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CONCENTRATION OF CAPITAL IN THE PUBLIC JOINT-STOCK COMPANIES, PROTECTION FOR THE INVESTORS AND THE CAPITAL MARKET: 1997-1999

In the period 1997-1999 in Bulgaria is imposed a tendency towards concentration of the capital in the public companies. The mentioned factors and carried out analysis give a reason for conclusion that this tendency is provoked by the insufficient protection of the people's rights and the institutions which provide the firms' resources. The normative system and the practical law execution in the studied period cannot give sufficient certainty that the resources provided to the firms by their shareholders and creditors are used effectively, in long-term interest of the firms and all shareholders. All this, as well as the passive role of the state, allows the creation of an environment that motivates the personal benefits of the managers or part of the shareholders on account of the firms and the other shareholders.
The mentioned weaknesses lead to limitation of the economic growth, trouble the development of the financial markets and the financial mediation, destimulize the insurance institutions and the savings.

JEL: E22; L33

The public joint-stock companies have been established in Bulgaria as a result of the proceeding of the first wave of mass privatization. During that process the establishments of the structure of property has been sporadic and in some way random, still not a consequence of the impact of long-term factors. As an effect of this, in a great respect it was clear, that a restructuring of the property was forthcoming. After the completion of the first wave it was convenient to expect (at least theoretically) either a tendency to partitioning of priority and strengthening of the share-holding form of priority (which is in accordance with the tendency in the developed countries) or, on the contrary, a tendency of concentration.

Explicit official data for the structure of property is not published due to specific normative regulations of the action of Central Depository, which does not allow public access to the information in the books of the shareholders. Despite this, indirect data indicating the development of the process of restructuring of property, can be acquired on the base of information found in the records of former privatization funds, which are accessible in the public register of the State Commission of Bonds.

Short after the end of the first wave of privatization trades (September 1997) and the opening of the Bulgarian stock exchange – Sofia (November1997), the situation with the share-holding type of participation in public joint-stock companies was denoting characteristics of dispersed property. In general the privatization funds were normatively limited to acquire up to 34% of company's capital. As a result of this, as well as of the specific procedure of acquiring shares through

contest trades, practically it showed up, that 2,3, or 4 privatization funds have invested in almost all the companies. Meanwhile, the state remained one of the biggest owners with s6ubstantial part in most of the companies. Moreover, in every company there have been tenths or hundreds minor shareholders, who acquired their shares through preferences, given to the employees of the company, but also through the conducted trades. As far as the privatization funds, there the property remained totally dispersed. As a result of the manner, in which they were formed and the mechanisms, by which there capital was accumulated through investment bonds the property of the privatization funds was characterized by a great number of insignificant shareholders, who separately owned a small part of the fund's capital.

A more general picture of the distribution of capital to the moment of conclusion of the trade sessions of the first wave of mass privatization can be observed in Table 1. In it are shown the statistical characteristics of the relative portions of capital, which are possessed by separate categories of shareholders. On this stage the basic categories are four. They include the state as a shareholder, the workers and employees of the companies, who acquired preferential shares, as well as individual shareholders with shares from trades and privatization funds.

Table 1

Distribution of the companies' capital after the first wave of mass privatization (Miller)

	Mean	**Minimal**	**Maximal**	**Standard deviation**	**Mode**
The state	40.8	9.6	96.8	25.8	10.0
Involved in privatized companies (%)	6.4	1.0	9.0	2.2	6.7
Individual (%)	12.9	0.0	81.2	18.4	0.0
Privatization funds (%)	39.9	0.0	81.0	24.3	0.0
Privatization funds for companies	2.3	0.0	18.0	1.7	2.0

In the past two year period – till the end of 1999, a serious change in the structure of property occurred practically in all companies, which are connected with the mass privatization. It occurred in the privatized companies as well as in the privatizing funds. This is unquestionably supported by the data.

In Table 2 it is displayed how the number of the ownership from the investment portfolios of the top 16 privatization funds[1] has changed. From the data

[1] These are the funds, which have succeeded to recruit resource greater then 1 billion investment bonds and because of that their behavior is determinant for the processes that

it is well clear that absolutely all of the considered funds have reduced the number of companies, in which they were possessing shares. The relatively big reduction of the number of companies is noteworthy. In most of the cases this happened rapidly – mainly in the period from the end of the trading sessions (September 1997) till the mid 1998.

Table 2

Number of companies in the investment portfolios of the funds

Fund	To 09/30/1997	To 6/30/1998	To 12/31/1998	Growth 31.12.1998-30.9.1997
Bulgarian-Holland PF	112	95	91	-21
KPF “Yug”	53	37	24	-29
OBPF “Doverie”	175	115	82	-93
ONPF “Zlaten Lev”	67	45	36	-31
“Petrol Fond”	66	33	29	-37
PF “AKB Forec-Socialen”	80	38	36	-42
PF “Aktcioner Favorit”	97	67	60	-37
PF “Albena Invest”	84	NA	29	-55
PF “Bulgaria”	88	50	19	-69
PF “Industrealen Capital”	21	10	9	-12
PF “Mel Invest”	73	56	NA	-17
PF “Multy groupelit”	36	27	25	-11
PF “Neftochiminvest”	34	22	NA	-12
PF “Orel Invest”	38	24	24	-14
PF “Sveta Sofia”	55	46	48	-7
PF “Severcoop-Gumza”	68	51	NA	-17
RMPF “Trud I Capital”	91	61	54	-37
Central PF	49	21	21	-28
Mean	71.5	46.8	39.3	-31.6

NA – no record.
Source: The informational catalogs of the respective firms.

The process of decreasing the number of companies in the investment portfolios of the funds is accompanied with the growth of the share packets, which

followed the mass privatization. The remaining 63 funds have possessed in total with less then 40 % of the bond resource. As a whole their behavior is similar in respect of the processes considered in the article, but accurate data can not be provided, because of the lack of explicit publicly accessible information.

are left in their portfolios. This can be observed in Table 3. It displays the sizes of the companies' average share packets, which are possessed by the funds to that moment. With the exception of ONPF "Zlaten Lev", where the average stake decreases insignificantly, and also PF "Orel Invest", where this stake is practically unchanged, in all the other funds the average share packet, which the fund possesses, is enlarged. Of course, this growth varies from fund to fund, but the data is indicating. PF "St. Sofia" has the smallest growth (excluding PF "Orel Invest") and it is equal to 2.0 percentage points, and PF "Bulgaria" has the highest, which equals 28.7 percentage points. The mean growth for this group of funds is 7.4 percentage points.

Table 3

Mean size of the fund's portion in the companies of their portfolios (%)

Fund	To 09/30/1997	To 6/30/1998	To 12/31/1998	Growth 31.12.1998-30.9.1997
Bulgarian – Holland PF	16.6	18.7	20.5	4.0
KPF "Yug"	17.8	17.4	21.4	3.6
OBPF "Doverie"	22.1	34.8	30.2	8.1
ONPF "Zlaten Lev"	17.2	NA	15.4	-1.8
"Petrol Fond"	21.2	26.5	31.0	9.8
PF "AKB Forec-Socialen"	20.9	32.0	30.8	9.9
PF "Aktcioner Favorit"	9.6	12.4	14.2	4.6
PF "Albena Invest"	17.4	NA	36.3	18.9
PF "Bulgaria"	17.0	16.7	45.7	28.7
PF "Industrealen Capital"	17.1	24.3	23.6	6.5
PF "Mel Invest"	22.5	25.6	NA	NA
PF "Multygroupelit"	18.8	21.8	21.6	2.8
PF "Neftochiminvest"	20.1	23.8	NA	NA
PF "Orel Invest"	14.6	16.7	15.0	0.4
PF "Sveta Sofia"	17.5	17.4	19.5	2.0
PF "Severcoop-Gumza"	19.3	29.1	NA	NA
RMPF "Trud I Capital"	20.1	25.6	27.8	7.7
Central PF	14.3	16.3	20.5	6.2
Mean	18.0	21.8	24.9	7.4

NA – no record

Table 4

Distribution of the numbers of companies regarding the participation of the respective fund

Fund	To 30. 09. 1997				To 30.06.1998				To 31.12.1998 г.			
	Over 50%	From 33.3 to 50%	From 10 to 33.3%	Under 10%	Over 50%	From 33.3 to 50%	From 10 to 33.3%	Under 10%	Over 50%	From 33.3 to 50%	From 10 to 33.3%	Under 10%
Bulgarian – Holland PF	0	24	47	41	3	19	42	31	8	16	35	32
KPF "Yug	0	8	26	19	0	4	22	11	1	4	14	5
OBPF "Doverie"	0	53	87	35	12	46	37	20	14	46	7	15
ONPF "Zlaten Lev"	0	15	28	24	0	12	20	13	2	4	12	18
"Petrol Fond"	0	15	40	11	5	8	12	8	8	6	8	7
PF "AKB Forec-Socialen"	0	32	26	22	5	17	8	8	5	17	7	7
PF "Aktcioner Favorit"	0	11	23	63	2	9	13	43	4	7	11	38
PF "AlbeNA Invest"	0	19	34	31	NA	NA	NA	NA	12	1	10	6
PF "Bulgaria"	0	6	61	21	0	2	35	13	10	1	8	0
PF "Industrealen Capital"	0	5	7	9	0	5	3	2	0	4	3	2
PF "Mel Invest"	0	28	30	15	9	15	25	7	NA	NA	NA	NA
PF "Multygroupelit""	0	4	25	7	2	3	15	7	2	3	14	6
PF "Neftochiminvest"	0	9	20	5	2	6	12	2	NA	NA	NA	NA
PF "Orel Invest"	0	6	16	16	0	6	8	10	0	6	8	10
PF "Sveta Sofia"	0	14	19	22	1	10	14	21	4	9	14	21
PF "Severcoop-Gumza"	0	16	33	19	3	13	25	10	NA	NA	NA	NA
RMPF "Trud I Capital"	0	22	48	21	5	18	24	14	8	14	17	15
Central PF	0	5	21	23	1	3	13	6	2	1	12	6

NA – no record.
Source: Own calculations based on the prospects of the privatization funds.

In Table 4 is shown the number of companies in the investment portfolios of the funds according to their participation in them. From here we can definitely examine the change in the structure of the portfolios. There is a tendency of expansion of the participation of the funds in the companies, in which they have shares. It can be seen from the data that the funds were seeking to get rid of the minor packets (the number of companies, in which the fund's share in the capital is less then 10% decreases). A tendency of acquiring the major or at least the controlling share packages can be observed (the number of such packets increases).

The limitation allowing to posses up to 34% of the capital of a given company expired, when the privatization funds reformed their activity into holding companies. Than it became possible for the funds to acquire the major share packets and to start active exchange and sale-trade of the packets they possessed. In the transactions, two funds were exchanging between each other shares from companies, in which they participated, and which were evaluated at the same price. This way the funds were closing their investment positions in one company, while they expanded the investments in another. Principally in most occasions, the funds, while purchasing were trying to expand and strengthen their participation in a certain company, and in fact they did not open new investment positions in their portfolios. Beside this, they (in many cases a group of funds altogether) were sailing mostly to strategic investors or to other funds. A great part of the exchanges or sales to strategic investors were formulated as future contracts with the potential purchasers even before the opening of the trading sessions. Certainly this can explain the relatively high speed at which the funds restructured their portfolios in conditions of not particularly active capital markets.

This process leads to substantial changes in the structure of capital of the public companies. In Table 5 is summarized the concentration of capital until mid 1999 for all the public companies.

Table 5

Concentration of property in the public companies up to 30.06.1999.

Characteristics	Number of companies
The biggest owner owns more then 66.7 % of the capital	257
The biggest owner owns between 50% and 66.7 % of the capital	357
The biggest owner owns between 33.3 % and 50 % of the capital	298
The biggest owner owns less then 33.3 % of the capital	230
Including companies, where the biggest owner possesses less then 10% of the capital	51

Source. Central Depositary.

The data in the Table shows that in 1999, already 257 public companies, which is 25% of the whole number, are entirely controlled by a single owner. Another 35% have a major owner, who can make decisions on his own for practically all the problems considering the company with the exception of special cases, which according to the Trade Law require qualified majority. In another 30% of the public companies the major shareholder possesses a blockage quota and is in the position, if he decides, to stop all the important decisions in the company. Depending on the structure of capital of the other shareholders, this owner can play a very important role. In case that the rest of the property is dispersed, he could even entirely control the company. From the Table it is clear that only 5% of the joint-stock companies do not have a shareholder, which possesses more than 10% of the capital. Only in these companies we have the reason to say that there is no such shareholder that dominates with his decisions over the rest.

The fact that clearly expressed tendency to concentration of capital can be observed may not be surprising. Despite this, what are the major reasons for exactly this tendency, and not a tendency to separation of property, to be established? Here should be mentioned that the mass privatization, which due to public companies and capital market in its present form, as a government program had other goals. In the process of transformation of property the program's goal was to engage a wide range of participants, to accomplish a more disperse structure of property, and to construct an active capital market.

The major reasons for accomplishing a fundamentally different result are the problems with corporate governance and control[2] of joint-stock companies in Bulgaria, as well as the insouciance of the state's economic policy with the development of the capital market. The problems of corporate governance and control arose from the imperfect normative environment and especially from the practical standards, applied to the current stage of development of Bulgarian firms. It shows up, that during the discussed period (and now also) the normative base, the style of carrying out business, and the way, in which the greater part of the economic subjects in Bulgarian economy function, is such that the rights of those, who provide the resources are not well protected. Because of this, the managers, who govern the resources, or separate major shareholders, who deal with the firm's problems in their interest, are able to gain benefits for themselves in favor of those, who provide the resources. In different respects this holds as for the shareholders with personal capital in the firms, as well as for the trade banks, which provide the lent capital.

The establishment of an environment, in which the rights of the investors are insufficiently protected leads to high-degree of risk and finally to unsatisfactory

[2] The tern "corporate governance and control" must not be understood as firm management. Here it means a set of relationships emerging between individuals and institutions, the one that provide the resources one side and the firm and its manager on the other. In this context the most commonly addressed relationships are those between the shareholders and the firm, presented by its managers. But the term has a wider meaning, which includes not only the shareholders, but also other basis for resources for the firm.

development of the financial markets. The logic is as follows. When the investors decide that they are well protected from misappropriations and deceptions with their revenues, they are tend to asses and pay more for the rights, with which the firms provide them through emission of shares and obligations. They encounter the fact, that in such case the greater part of the profits will be transferred to them in the form of dividends or interests. On the contrary, if the investors are not well protected, they will encounter the higher degree of risk for the firm's resources not to be fully utilized, but to be used for other purposes. This decreases their inclination to provide means for the firms and thus, in equal other conditions, they would have paid less for their rights, which are provided to them by the possession of corporate bonds.

In this way the good normative and practical protection of the investors increases the price of the corporate financial instruments. This on its term allows the enterprisers to better finance their projects through outer sources. Finally, this leads to expansion of financial markets, to diversification of financial instruments, to consolidation of the exchange on those markets, to development of financial stockbrokers as institutions. Or in other words, the degree of protection for the investor's rights is an important determinant for the development of the financial markets. Where the normative base and the application of low guarantee the rights of the outer investors they are tend to finance the firms. Thus, the value of the financial instruments is higher, the financial markets are wider and deeper and create more value. On the contrary, where there is not a good protection for the investors the markets are underdeveloped and are not able to substantially support the economic growth. In such circumstances the financial intermediation is reduced mainly to traditional banking, and the savings only to bank deposits. A number of contemporary analyzers of the finical structures have reached to conclusions of the same nature. For example La Porta, Lopez-de-Salinas, Shlaifer (1999), Vishny (1997) on the basis of comparative analysis in their researches have determined that the differences between different countries, in respect of their law structure and law application, play decisive role in the development of their financial markets. The influence of the law basis on the efficiency of the investors can be seen in the research of Rajan and Zingalis (1998).

The mechanisms of corporate governance and control, which create protection for those, which provide the firms with resources are principally of two kinds – inner and outer. The inner ones include three basic components. The first one includes the set of rights of shareholders – to take part in the general meeting of the joint-stock company and to vote, to elect members of the administrative organs, to receive dividends and liquidation quotes, to participate in the accumulation of the company's capital, etc. The second component consists of the system of responsibilities of the administrative organs towards the company and its shareholders and a system of monitoring the administrative organs' activity. The third component is the quality of financial and non-financial information, which is acquired by the administrative organs for the purpose of making administrative

decisions, as well as from the shareholders of the company for the purpose of their investment decisions.

On their side, the outer mechanisms of corporate governance and control include the basic opportunities for practically achieving "overtaking" (purchasing) of the company, the efficiency of the system of justice, as well as the possibilities for monitoring the activity of the company by its creditors.

On the current stage the inner as well as the outer mechanisms of corporate governance and control do not yet provide good and reliable protection for those, who supply the firms with resources. The major problem is essentially the real application of law and the definite action of the mechanisms for control in practice. Despite the formal regulations, many of the rights of the shareholders and the creditors meet particular difficulties in realization. For these difficulties constitutes the incomplete normative organization, the ineffectiveness of the system of justice, and the lack of experience and resources by the regulative institutions.

During the considered period it was possible for the rights of the shareholders to be effectively limited in many aspects without this coming in conflict with the normative organization. This refers to the smallest fundamental rights inclusively. Such right is the right to participate in general meetings and the right to vote. The normative organization, which was acting during the considered period, did not explicitly state the place and the time of holding general meetings of the shareholders. This gave the administrative organs the prospect to chose a place and time for holding the general meeting, such that would prevent a part of the shareholders from attending. As a result of such actions it becomes possible for the administrative organs or part of the shareholders to actually manipulate the decisions at the general meetings, when consciously obstructing the shareholders in exercising their right to attend and to vote at the general meetings[3]. The right of the shareholders to organize themselves was also not well protected. This practically impeded their ability to influence the administration of the company. The reason for this is that the regulation of the activity of Central Depositary did not allow the shareholders from a company to access information for the other shareholders, nor was this a normative obligation to the administrative organs of the company.

Another right of the shareholders, which was not defended during the considered period, was their right to participate in the accumulation of capital of the company. The accumulation of capital in conditions of emission price, which does not represent the actual value of the shares, constitutes to a practice of damaging the shareholders' interests. The latter are not let to participate in the emission, because the value of their share partaking "perishes". When one or a group of shareholders manage to navigate such a decision on the general meeting, this would let them amass benefits on behalf of the rest of the shareholders and the company.

The prospects of the minor shareholders to affect the elections for administrative organs of the company are very slim. The normative organization

[3] In many cases general meetings of public companies have been held in places, where the access for the shareholders has been seriously obstructed – for example, places where there is no public transportation interface, or even abroad.

concerning the rights for voting defines a proportional vote for each separate member of the administrative organs. In fact, this way a shareholder, which owns 50% of the capital, (or even less) is usually able to predetermine the choice of administrative organs. This way a major shareholder can carry out management policy working in his favor, which would violate the interests of the other shareholders of the company. In general, the balance of interests and rights between major and minor shareholders definitely remains disrupted in the considered period. There are a number of cases, in which the major shareholder imposes a way of development for the company, which conforms only to his interests, and not to those of the remaining shareholders, not even to those of the company itself. It should be mentioned that in such an environment it shows up that it is extremely difficult not only for the individual, but for all the minor shareholders to protect their rights[4]. In general this also sustains for institutional shareholders such as investment, pension, and insurance companies, which are portfolio investors, and their activity is characterized as passive.

The system of responsibilities of the administrative organs of the companies also does not contribute for the protection of the investors and the creditors. The practice during the considered period is overflowing with cases, in which the managers consider themselves as single owners and do not regard the other shareholders as actual possessors of the company. Their attitude is strongly furnished by the business environment, which in many cases makes the business "personalized". Very often the managers develop a system of relations with the respective institutions. This makes them very much independent, because of the informal character of the establishment of those relations. Their closeness with politicians, municipals, local taxation administrations, justice system, hygienic organs, ecological inspectors, etc. more often than not shows up to be personal. This way the business of the company is "personalized", because it depends on the private contacts of the particular manager.

Of course, each manager has to be in a certain degree independent and to be of special value for the company. But here we are talking about different values. In the ideal case the good managers possess many qualities considering their knowledge of the specificity of the markets and the effectiveness of the production. The problem is that a great part of the present generation of managers has been motivated not to develop those abilities, but instead to develop the so far mentioned relations and to attempt to "personalize" the business. This objectively hinders the development of the market of "managerial labor" and makes difficult the restructuring of the company. It also creates real potentials for the company's interests to be violated by its managers for their own benefit. The damaging of

[4] The battle for the control over the company "Deckotex Carpet", where the victim of mendacious actions was a foreign investor, the scandal for the general meetings of "Novotel – Plovdiv", the struggle for the overtaking through manipulation the control over the former privatization funds "Bulgarian-Holland" and "Otechestvo" are only a small part of the cases of negligence and insufficient protection of the investors rights, which have gained publicity.

company's interests was most drastic in the period when the companies were state or partially state share property. During that period in one or another form a great part of them were pillaged and exhausted of capital in order to satisfy personal interests, concerning the managers.

Another element of the dangerous set of problems is when the managers act not only for their own interest, but also on behalf of a particular shareholder, while ignoring the others. In this case the effect is the same – private benefits for that shareholder and for the managers, while sacrificing the company and the other shareholders.

Meanwhile, the responsibility of the administrative organs concerning the effective governance of the business and the protection for the interests of all the investors and creditors of a company is only fairly mentioned or even missing from the active normative system. In practice this responsibility is restrained to monetary guarantee that usually can not recover the losses, which the company may suffer during a potential bad management.

Formal norms and criteria, to which the individuals participating in corporate governance should be subjected, are missing on that particular stage. There are no clearly stated division between the authorities of the organs of administration – executive management, council of directors, monitoring council, and general meeting of the shareholders. The system for distribution of the rights and responsibilities of those organs is usually "ad hoc" and indicates a concrete proportion between the authorities and the interests, which can often remain "behind the scene". The administrative organs are not expected to declare potential contradiction of interests, nor they have any restrictions when voting if such conflicts occur. They do not have the responsibilities or the restrictions to manage business in a way that minimizes the risk for the shareholders.

In respect of the quality of information, which the companies provide to their shareholders and potential investors, numerous drawbacks can be suggested. Primary during the considered period a major part of the public companies did not fulfill the normative requirement to submit periodic information to the Commission of Bonds and Stock Exchanges (CBSE[5]). Likewise, the contents of the submitted information did not have the proper normative organization. Besides this, the access to this information was not as quick and as easy as it should have been, in order to satisfies the needs of potential investors and shareholders in making investment decisions.

Specific attention should be paid to the information, which the auditors render to the company. Basically they are the most important source of impartial information, which enables the shareholders and potential investors to assess the position of the company. Meanwhile, the auditor's obligation to the shareholders for the reliability of the performed inspection and the given assessments is not adequately well regulated. Very often this reflects in insufficient and incorrect

[5] When the Law for public offering of the bonds was passed in Feb. 2000 the institution was renamed as State Commission of Bonds (SCB).

information provided to the shareholders. This way can be created an environment, which enables malfeasance.

Besides the auditor's responsibilities remains the question about the compatibility of the national accountant standards with the international. The presence of substantial discrepancies in this aspect definitely hinders the interests of the international investors[6].

The outer mechanisms of corporate governance and control are also not successfully developed during the considered period. The capital market does not play the role of factor, which would discipline, while creating an actual danger of "overtaking" a particular company.

As an outer mechanism the justice system plays a great part in the corporate control, because it is associated with the inscriptions in the trade register, as well as with the bankruptcy procedures. During the considered period there are controversial actions in both directions. The actions are associated with peculiar decisions, which lead to violating the rights of the shareholders and the creditors. An example in this direction is the years long obtrusion of the bankruptcy procedures for the closed during the financial crisis of 1996 banks. Regarded from a wider perspective, this is one of the most severe common problems of the economies in transition – the lack of adequate justice infrastructure, which would resolve objectively and perceivably the complex business cases.

The economic subjects act rationally, and that is why it is not extraordinary that from the so far described circumstances emerged the effect mentioned in the beginning of the article. Those, who desire to have an actual influence on the management of the firms attempt to acquire the majority of the property in one or another way. Meanwhile, those, who are minor shareholders, do not retain mechanisms through which to induce increase for the value of their investments. This inclines them to release them relatively easy. This way is formed an environment, in which the concentration of property is a natural tendency. Similar conclusions about the conditions, from which such a tendency emerged, can be found in the works of a number of economists such as Grossman and Hart (1988), Zingalis (1995), La Porta, Lopez-de-Salinas and Shlaifer (1999), Bebchuk (1999). In the quoted articles is analyzed the way, in which the big private benefits from the control are usually connected with the low degree of protection for the shareholders. The aftermath of this is a huge consolidation of the property. The influence of the normative environment over the structure of property is also researched by Claessence, Djankov, Lang (1999).

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The high degree of concentration of capital together with the lack of protection for the shareholders and creditors, leads to weak market of corporate

[6] The problems of corporate governance and control from the perspective of institutional actions are discussed in a publication of the Center for Researching the Democracy, 1999.

bonds and respectively to weak capital markets. The reason for this is that the firm's outer investors will restrain themselves in providing financial resources (in other words, to invest in shares or corporate debt), whenever they decide, that there is a risk for their rights not to be fully protected. When such an environment is settled permanently, a great part of the investors do not have interest to participate in the capital market. Those, who have taken part are tending to quit. As a result of this a small underdeveloped capital market, which leads to scarcity of investment capital can be expected. This on its term means, that the firms and the economy have limited growth, as a result of the scarcity of investment capital. The effect is further consolidated by the specificity of the Bulgarian capital market, which was established in somehow artificial way.[7]

When the market of corporate bonds is weak, the investors are either not going to invest in the firms at all, or are going to expect the presence of a high level of risk and are respectively going to insist on high rate of return for their investments. Rate, which corresponds to the risk. For the firms this means, that they are either not going to be able to recruit capital from the market, or for those, which somehow manage to do so, the capital will be relatively expensive, because they will have to ensure high rate of return for their investors. Moreover, this means that in general the firms would be lowly evaluated at the market, because at a particular level of expected dividends and capital profits, the higher required rate of return, will mean lower price[8]. In this respect the following comparison between two of the countries in transition is indicating – Poland, which is accepted as a good example in terms of protection of investors rights and regulation of capital market, and the Czech Republic, which is more likely considered to be the opposite case. According to the data of the stock exchanges of both countries, in Poland during the 1996-1998 period, 101 private firms have emitted shares through the Warsaw stock exchange and have attracted capital of the size of 2.5 billion US dollars. For the same period in the Czech Republic, not a single firm has attracted investment capital in that way. The situation in Bulgaria is similar. To this moment there is not a case of a firm from the real sector to have made initial public emission of shares. There are just a minor number of cases of accumulation of capital. This accumulation is usually undertaken from the firm's inner investors, and only a few emissions of corporate obligations in limited size.

In case the firms and the economy are not able to financially support themselves through the capital markets, they will eventually develop other ways for financial support of the business. If this holds, the bank financing is an obvious possibility, but this alternative is in no respect problem free. When the financing of

[7] For the role, which the specific way of occurring of the capital market in Bulgaria plaid for its development see Петранов и Милър, 2000.

[8] The presence of dependency between the structure of property and the value of the firm is investigate by Demzetz and Lehn (1985), Morck, Shlaifer and Vishny (1988), McConell and Servaes (1990), Holderness, Kroszner, Sheehan (1999). Gorton and Schmid (1999) also do find empirical proofs for the positive effect of the banking property over the value of the firms in Germany

the business is based only upon the banking system, this eventually leads to bank monopoly at the financial markets. The trade banks gain market power, begin to dominate the markets, become financially powerful in terms of financial resources, but also in terms of political support. As a result they usually resist to regulative changes, which would have enforced the markets of bonds.

It comes naturally that the firms in countries with developed markets of corporate bonds are less dependent on bank financing. The trade banks are institutions, which principally are tend to provide floating credit, a credit given only for a certain period of time (usually short), to support financially operations in case of temporary difficulties or seasonal irregularities in production. However, they are not tend to finance risky projects. Such projects are most effectively financed by share capital. This is why in the environment of well functioning markets of corporate bonds, the joint-stock companies, in equal other conditions, are motivated when recruiting investment capital to relay more on shares and less on loaned capital. As a result they gain greater financial stability and flexibility and also the risk is less significant. And what is particularly important – this leads to fewer negative consequences for the joint-stock companies in the cases when they undergo difficulties. Those difficulties are a consequence of inconvenient business situation, because the share capital undertakes the risks of the business unlike the loaned one.

Beside that, the presence of well functioning markets of corporate bonds motivates the joint-stock companies, in equal other conditions, to relay more on outer financing and less on the firm's inner sources – reinvestment of the profit, which on its term gives the opportunity to expand quickly, when the market allows such a prospective. This way there are no more lost (or are lost fewer) opportunities for growth of the firms. All these positive aspects of the financing through shares are missing in an environment similar to this of the considered period in Bulgaria.

Another alternative for financing, which the common practice establishes are the conglomerates. Despite under some conditions, in Bulgaria the former privatization funds, which reorganized their activity as holdings, can be certainly regarded as such institutions. Once established, such conglomerates are subsiding the need of strong markets of corporate bonds, because in such case the financing of the companies can be accomplished through exchanging resources inside the conglomerate. The common practice indicates that the conglomerates also resist regulations and institutions, which would enhance the capital markets, because these regulations inevitably limit and control the trade relationships between connected subjects such as the branches of a company.

The conglomerates are likely to develop dynamically in countries with weak markets of corporate bonds. The reason for this is that they can provide access to the capital, which is essential for the fast-growing companies. However, the conglomerates compared to the firms have lower efficiency and also induce systematic risk, while the firms have a convergent business. Many experts think

that exactly those deficiencies of the bank financing and the inner capital markets, which are created by the conglomerates, are the fundaments of the last financial crisis in East Asia, that broke out in the end of 1997.

When the capital markets do not develop as a component of the financial system, this can have a negative impact on the economic development, not only because the growth of the firms is limited as a result of their inability to recruit long-term investment capital. Most of all the capital market in long-term can remain in rudimentary condition. The problem arises, because many of the institutions essential for the support and maintenance of strong capital markets are in essence endogenous, when concerning the market. For example, if there is no active market of initially, publicly offered bonds, there will be an insubstantial motivation for the investment agents to invest in the reputation and expertise, which is required when promulgating such emissions. The need for developing organized (stock and non-stock exchange) markets, which will impose certain requirements toward the companies. Respectively there will be missing opportunities for the regulative organs to develop expertise, because there will not be any necessity for good accounting standards. This way the economic environment of weak for one or another reason markets of bonds induces a unique equilibrium state. In such state many of the required prerequisites for the presence of strong capital market are missing, and their construction faces a strong opposition from the existing institutions.

Other sectors of the economy will also be negatively affected. From the perspective of the possessors of savings, not developing the capital market will mean lack of alternatives for their savings. They will have to be content with mainly the only form of saving – bank deposits. For them this will mean a low position at the market and respectively low (or even negative) interests, despite the results from the bank's active operations.

Some financial institutions, as insurance (pension, health, etc.) companies will be also negatively affected. They will not have (or will have limited) choice of financial instruments, which to respond to the needs of their specific investment portfolio. In that case those portfolios will be practically restricted to state bonds. Due to the low return rate of such instruments, this will inevitably make the insurance charges relatively high and would not stimulate the financial exchange.

In the 1997-1999 period, in Bulgaria a tendency of concentration of capital is incorporated in the joint-stock companies. The so far discussed facts and analysis give us the reason to conclude that this tendency emerged from the insufficient protection for the rights of the subjects and institutions, which provide the firms with resources. The normative organization and the actual application of laws in the considered period can not guarantee a sufficient level of safety, in order that the resources provided to the firms by their shareholders and creditors to be used effectively in long-term interest for the firms and for all of their shareholders.

The weaknesses in the normative base and in the application of law, as well as the lack of experience and resources of the regulative institutions and also the

passive role of the state, regarding the development of capital market, provide the opportunity to create an environment, that motivates the managers or part of the shareholders to amass personal profits on behalf of the firms and the remaining shareholders. Such an environment is sTable and makes the functioning of the markets of corporate bond impossible and obstructs the developing of the financial markets. As a result the firms are unable to effectively recruit relatively cheap, long-term investment capital, despite the high level of liquidation of the financial system and the banking system in particular.

All this limits the economic growth, because it makes the investment capital relatively expensive, obstructs the development of financial markets and financial intermediation, discourage the insurance institutions and the savings possessors.

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