parts of the economy. The low interest of foreign investors in the rural regions as well as their unwillingness to foster better linkages with local suppliers has also become a source of concern.

Fifth, although Bulgaria has experienced abrupt changes in its export structure by countries since 1991, no such changes have been observed in the structure by products. Therefore, the low share of medium-to-high-tech products within the total volume of exports has remained stable. Ultimately, these trends prevent a country to realise the comparative advantages of its skilled labour force.

Sixth, the brisk privatisation in the banking sector since 1996 has invited some reputable foreign investors such as Société Général, Uni-Credito Italiano and Na-

tional Bank of Greece. They imposed a strategy-driven restructuring with its primary goal being the clients' satisfaction and contributed a lot to post-crisis bank operational restructuring. Substantial positive developments have been registered in bank planning and marketing, implementation of sound „best recommended“ practices in bank risk management, problem credits workout, as well as in the greater transparency of bank financial statements. These investors (1) encourage the technological transfer to a local bank industry; (2) contribute to the successful entry on the international arena; (3) raise the quality of corporate policy; (4) push individual banks and, hence the sector to speed up their restructuring in alignment with the international criteria for sound banking; (5) enforce internal management rules, control and reporting mechanisms; (6) induce the development of a new corporate culture, closely resembling that of world-recognised banks.

However, while the banking sector currently appears to be sound, it may face significant challenges in the future. The sector enjoys very high capital adequacy and liquidity, and does not face major risks associated with non-performing loans or foreign currency exposure. The presence of a large number of smaller banks and the conservative strategies recently implemented by many banks will likely lead banks to reassess their earning strategies, and opt for an increase of lending as a result of the greater competition following from recent privatisation. Together with the expected increase of capital flows associated with the prospective EU membership, this will pose new challenges to banks' internal risk management systems and banking supervision. The high liquidity requirements of the currency board arrangement, which restrict active tuning of the overall liquidity by the central bank, add to these challenges.

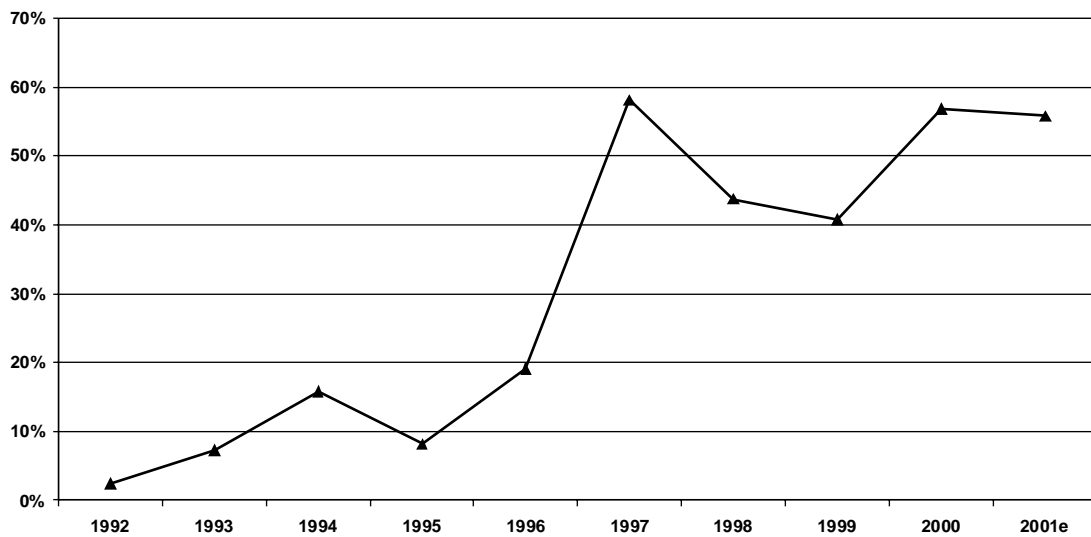
2.4. Macroeconomic Consequences of the Capital Flows

Bulgaria's growth performance in the last decade has been uneven. The initial transformation recession was prolonged and deepened by the inability of successive governments to implement prudent macroeconomic policies and pursue structural reforms, which culminated in the 1996-1997 financial crisis and a second recession. The consistent implementation of sound economic policies since mid-1997 has resulted in a turnaround of the situation. Macroeconomic stabilisation is an unquestionable achievement of the recent reforms. The fact is reconfirmed by all reviews under different IFI agreements as well as by the EC decision to start pre-accession negotiations with Bulgaria.

The accelerating GDP growth dynamics reached a peak of 5.8% in 2000. Unfortunately, aggregate demand in recent years has been driven mainly by the rebound from the 1996-1997 crisis and external demand. A look at the supply side also suggests that the economy is still in a recovery phase, with the factors of production being far from their full utilisation. The broad pattern of recent changes in the factors of production and productivity in Bulgaria indicates that the restructuring process is still incomplete.

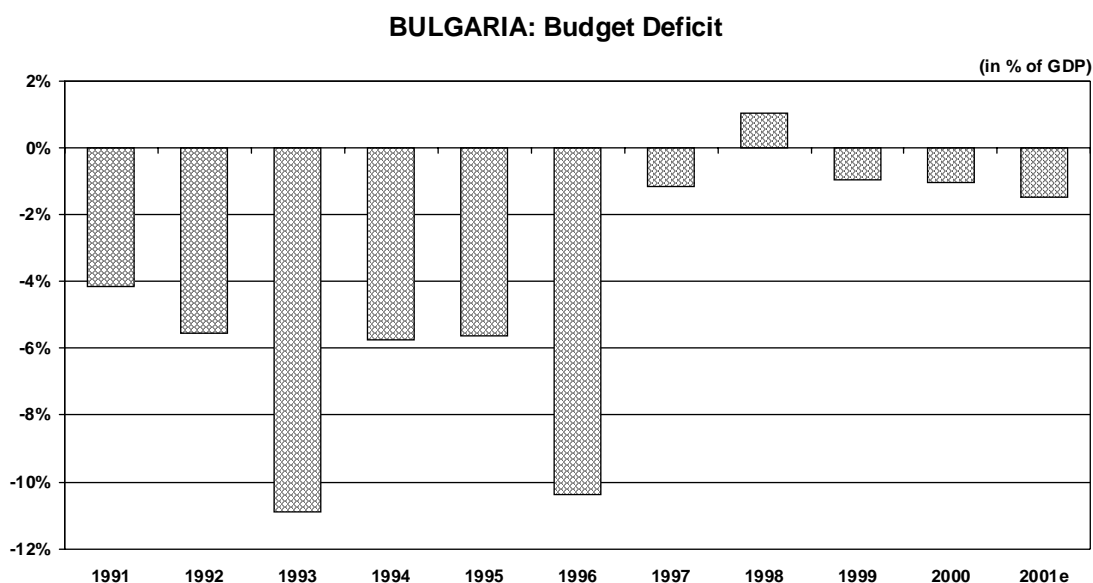
Capital flows played a particularly significant role in the Bulgarian economy after the financial crisis. Overall foreign direct investment inflows in Bulgaria rose from around 4% of GDP to a peak of about 10% of GDP in 2000. They not only financed the current account deficit, strengthened the export capacity, and thus supported the smooth functioning of the currency board arrangement, but also represented a significant share in the gross fixed capital formation. Since 1997, the foreign direct investment to gross fixed capital formation ratio has fluctuated between 41% and 58%, far above its pre-crisis levels. Unfortunately, no important data are available on the share of companies with a dominant foreign participation in GDP and gross exports.

BULGARIA: FDI to Gross Fixed Capital Formation Ratio



Source: National Statistical Institute, Bulgarian Foreign Investment

The sound macroeconomic policy in Bulgaria since mid-1997 could be considered as a cornerstone for the accelerating capital inflows. The conduct of prudent fiscal policy has helped to contain the budget deficit to around 1% of GDP or to maintain a small surplus, which is a far better performance compared to the first half of the 1990s. The sound government budget accounts in recent years are associated mainly with (1) the increase of the overall tax burden; (2) the improvement in budget revenues collection; (3) the optimisation of non-interest expenditures through the reforms in social security, pension and health care systems; and (4) the consolidation of extra-budgetary accounts and the implementation of a „single budget account“ procedure contributing to a more efficient cash flow management. The following factors also contributed to the maintenance of an almost balanced budget: (1) the medium-term agreements with IMF and other international financial institutions on external financing of the country by official donors; (2) the deepening of the trade and price liberalisation process; (3) the relatively successful restructuring of the banking sector through confident privatisation; and (4) the fast privatisation of state-owned enterprises except the monopolies in the energy, telecommunication and tobacco industries.



Source: Ministry of Finance, National Statistical Institute

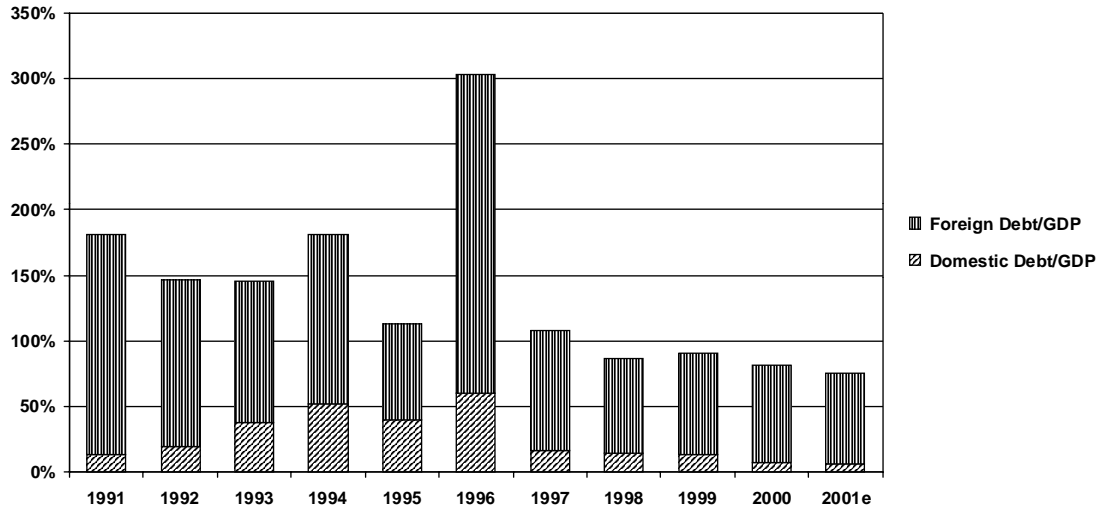
The initially designed government income policy based on the implementation of tight budget constrains contradicted with the high cost of painful reforms paid by Bulgarians and the needed instant changes in the quality of life. Certain contradictions originated also in the discussions with the social partners on the appropriateness of income policy. Several violations could be found in the implementation phase of the income policy, which substantially reduced its effectiveness. Regardless, the income policy has contributed to a decline of the wage bill in some loss-making enterprises and to a freeze of the wage bill in large state monopolies.

The stability of the currency board arrangement and the steady progress in the reduction of gross external debt further provided a relatively low inflation and an ensuing stability of real interest rates. All these developments are strongly associated with the increasing capital inflows. The capital and financial account rose from 0.4% of GDP in 1997 to more than 6% of GDP in the year 2000. Since 1997 the foreign exchange reserves of the central bank, incl. gold, have risen by 39.3% to reach 3.46 bln USD in end-2000. Government and government-guaranteed debt has fallen from a level of more than 100% of GDP in the end of 1996 to 81% of GDP in end-2000. Over the same period, Bulgaria has received a serious balance of payments support⁴ from the IMF (427.2 mln USD.) and other donors (831.9 mln USD).

The pegging of the Bulgarian lev to the DEM contributed to the relative convergence of price dynamics in both countries. Against the background of the general price stabilisation in Bulgaria, the changes in administered prices turned out to be a major inflationary factor. No matter that following the recent price liberalisation the share of administered prices in the consumer basket was reduced to less than

⁴ *On net basis.*

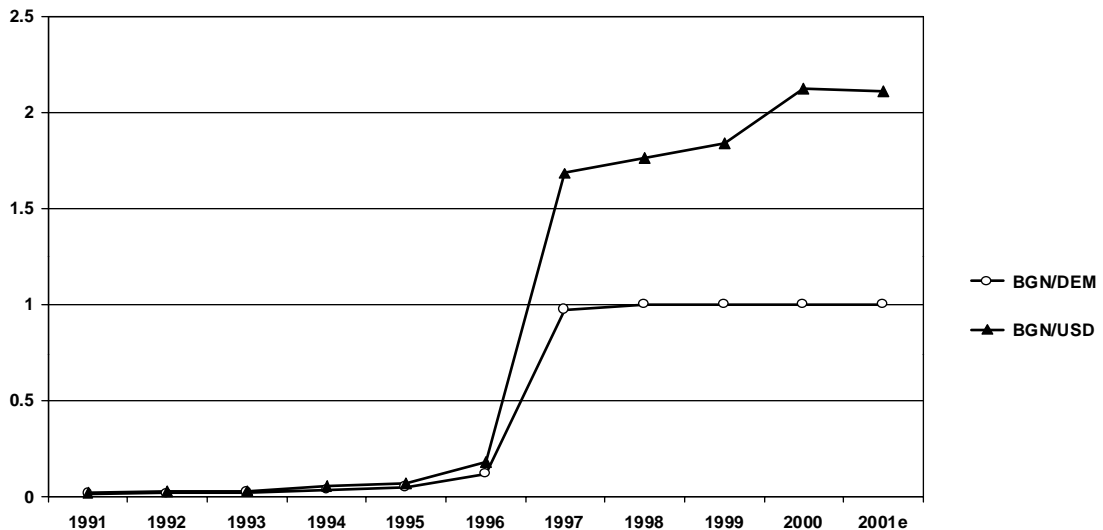
BULGARIA: Government Debt



Source: Ministry of Finance, National Statistical Institute

10%, their contribution to overall inflation remains very high. The sharp fluctuations of the international prices of fuels and some raw materials in recent years also affected consumer prices in Bulgaria. As a result, the positive effects of the exchange rate stability were to a certain extent offset.

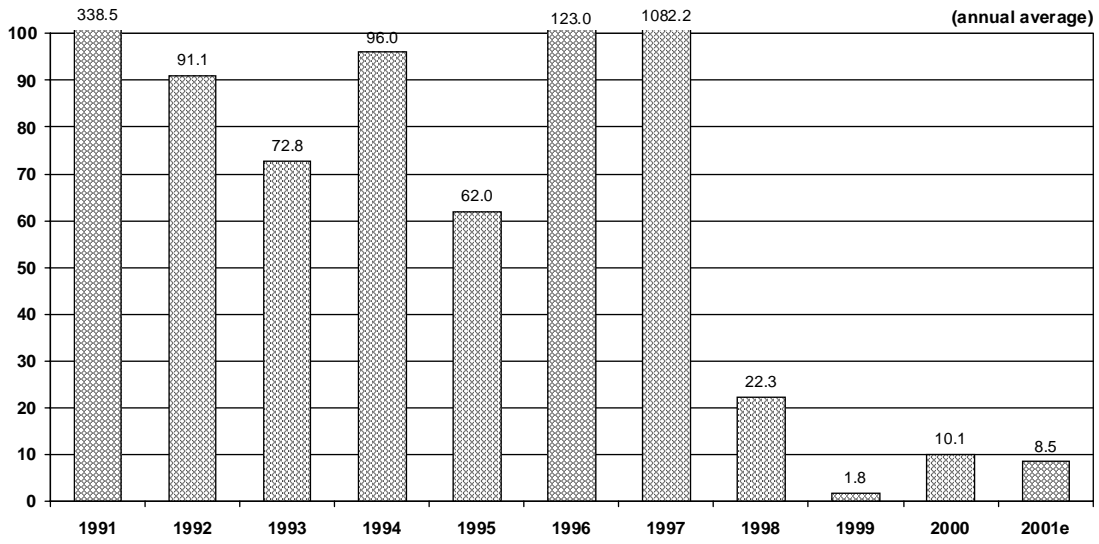
BULGARIA: Exchange Rates



Source: Bulgarian National Bank

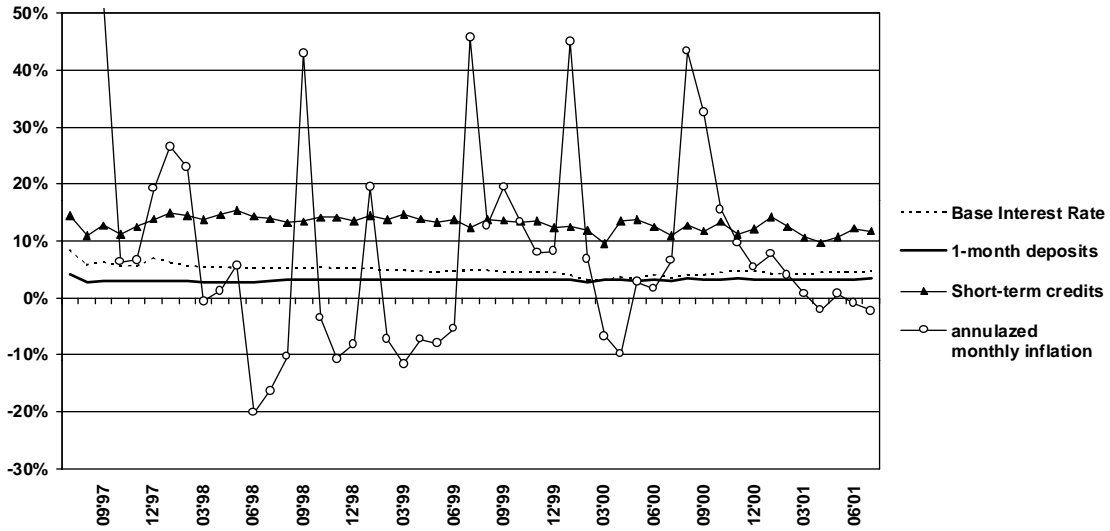
After the introduction of the currency board arrangement, the commercial banks dependence on central bank refinancing and the associated tying up of their interest rates to the base interest rate have been abolished. All commercial banks determine their interest rates and interest rate spreads primarily on the basis of their cost of fund structure and market demand. Fortunately, the pace of the banks operational restructuring and the trend of domestic demand in recent years forced the banks to change their interest rate policy and Bulgaria currently enjoys a relative stability of the interest rates.

BULGARIA: Inflation



Source: National Statistical Institute

BULGARIA: Nominal Effective Interest Rates and Inflation



Source: Bulgarian National Bank, National Statistical Institute

3. APPROACHES TO THE MANAGEMENT OF CAPITAL FLOWS

Since the start of financial liberalisation in the beginning of 1990s, all governments have accorded in their program statements a primary importance of foreign investment for economic restructuring and the building of a competitive market. Only in a few cases, however, a practical evidence of this could be found. The successful macroeconomic stabilisation and continuous economic growth since 1997 at least partially could be attributed to the rebuilding confidence of foreign investors in the Bulgarian economic policy.

3.1. Strategies Followed

Since the key political players have pledged a strong political commitment to full integration in the EU within the next 5 to 6 years, Bulgaria pursues liberal foreign exchange and trade regimes, striving to strengthen the capacity of public administration, and align financial legislation, banking supervision and regulations with the world's best practice. All these efforts also fully respond to the necessity to develop a functioning market economy in the country and to foster long-term growth and standard of living by improving efficiency and resource allocation. The liberalisation is also considered a powerful instrument to improve transparency and to facilitate sound rules of corporate governance encouraging investments and protecting investors and lenders from fraud and unfair practices.

3.1.1. Administrative Regulations

A new Foreign Investment Act (FIA) was adopted in October 1997. The Act brings the legal framework on foreign investment in full compliance with the accepted international standards and provides for an even more attractive investment regime. According to the provisions of the law, foreign investors are: (1) legal persons, who are not registered in Bulgaria, (2) partnerships, which are not legal persons and are registered abroad; (3) individuals, who are foreign citizens and have permanent residence abroad, (4) Bulgarian nationals, who have a second nationality as well, and avail themselves of the status of foreign citizens under the act.

The Bulgarian Constitution and the FIA provide equal treatment to foreign investors, which means that foreign investors are entitled to perform economic activity in the country under the same provisions applicable to Bulgarian investors, except where the law provides otherwise. In particular, this principle covers the whole range of economic and legal forms of activities for carrying out entrepreneurial business. The Foreign Investment Act stipulates that foreign investments shall be guaranteed against subsequent legislative changes. Foreign investors receive the guarantee that an expropriation may only occur in case of *force majeure* state needs, which could not be met otherwise. The Act provides for compensations in the form of another immovable property in the same location, and only given the foreign investor's consent, in another location, or in cash if the investor prefers so.

The prospective compensation equals the immovable property's market price on the day of expropriation.

Foreign Exchange Law (Currency Law) was adopted in September 1999 and entered into force in the beginning of 2000. The Law replaced the Law on Transactions in Foreign Exchange Valuables and Currency Control, which dated from 1966, but had been subsequently amended several times. The new law introduced and clarified the procedure for capital account transactions and brought the legal framework in line with the de facto existing liberal regime. The law stipulates that all transactions, unless otherwise stated, may be undertaken freely. Under the Foreign Exchange Law, the exchange control and administration are delegated to the BNB and the Ministry of Finance. They are in charge of the elaboration and implementation of sub-legislation, which was adopted in late 1999.

According to the Foreign Exchange Law, foreign investors can repatriate profits freely. Tax preferences for foreign investors were recently abolished and currently foreign and domestic investments are treated on an equal footing. The Constitutional problem arising from the prohibition against the acquiring by foreigners of direct ownership of real estate and land is now partially resolved. Joint ventures or 100%-foreign owned companies registered under the Bulgarian legislation are allowed to buy land for business purposes. Operations in securities dealt on the money- and capital markets, as well as operations in units of collective investment undertakings, are free. Credits related to commercial transactions, financial loans guarantees granted by residents to non-residents and vice versa, transfers in performance of insurance contracts, personal capital movements, operations in current and deposit accounts with financial institutions are also free.

The Law on Measures against Money Laundering (1998) is largely in line with international standards. The law set forth the obligations of the BNB and the Bureau of Financial Intelligence within the Ministry of Finance for the development of operational procedures for detecting and preventing money laundering. It also determines the obligations and activities of the specifically mentioned economic agents with regard to the identification of „clients' and the collection, storage and disclosure of the information required for the implementation of the measures against money laundering.

Law on Public Offering of Securities was passed in end-1999. The main objective of the law is to govern the public offering and trading of securities, the activities of regulated securities markets, the Central Depository, investment intermediaries, investment companies, fund management companies, and the conditions for carrying out such activities and the government control over them. It treats domestic and foreign persons on an equal basis. The law explicitly provides for the admission of foreign securities to the Bulgarian capital market. Both policy-makers and investors have broadly accepted the view that the Law on Public Offering of Securities provides an adequate protection of investors and creates the prerequi-

sites for the development of a transparent and efficient capital market in the country.

While the external debt to GDP ratio remained high at 80%, the Bulgarian government expects it to decline quickly in the medium term, due to rapid economic growth, the real exchange rate appreciation, and the relatively limited net borrowing needs of the country. A draft Sovereign Debt Law, treating the prudent management of external debt, has recently been submitted to Parliament by the government. It sets debt ceilings at levels ensuring a continued reduction in the debt-to-GDP ratio, while accommodating borrowing from international agencies and investment and balance of payments support. Moreover, the government had settled the remaining bilateral debt disputes, entered into negotiations with several Paris Club creditors regarding debt service swaps, and agreed to open talks with eligible countries to reconcile outstanding claims.

The EU highly appreciates the recent policy efforts of the Bulgarian government to bring as soon as possible legislation and administration of trade and capital movements in line with the *acquis*. This is emphasised in the latest report of the European Commission on Bulgaria's progress towards accession.

3.1.2. Trade and Capital Liberalisation

The first steps towards trade and capital liberalisation were made in 1991 when the central allocation of convertible currencies was abolished and the state monopoly over foreign trade was dismantled. However, the incomplete liberalisation of prices combined with the stalled institutional reforms was responsible for the instability of foreign trade policies and had unavoidably led to the proliferation of micro-management of foreign trade. In consequence, the Bulgarian markets were significantly protected throughout most of 1990s, thereby also contributing to a reduction of the country's export potential. These developments combined with relatively high Most Favoured Nation (MFN) tariff rates and frequently introduced import surcharges imposed an extra barrier to trade that was already negatively affected by the adverse external shocks.

Serious efforts to remove foreign trade policy-related distortions and to abate the instability in Bulgaria's policy began after the 1996-1997 financial crisis. Bulgaria slowly restarted trade liberalisation in 1997, but the pace picked up subsequently. The accession to the World Trade Organisation (WTO) was the first step in the reform process. Since then, Bulgaria has made significant steps in liberalising trade in telecommunications and financial services and, to a lesser extent, in improving the conditions for access of foreign goods to the local market. The country agreed on a limited reduction in bound rates for industrial and agriculture products. The schedule envisaged a reduction in the unweighted average industrial tariff from 28% in 1998 to 24% in 2002. For agriculture, the reduction envisaged was from 59% to 46% over the same period. The import surcharge was removed a year

ahead of the initially designed schedule on January 1, 1999 and contributed to the significant decrease of the cost of import.

regional free trade agreements represent the second driving force in the Bulgarian trade liberalisation process. Beginning with the Europe Agreement (signed in the end of 1993), Bulgaria has signed Free Trade Agreements (FTAs) covering industrial products as well as many agricultural product categories with countries with whom the EU already had signed or intended to sign preferential trade agreements. As of 1 January 1998, Bulgarian exports of industrial products have tariff-free access to EU markets. The removal of Bulgarian barriers proceeds at a slower pace and is to be completed by the end of 2001. Around 95% of Bulgaria's industrial imports were not subject to tariffs in 2000. As for agriculture products, the preferential access for some products that Bulgaria had under the unilateral GSP scheme of the EU was retained. Trade in wine was covered by a separate agreement. The EU granted preferential treatment within tariff quotas to some Bulgarian agricultural products such as wine and, without limitation, to certain processed agricultural products. Since July 1998, the EC have increased tariff quotas by 5% annually and as of July 2000 they were 25-28% higher than in the 1995-1997 period. In 2000, new conditions for the access of some agricultural products were negotiated. As of July 1, 2000, tariff rates for some agricultural products were zeroed and new duty-free quotas were established.

Although Bulgaria joined CEFTA on 1 January 1999, it had already concluded FTAs with some CEFTA members long before that date. As a result of the commitments made under both the multilateral and bilateral components of CEFTA, Bulgaria is not subjected to any tariff and non-tariff barriers for industrial products by the Czech Republic, Slovak Republic, Hungary and Slovenia and enjoys full tariff relief on 80% of industrial products in Poland and Romania. All tariff and non-tariff barriers (with some exceptions) have to be removed by the end of 2001. As far as agricultural products are concerned, there are reciprocal concessions in terms of zero or reduced duties applicable to specific tariff categories within tariff quotas or without tariff quotas.

Bulgaria has also signed FTAs with Turkey and FYR of Macedonia. Similar agreements are in the process of negotiations with the Baltic States, Israel and Morocco, i.e. countries which also enjoy a preferential status in EU markets. The free trade agreement with Turkey envisages the gradual removal of tariffs on industrial products till the end of 2001. Bulgaria has agreed with the FYR of Macedonia to free trade with about 80% of industrial products, while as for the remaining 20% this is expected to happen until the end of 2004.

The pursuit of regional liberalisation has produced at least two positive effects for Bulgaria. First, it dramatically increased the contestability of domestic market for industrial products due to the fall in duties on imports from preferential partners.

Second, it led to a significant increase in reverse discrimination as the differences between MFN rates and other rates widened. Recently, Bulgaria has also taken measures to improve internal trade, aimed to simplify and rationalise the licensing and regulatory regime. In 2000, some 121 requirements were revoked following this initiative. The creation of „one stop shops“ for citizens began in 2001 in all ministries, and 28 districts and 14 municipalities are expected to follow suit.

3.1.3. Exchange Rate Regime.

In mid-1997, Bulgaria drastically changed its foreign exchange regime – from an independent float to a currency board arrangement, as a part of the stabilisation program supported by the international financial institutions. This change is considered one of the corner stones of the post-crisis economic stabilisation in the country. The new foreign exchange regime has been constituted by a new Law on the Bulgarian National Bank (BNB) and plays a major role in the ensuring of a friendly climate for the foreign investors in line with the recent recommendations from the international financial institutions for small open economies. In order to re-establish the stability of the national currency, the Law on the Re-denomination of the Bulgarian Lev was adopted in February 1999, effective from 5 July 1999.

According to the provisions of the Law on the BNB, 1000 Bulgarian levs are equal to 1 DEM since July 1, 1997⁵. For accounting purposes, fixed exchange rates are also applied to the euro (1 euro = 1955.8 levs) and all other euro area currencies. These rates are fully correspondent to the fixed rates applied in the framework of EEMU. The BNB quotes daily the exchange rate of the lev to the US dollar and other hard currencies outside the euro area „central“ exchange rates, on the basis of the developments on the external and domestic foreign exchange markets. BNB freely exchange on request levs for DEM in cash and vice versa. The prices of the foreign currencies on domestic markets fluctuate according to the international market dynamics. There are no arrangements for forward cover against exchange rate risk operating in the official or commercial banking sector.

The Bulgarian currency is already very much aligned with the euro. The currency board effectively guarantees the exchange rate against the euro and the authorities are committed to maintain this rate until Bulgaria joins the EMU. This guarantee fosters long-term stability, facilitates trade, and encourages foreign investment. At the first glance, it even seems that the formalising of the euro as a currency for cash transactions in Bulgaria should not be problematic soon after its appearance.

3.1.4. Banking Supervision and Regulations

According to the Foreign Exchange Law, the BNB and the Ministry of Finance are the authorities that regulate capital movement. Six Regulations under the Law

⁵ According to the Law on the Re-denomination, starting from 5 July 1999, 1 Bulgarian Lev is equal to 1 DEM.

have been implemented, including Regulation No.26 on the Foreign Exchange Transactions of Brokerage Financial Houses, Regulation No.27 on the Registration by the BNB of Transactions between Residents and Non-residents, Regulation No.28 on Trans-border Transfers and Payments, Regulation No.29 on the Terms and Procedure for the Submission of Reports and Declarations on the Liabilities of Residents to Non-residents, Regulation No.30 on the Export and Import of Lev and Foreign Exchange Cash, Precious Metals and Precious Stones and Regulation on the Collection of Information on the Balance of Payments Statistics.

Under the Law on BNB, the central bank is responsible for implementing the exchange rate policy and developing banking regulations as well as exercising the banking supervision. Licensed banks do not request any guarantee from the Government of Bulgaria and their borrowing complies with the prudential regulations set up by the BNB. These banks may borrow abroad without the authorisation of the BNB. They may also extend foreign currency and lev loans to residents and non-residents. The prudential regulations of the BNB related to the open foreign currency positions of banks have been changed recently in lines with Basle Committee recommendations. Under these regulations the banks have received both greater freedom in managing their open positions in foreign currencies and clear obligations to develop internal risk management systems in line with the best international practice in this area. According to the regulations, open euro area currencies positions of commercial banks in are not considered when calculating their net open foreign currency position.

The regulations, issued under the Foreign Exchange Law, determine the status of the resident and non-resident accounts with banks. Residents may maintain foreign currency deposit accounts with domestic banks, these accounts may be credited without any restrictions, and transfers from them may be made abroad freely up to the amount of 20 000 DEM or upon authorisation by the BNB and the MoF for greater volumes. Non-residents may maintain accounts in foreign currencies or levs with domestic banks as well.

Bulgarians and foreigners can enter the country with cash balances without any limits, but are obliged to declare amounts greater than 5 000 levs. Bulgarians do not need a declaration to exit the country with cash of up to 5 000 levs. Cash balances between 5 000 levs and 20 000 levs are subject to declaration. All amounts above 20 000 levs are subject of authorisation by the BNB.

Foreigners can exit the country without declaration with cash in hand of up to 5 000 levs. Cash balances between 5 000 levs and 20 000 levs must be declared and the documents proving the appropriateness of money holdings should be presented. All amounts above 20 000 levs are subject to authorisation by the BNB if the money has not been declared during the entry procedures.

The effecting by banks of transactions or operations representing money launder-

ing or such in violation of the Law on the Measures Against Money Laundering and the acts of its implementation represent a violation against which the BNB imposes measures and penalties under the Foreign Exchange Law. Regulation No.26 of the BNB stipulates the obligations of the central bank concerning money-laundering prevention in the non-banking financial system. The effecting by financial houses of transactions or operations representing money laundering or such in violation of the Law on the Measures Against Money Laundering and the acts of its implementation represent a violation against which the BNB also imposes measures and penalties as per the Foreign Exchange Law.

In 1998, the Law on Bank Deposit Insurance was adopted by virtue of which an independent self-funding scheme was created to limit moral hazard. According to international classifications of deposit insurance schemes, Bulgaria's scheme is a typical explicit deposit insurance scheme with a limited coverage and a compulsory guarantee fund. The sources of the guarantee fund include mainly the initial and annual premiums from banks, participating in the scheme. The fund, however, can also raise funds from a bank's property in case of subrogation, donations, or foreign assistance, as well as generate income from investing raised other funds. The fund guarantees the repayment of money held in depositors' accounts with banks regardless of the number and size of deposits and the type of currency. The coverage scheme is quite complicated and currently the total amount of deposited money repaid could not exceed 8 250 DEM.

3.2. Sterilisation of Capital Flows

Under the currency board arrangement, the central bank cannot design and implement a sophisticated sterilisation policy to the capital inflows. The BNB possesses only the minimum reserve requirements ratio as an instrument to guide commercial banks liquidity and money supply process. Developments since mid-1997 have shown that Bulgaria has not consciously implemented any special policy measures to sterilise capital inflows. Meanwhile, the BNB has changed the reserve requirement ratio once⁶ - by three percentage points down to 8%, thereby providing an additional liquidity of about 150 mln DEM to the banking system.

The model of the currency board arrangement in Bulgaria places a key role to the Government in the money supply process through its deposit with the Issue Department of the BNB. In the beginning, the Government's deposit amounted to almost 50% of the Issue Department's liabilities. All transactions in the Government deposit with BNB's Issue Department, not inviting subsequent changes in the gross foreign exchange reserves of the BNB (the assets of the Issue Department), directly affect the money base and indirectly the money supply through multipliers. Regardless of the fact that the major part of transactions in the Gov-

⁶ *In mid-Y2000.*

ernment deposit since mid-1997 have not been intended in any way to guide the capital inflows process, they practically have had such an impact. Sterilising is one of those which increase the government deposit with the central bank.

Some deficiencies in the legislative and institutional framework of the reform process could also have a sterilising effect. Some of them include the administrative impediments to foreign investors, any unexpected turns of the privatisation principles, the subsequent changes in related legislation and policies, and to some extent, the alteration of large-scale privatisation schedules. The absence of special bank bankruptcy legislation and the slow pace of reforms in prosecution, justice, and public administration could also be seen as barriers sterilising the capital inflows in Bulgaria.

3.3. Structural and Institutional Characteristics of Capital Flows Management

Pursuant to the Foreign Investment Act and the Foreign Exchange Law, the BNB and the Ministry of Finance are the authorities sanctioned to design and implement capital flows management in Bulgaria. To a lesser extent, the State Securities Commission, approved by the Council of Ministers as stipulated by requirements of the Law on Public Offering of Securities, can also influence capital flows. Both the recently established Bureau of Financial Intelligence and the Banking Supervision Department of the BNB are responsible for the prevention of money laundering associated with large capital transactions.

At present, the BNB cannot pursue an independent monetary and foreign exchange policy. Monetary, foreign exchange and credit policies of the central bank are restricted by the Law on the BNB. These policies, being unsuccessfully carried out in the first half of 1990's, resulted in the 1996-1997 financial crisis and the lack of people's confidence in the central bank. Current monetary, foreign exchange and credit policies are carried out under the currency board arrangement, which forbids the central bank to provide any unsecured loans to the government and commercial banks. The lender-of-last resort facility of the BNB is limited only to a secured lending to banks in the presence of a systemic risk.

On demand, the central bank can only exchange in cash levs against DEM at a fixed exchange rate. The maintaining of the stability of Bulgarian lev is among the main tasks of the BNB according to the Law on the Bulgarian National Bank (1997). The practical realisation of this task under the currency board arrangement together with the adequate changes in the legislative and accounting framework for financial transactions, and the institutional and technological changes contribute a lot to the increase of capital inflows in the country and the growth of transactions on the domestic financial markets.

The Accounting Act introduced in 1990 enacted new requirements of the account-

ing practice and required interbank transactions in Bulgaria to be made through the interbank payments system. The banking integrated system for electronic transfers (BISERA) managed by the central bank was created in the beginning of 1990s. The entry points and the average daily value of payment transfers through BISERA gradually revived after financial crises. In the end of 2000, BISERA has integrated 686 entry points through which interbank payments could be initiated, or 17.5% less than in the end of 1997. Over the same period, the total number of transactions through BISERA increased by 87% and reached 19.4 mln per annum. The total value of payments increased to more than 55 bln levs in 2000, or about twice the annual GDP. However, Bulgaria is still far behind the industrial countries by the number of entry points per person and the daily value of payment transfers to GDP ratio.

The future modernisation of the payment system is currently under consideration. A medium-term strategy for the development of a modern real time gross settlement system (RTGS) has recently been launched by the BNB. The project is expected to be accomplished in the end of 2002 and to bring the quality of the Bulgarian payments system in line with with the EU standards.

The Banking organisation for payments initiated by cards (BORICA) was set up in 1993. Debit card payments market has been rapidly evolving in recent years. Since 1997, the number of debit cards issued, banking teller-machines and points of sales has been rising substantially. However, given the traditional payment habits, the majority of retail payments are still made in cash.

Foreign investments in Bulgaria as well as investments in real estate made by foreigners are subject to registration. The Bulgarian Foreign Investment Agency (BFIA) with the Ministry of Finance was established under the Law on Foreign Investment with the task to register all foreign investment and to maintain an integrated information system on them. All foreign investments of Bulgarian citizens and their real estate investment abroad are subject to registration at the Ministry of Finance and BFIA. The BFIA also plays the role of the main information centre for potential foreign investors, no matter that the Privatisation Agency is also in charge of providing information to them.

In accordance with the provisions of the Foreign Exchange Law, the BNB collects statistical information related to cross-border financial flows for balance of payments purposes. Bulgarian legal entities, banks, financial institutions and physical persons are obliged to report to the BNB on ex-post bases by using reporting forms issued by the central bank. The more complete information gathered during the first year of implementation of the law led to the improved reporting of financial flows in the balance of payments. For example, the payments on current transfers in 2000 were higher by 33.3 mln USD, reporting an increase of 122% on a year earlier. Although this was most probably due to the implementation of the more

liberalised regime on such transfers, the importance of the information coverage should not be underestimated.

The Bureau of Financial Intelligence, established within Ministry of Finance in late-1998 and the BNB „Special Supervision“ Directorate are responsible for the implementation of the Law on the Measures Against Money Laundering in the banking system and in respect to financial houses. The administrative capacity of these units is insufficient for the exercise of such responsibilities and further improvement is needed in terms of experience and organisational development.

According to the provisions of the Law on Public Offering of Securities, the government appoints the State Securities Commission. The Commission licenses and supervises investment intermediaries and the regulated stock markets, and requires the initial and regular disclosure of information in cases of public offerings. Security issuers have to file prospectuses and register with the Commission. Shareholders are allowed to designate proxies to vote for them. The aim of these provisions is to ensure the protection of investors and encourage the development of the securities market. The BNB, jointly with the Commission, also supervises the operations of banks, which act as investment intermediaries and custodians.

The Bulgarian Stock Exchange-Sofia (BSE-Sofia) is the only regulated security market in Bulgaria, licensed by the State Securities Commission. The Rules and Regulations, prepared in conformity with the legal requirements of the Law on Public Offering of Securities, govern the activities of the BSE-Sofia. They arrange the organisation and governance of the Exchange, set up the terms and procedures for listing of securities and admitting members and brokers, and stipulate the principles and methods of trading and concluding of transactions and the organisation of internal control. The recent modernisation of BSE-Sofia and the Central Depository through the implementation of a remote electronic trading infrastructure meets all the requirements of the more developed stock markets. From both the technological and organisational point of view, the BSE-Sofia has the potential to handle much higher trade volumes than the ones registered in the preceding years.

4. CONCLUSION

The conclusions that can be drawn on the basis of the presented analysis go into several directions. The general conclusion of the analysis is that the sound management of capital inflows can to a great extent offset the adverse developments in the external environment and it is a prerequisite for the successful economic development of small open economies. Below are presented some of the more concrete remarks:

First, the Bulgarian experience in the transition to a market economy during the last decade proves in the utmost possible degree the hypothesis of the high importance of capital inflows for economies with a low rate of domestic savings and in need of investment for the technological and operational restructuring of the economy.

Second, the design of the overall reforms strategy, its proper communication to foreign investors and the international financial community, the credibility of legislative and institutional reforms and the sound macroeconomic policy have been the major factors behind the positive turn in the volume of foreign investment in Bulgaria since the mid-1997, despite the continuous adverse shocks affecting the economy.

Third, debt and debt service reduction operations for high indebted countries, like Bulgaria, together with the financial support from the international financial institutions coupled with restrictive macroeconomic policy, and especially fiscal policy, could be successful in closing the financial gap in the short term, but are insufficient to bring back the economy on the road of sustainable long-term growth. Deep structural reforms are needed to restore the foreign investors' confidence and to smooth the path of capital inflows and economic growth.

Fourth, the key measures of the successful recent economic reforms and capital inflows management in Bulgaria have also included: (1) the enacting of legislation, which properly defines and defends property rights and supports the enforcement of investment contracts; (2) the adequate trade and capital liberalisation; (3) sound monetary policy based on the simple rules of the currency board arrangement; (4) swift privatisation; (5) appropriate banking regulations and bank supervision based on the achievements of the best international practice. □

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