ICR Review
Operations Evaluation Department

Report Number: ICRR11098

1. Project Data:		Date Posted: 07/31/2001		
PROJ ID:	P008317		Appraisal	Actual
Project Name:	Financial and Enterprise Sector Adjustment Loan II	Project Costs (US$M)	150	150
Country:	Bulgaria	Loan/Credit (US$M)	100	100
Sector(s):	Board: FSP - General industry and trade sector (67%), General energy sector (17%), Banking (16%)	Cofinancing (US$M)	50	50
L/C Number:	L4521			
		Board Approval (FY)		0
Partners involved:	Japan Bank for International Cooperation	Closing Date	03/31/2000	03/31/2000

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2. Project Objectives and Components

a. Objectives

Support substantial progress in the implementation of structural reforms in the financial and enterprise sectors and initial phase of the energy sector restructuring program

b. Components

(a) accelerate the privatization or liquidation of SOEs; (b) maintain financial discipline in the enterprise sector; (c) sustain banking reform focusing on privatization of banks and upgrading of supervision capacity; and (d) restructure the energy sector.

c. Comments on Project Cost, Financing and Dates

FESAL II was designed as a one tranche operation where all actions had to be completed prior to Board presentation. It was approved on December 2nd, 1999 and made effective on December 15, 1999. It continued essentially the same agenda as FESAL I with the addition of the electricity sector. The IMF's Extended Fund Facility of 1998 followed FESAL I but preceded FESAL II and incorporated many of the conditions in both FESAL I and II.

3. Achievement of Relevant Objectives:

(a) Privatization or liquidation of SOEs was accelerated and by end of 2000, 90 percent of non-energy and non-infrastructure assets had been divested. But the pace of privatization post-FESAL II was slower than envisioned in the Letter of Development Policy. The negotiations for the sale of the Bulgarian Telecommunications Company fell through. The attempt to privatize Bulgartabac-large tobacco holding company-failed. Another factor slowing the privatization was a Government review of the privatization program and the subsequent Parliamentary approval of amendments in the Privatization Law to improve the transparency of the process. The Government put in place the legal and regulatory framework for energy restructuring, including the unbundling and privatization of the National Electricity Company.

Concerning (b) *financial discipline on the SOE sector*, through the isolation program, all 48 SOEs exited; 32 were privatized, 13 were liquidated, and 3 were placed under bankruptcy proceedings. The exiting of the SOEs significantly reduced the risk of Government funding of SOE losses. As a conditionality of FESAL II, many of the loss making energy and infrastructure SOEs increased tariffs and divested non -core assets which improved their financial results. The district heating companies, railways and coal mining companies running losses submitted restructuring plans. The Government put in place actions to ensure that major source of funds to the SOE sector --the National Electricity Company. the gas company, the tax office, the National Social Security Institute and the banking system imposed financial discipline on SOEs. The Government initiated reforms to improve the liquidation process for SOEs and court administered insolvency procedures.

(c) *Reforming the banking system*: Conditionalities included the completion of two bank privatization transactions and the preparation of three other bank privatizations. Privatization transactions for four were completed. The fifth

fell through and a new procedure is under way. By the end-2000, the share of the private sector in the banking system had increased to 86 percent from about 50 percent in mid-1997. The Bulgarian National Bank (BNB) continued the process of upgrading its banking supervision capacity. In addition prudential regulations were improved, including the issuance of regulations on consolidated supervision. The government and the BNB successfully dealt with the problem of lack of progress in the liquidation of banks that were under court supervised bankruptcy procedures.

(d) *Energy restructuring*: A Law on energy and energy efficiency was passed by the Parliament, a State Commission for Energy Regulation was established and NEK was unbundled. In addition NEK raised electricity prices twice in 1999. The Parliament approved a District Heating Strategy acceptable to the Bank. Post FESAL II there were delays in implementation of the privatization component of the energy restructuring plan.

4. Significant Outcomes/Impacts:

The privatization of SOEs and state-owned banks broke the link which caused the quasi-fiscal deficit and money supply to increase so rapidly in the past. It also set the stage for private sector development and continued growth.

5. Significant Shortcomings (including non-compliance with safeguard policies):

At the time the project was approved there was a substantial body of evidence from other transition economies to indicate that some privatization processes for SOEs can impede private sector development. In Bulgaria, the FESAL II would have been a stronger project if it had drawn on this evidence and had specified more clearly the details of the privatization process. In particular, it would have been useful to more firmly ensure that privatization processes brought in new management and ownership, rather than rely on buyouts by management and employees to any great extent. In Bulgaria's case MEBOs were favored for a range of purchases which evidence indicates are not as likely as other privatization modes to bring injections of management and capital to restructure SOEs. Another issue relates to the post-privatization constraints placed on enterprises. The largest loss-making SOEs were handled by the Privatization Agency. 90 percent of privatization agency deals included investment commitments and employment arrangements. This will further slowdown restructuring and adjustment needed by many of the enterprises.

Considering banking sector reforms, although 80 percent of bank assets are now privately owned and credit to the private sector has increased, IMF and Bank documents as well as bankers interviewed in Bulgaria indicated the need for additional reforms for the banking system to function as a financial intermediary. Currently difficulties are encountered in seizing collateral, in assessing the situation of potential borrowers, and from a Commercial Code that indicates no order of priority for payment of creditors. These issues could not necessarily have been addressed at the time the loan was designed but they have diluted the impact of FESAL II.

Aside from these a number of broader issues concerning governance were not adequately addressed in the Bank's country assistance strategy. With the backstopping by the IMF on the privatization agenda (and successful implementation of the IMF program), the Bank had a certain degree of freedom to expand the reforms in areas complementary to privatization itself. Thus, the Bank had the flexibility to move on to address governance, judicial reform and related issues. Admittedly these were beyond the scope of FESAL II, but they could have been addressed in a separate adjustment operation. The lack of progress in these areas also reduced *ex-post* the relevance and efficacy of FESAL II.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Moderately Satisfactory	Please see para 5.
Institutional Dev.:	Modest	Modest	A substantial amount needs to be done before new institutions have the desired impact on the economy. Newly privatized banks operating in the absence of an adequate judicial and legal framework are not yet engaging vigorously in new lending.
Sustainability:	Highly Likely	Likely	Concerning the SOE and financial sector reforms, privatization and liquidation of SOEs is unlikely to be reversed. However, a number of complementary reforms are needed for satisfactory private sector development. In addition, the prevalence of MEBOs and constraints

			imposed by post privatization employment and investment agreements could pose some risk to sustainability and they might reduce growth and employment benefits to the economy and lessen support for reforms over time. In the energy sector, follow-up actions have to be taken before institutional arrangements will deliver their mandate. For instance, even though enabling legal and institutional structures are mostly in place, the only element of competition envisaged in Bulgaria's electricity market in the foreseeable future is the bidding process for new capacity.
Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Satisfactory	Satisfactory	
Quality of ICR :		Satisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

First, complementary public sector reforms for private sector development need to be addressed. Second, it is important to focus on the quality of privatization which will affect private sector development in the future. Third, close collaboration with partners (such as the IMF) can help the agenda to move forward. Fourth, adjustment lending instrument (together with partners) can lead to reform progress in politically sensitive areas such as energy because of the involvement of Government institutions beyond the energy ministry.

8. Assessment Recommended? ● Yes ○ No

Why? It was part of a package of four loans that should be assessed as a cluster to understand the Bank's involvement during the transition in the financial and enterprise sector in an economy with stop-and-go policies. The loan raises interesting coordination issues with the IMF. The audit will be useful for Bulgaria Country Assistance Evaluation.

9. Comments on Quality of ICR:

The ICR is of satisfactory quality. However, the ICR could have tracked the outcomes in the three levels on which privatization was pursued (privatization agency, line ministries and mass privatization). It could have highlighted the use of MEBOs, investment commitments and employment arrangements in the privatization transactions. The implementation of conditionalities in the all important energy sector could have been further elaborated in the main ICR. This sector has enormous implications for macro/fiscal, social and private sector development. Finally there is no mention in the ICR of the loan amount. Project costs and financing are listed as 0.0 in all columns of annex 2.