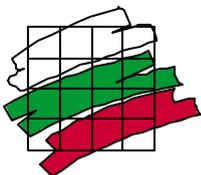


BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 1996

ANNUAL REPORT



**AGENCY FOR ECONOMIC
COORDINATION & DEVELOPMENT**

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I. THE WORLD ECONOMY IN 1996

The world economy in 1996 sustained some of the positive trends that emerged in 1995. GDP growth in the world as a whole in 1996 was about 2.4% (3.2% in 1995) according to the preliminary estimates of the IMF, the Economic Commission for Europe (ECE), the European Union (EU) and the Organisation for Economic Co-operation and Development (OECD). The decline of GDP growth rate relative to 1995 was determined by the aggravation of a number of macroeconomic parameters in the European Union and the least developed countries in Africa and Latin America. The developing economies, including the newly industrialised countries in the Asia-Pacific region and China, registered accelerated growth due to their export-oriented model of development and active participation in the international economic relations.

In 1996 GDP growth in the developed market economies of the OECD member states ran at about 2% with the American and Japanese economies registering the highest growth rates. Economic growth in the USA (2.1% according to IMF data) was a result of the developments in the spheres of monetary and fiscal policies (the adoption of less restrictive monetary policy designed to lower short- and long-term interest rates), the reduction of budget deficit by 1.9% and the increase of money stock leading to stability of the velocity of money circulation. 1996 saw further busy talks between the President and Congress regarding the federal deficit and planned social expenditures. Low inflation (2.1% according to OECD and IMF estimates), the unessential rate of unemployment (5.5% of active population) and the intensification of the industrial branches with a high rate of value added were among the other macroeconomic indicators that directly influenced GDP growth rate in the USA. The strengthening of the established positions of the USA on the capital markets also had an impact, although indirect, on the economic status of the national economy.

Most forecast offices are optimistic about the development of the American economy in 1997. Their estimates show a steady GDP growth rate of about 2.2 - 2.4%. No sharp deviations of the main macroeconomic indicators are expected and

the country will preserve its leading positions in the world economy.

In 1996 Japan strengthened its leading position among the OECD member countries by values of the main macroeconomic indicators: GDP growth rate of about 2.2 - 2.4% (OECD) and 3% (IMF), 6% increase of industrial output, unusually low inflation (-0.3:-0.1% (OECD); 0.1% (IMF)) and 3.3% unemployment (OECD, ECE and IMF) and an active balance of trade (1.8% of GDP - IMF and OECD estimates). Forecasts for the development of the Japanese economy in 1997 are exceptionally favourable. Expected GDP growth rate is to hit 3.2% and the rates of inflation and unemployment are to sustain their low levels compared to all other developed market economies. Japanese economic growth and the stable macroeconomic environment in the country in 1996 were due to the pursued prudent economic policy of low interest rates, the maintenance of a stable (low) exchange rate of the national currency, tax cuts, the sharp rise of investment activity, the aggressive foreign economic strategy and the active participation of the country in the international economic relations.

In 1996 the macroeconomic indicators of the developed industrialised European countries registered more moderate values compared to the other OECD countries. Gross Domestic Product increased by 1.1% (recording a decline of over 1% relative to 1995), industrial output grew by 3.7%, inflation steadied at 2.6 - 2.8% and unemployment rates remained high at 10.5 - 11%. According to IMF data the balance of trade was negative while the current accounts balance dropped to zero values (OECD estimates). Macroeconomic policy in 1996 was characterised by a further lowering of interest rates in order to stimulate investment, trade on the Stock and Commodity Exchanges, overall growth and cutbacks in budget deficits.

Restrictive fiscal policy, however, may have serious impact on the economy. Thus, unemployment rate - an acute problem for the Western economies varying from almost 22.7% in Spain to 10.5% on average in the EU member-countries - may be increased.

As a whole, the economic policy of the European „industrialised centre“ was designed at preparing the national economies to meet the Maastricht convergence criteria. The necessity of „tolerable“ public finance required the application of com-

plex measures for the maintenance of stable prices and exchange rates, cuts in budget expenditures and certain shrinkage of domestic demand.

Preliminary estimates from most forecast offices show that the business cycle development of the European Union in 1996 was unstable compared to that of Japan and the USA. The second half of the year saw some positive trends in GDP growth due, to a certain extent, to the policy of *Bundesbank* designed to lower interest rates, the slight rise of industrial output in Germany and France since July, the increase of the quotations on the Stock Exchanges, etc. The economic stability of the European Union is of utmost importance to the countries in Central and Eastern Europe (CEE), including Bulgaria, as the EU member states are their main trade partners and investors. Any aggravation of the macroeconomic situation in the region has a direct impact on GDP growth rates in the associated CEE states, leading to a decline in industrial output, unfavourable trade and current accounts balances, lessening of foreign direct investment and declining international capital flows to them.

In 1996 some of the main economic indicators in the CEE countries were more unfavourable compared to 1995. Poland, Hungary, the Czech Republic and Slovakia are the transition economies which have already accomplished the main steps towards a market economy - liberalisation of markets and trade, creation of new businesses, stabilisation of prices and clear regulation of the rights of ownership. GDP growth in 1996 in Poland ran at 5.5% rate, in the Czech Republic - at 5.2%, in Slovakia - at 5% and in Hungary - at 4.8%. According to OECD and the World Bank industrial output in the four countries declined slightly on a year ago. Thus, the increase of industrial production in Poland in 1996 amounted to 5.3% (7% in 1995), in Hungary - 5.2% (5.9% in 1995) and in Slovakia - 5% (7.4% in 1995). All Visegrad states registered trade balance and balance of payments' deficits. At the same time, the foreign exchange reserves of the Czech Republic, Hungary and Slovakia increased by 5.3 bln dollars, 1.2 bln dollars and 0.7 bln dollars respectively due to the inflow of short- and medium-term capitals. The Czech and Hungarian currencies appreciated in real terms and maintained relatively stable exchange rates. Inflation in Poland fell from 22% in 1995 to 19% in 1996, in the Czech Republic it was neg-

ligible, in Hungary it remained moderate and in Slovakia it was about 7%.

The 1996 World Bank Report points out that the economic achievements of the specified four countries were mainly due to the more adaptable structure of their economies, the stability of the key institutions and the ability of their political systems to channel public opinion. Ownership rights in these countries are clearly regulated and the private sector produces more than half of GDP. Foreign direct investment and privatisation play a major role in their economic growth while the governments exercise efficient control over the existing, market-oriented state-owned companies. At the same time, membership in the World Trade Organisation (WTO) gave the Visegrad four access to new markets and provided relative safeguard against the arbitrary imposing of trade barriers. The four countries recognise that integration in the international economic institutions with the respective rights and obligations stemming from it may only foster the the accomplishment of the larger aims of transition.

1996 saw economic transition in Romania further lagging behind transformation in the Visegrad four countries. Reforms proceeded slower without substantial changes in the form of ownership and the implemented social policy lacking large public support.

The values of the main macroeconomic indicators in Rumania in 1996 are the following: industrial output dropped from 6.9% in 1995 to 4% in 1996; annual inflation declined from 28.1% (1995) to 25% (1996); unemployment rose by 1.3 points to reach 10.2% of the active population; the country registered budget deficit of -2.5% as well as deficits in the balance of payments and the trade balance.

According to OECD and the World Bank data, the Russian economy in 1996 continued to overcome the acute macroeconomic disparities and structural distortions created by the existing economic basis (overextended industry, several times higher energy-intensity of production compared to the market economies, the generation of negative value in many enterprises, etc.). Decline-stricken, in 1996 the Russian economy registered some 11% drop of GDP (7% in the first half of the year), and industrial output decreased by over 10%.

On the other hand, inflation in Russia fell sharply from 131% in 1995 to 50.1%

in 1996 (OECD), unemployment (excluding hidden unemployment which is not reported by the national and international statistical offices) remained low, though it grew by another point reaching 9%. In 1996 Russia recorded large surpluses in its balance of trade and balance of payments and the foreign exchange reserves of the Central Bank increased by some 20% in the first nine months of the year. All international forecast offices expect the Russian economy to start stabilising in 1997, to overcome recession and to enter a phase of sustainable growth. According to OECD and IMF estimates, in 1997 industrial production in Russia is expected to increase by 3%, inflation - to fall to 30% annually, unemployment to remain below 10%, the budget deficit to be -3.5% and the balance of trade to register surplus.

The CEE countries and Russia are established trade and economic partners of the Republic of Bulgaria. Our country should follow very closely the economic situation and developments in this region and react adequately to them in conformity with its national interests. The question many economists ask themselves is what growth rates (and what kind of growth) can the former socialist countries maintain. The answer to that question is not simple inasmuch as the factors influencing GDP growth rate in the short-term differ from those affecting it in the medium- and long-term. Evidently, in the short-run the Visegrad four countries emerge as the leading transition economies since they managed to curb inflation quickly, reduced unemployment, and accomplished the necessary structural reforms (especially in the real sector). They succeeded in reforming their legal and financial systems and already maintain positive macroeconomic indicators. In 1996 the economies of the four CEE countries demonstrated that a relatively well functioning financial system may be useful in the re-channelling of resources and property. The prospects for development in the region are determined by the following main factors:

- the availability of qualified workforce and the constant improvement of the educational standards. The ongoing decline of labour resources and the rapid increase of the relative share of pensioners are and will remain serious problems for these countries;
- the accumulation of capital and the theoretically higher rate of return on capital investment;

- the consistent policy of cutbacks in state budget expenditures as percentage of GDP;
- pushing on savings and investment as percentage of GDP;
- joining the international division of labour and speeding up integration processes in Europe.

China and the newly industrialised countries in Asia were the most dynamic economic region in 1996. GDP growth rate ran at 10.5% in China (OECD and IMF), 8% in Thailand and Malaysia, 7.8% in Singapore and 6.8% in South Korea. According to OECD estimates, the average rate of economic growth in the six Southeast Asian countries ran at 6.4%. Most of them registered low inflation and unemployment rates, unessential or zero budget deficits and positive balances of trade and payments.

As in the last decade, in 1996 the priorities of „the four little dragons“ were the high rates of external financing, domestic accumulation, massive export, extensive utilisation of the available capital and commercial resources in the region and assertive market orientation. The political and business elites in these states are clear about the fact that the ongoing trend to globalisation of the world economic system will embarrass every non-competitive market economy. In 1996 the Southeast Asian countries continued the restructuring of their economies aimed at further diversification of industrial structure, the acceleration of technology renovation, the establishment of more liberal market mechanisms and the creation of stable investment-inducing business environment.

The driving-engine of Chinese economic policy in 1996 was the carefully struck balance between the interests (co-operative and private) of the market and the state, the latter always occupying an important place in Chinese traditional values. In 1996 the effect of the initial reform in agriculture was again positive. The partial liberalisation and the development of the non-government sector which have created some 100 mln new jobs since 1978 led to a rapid increase of labour productivity without administering acute measures for the adaptation of the state-owned enterprises. The second reason for the excellent economic results of the Chinese economy was the fact that growth and efficient macroeconomic manage-

ment stimulated a high rate of increase of savings from initially low levels of monetization. Notwithstanding these economic achievements, the economic authorities of the country declare that they will direct their efforts towards: clear regulation of the relations between the state and the various economic agents; improvement of the management and control over government assets; renovation of the social security system and reduction of the heavy financial debts of the enterprises.

Preliminary estimates by the World Trade Organisation (WTO) point to about 7% increase of world trade in 1996. Industrial output has been lagging behind for a sixth year in a row. Data show that the volume of production in 1996 registered some 3% growth, i.e. 0.5 percentage points less than registered growth in 1995. The total value of goods and services traded on the international markets in the first nine months of 1996 reached some 6 000 bln USD.

WTO Annual Report points out to a steady upward trend in the share of the Southeast Asian countries in world trade as well as of Japan due to its strategy aimed at speeding up economic co-operation in the Asia-Pacific Region. The strengthening of the established commercial positions of the USA, the intensification of trade flows within the European Union and the increasing share of the CEE countries were among the other main features of world trade in 1996 according to the WTO. World export increased by some 8% on a year ago and almost reached 5 000 bln dollars. This positive export value was probably due to the depreciation of the USD against the Japanese Yen and the Western European currencies. In 1996 export of services recorded more than 15% growth relative to 1995 reaching over 1 400 bln dollars. The value of exported telecommunication technology and office computers increased by the record 25% on a year ago while trade with raw materials was the most dynamic element of world merchandise trade.

Bulgaria's export in 1996 was about 60% of GDP - a typical value for small and open economies. The National Assembly of the Republic of Bulgaria ratified the Protocol for accession of the country to the Marrakech agreement for the establishment of WTO. Thus, Bulgaria undertook the obligation to adapt its legislation and adjust its trade and economic policies to the WTO principles and regulations. In this way, the integration of the Bulgarian economy in the world trade system will allow

the country to utilise the processes of liberalisation of world trade and the globalisation of production for the accomplishment of specific national economic goals. The liberalisation of world trade with industrial goods, the reduction of customs import rates for industrial commodities in the developed market economies by 40% on average in a 5-year period and the increasing degree of access of Bulgarian companies to the international markets guaranteed by the mechanism for customs duties linkage will create favourable conditions for the restructuring of the Bulgarian industry. Moreover, the clearer and precise regulations set by the multilateral trade agreements will guarantee Bulgaria, as a transition economy, increasing stability, transparent and predictable trade relations and sustainable volume and dynamics of commodity and investment flows thus ensuring more effective protection of the national economic interests.

At the same time, Bulgaria should adopt a more aggressive economic strategy in order to maximise its potential gains from the participation in global trade. The accomplishment of this task requires accelerated restructuring of all industrial branches, and especially promotion of export-oriented enterprises in order to enhance the competitiveness of their products on the international markets, attract capitals and foreign direct investment in particular. □

II. EUROPEAN INTEGRATION

2.1. THE STRUCTURING OF THE EUROPEAN MONETARY UNION

1996 saw the third and final stage in the preparation of European Union (EU) member-states for the structuring of the European Monetary Union (EMU). The December 1995 EU summit in Madrid put an end to the lengthy debates on the timetable for the introduction of a single currency system, agreed on the name of the future currency unit (EURO), and adopted the guidelines for the development of the single market. The Maastricht treaty option for a more rapid introduction of the currency union starting in early 1997 was rejected; the deadline for transition was set for 01.01.1999 which, however, is still under criticism by the opponents of the unification of the members' economic and currency policies.

As of 01.01.1999, the currency basket which serves as basis for the ECU, will cease to exist. It will be replaced by the new currency unit, EURO, which will become a full-fledged currency. The national currencies of EU member-states will have fixed exchange rates to the EURO. No later than 01.01.2002 EURO coins and banknotes will enter into circulation. Six months after that date the national currencies in all members of the EMU will be withdrawn from circulation.

The first group of EMU members will be determined on the basis of the 1997 macroeconomic indicators. On 1996 estimates, the Maastricht criteria on the budget deficit level are met by only six members (EU budget deficit average of 4.7% of GDP instead of the required 3 % of GDP), on the volume of domestic government debt - by four members (the EU domestic government debt total amounting to 71 % of GDP instead of the required 60 % of GDP), on the rate of inflation - by eleven members, and on the interest rate level - by ten members.

The future system of relations between the member-states which can introduce the single currency and the remaining members should prevent the splitting of the Union into two groups: of privileged and second-class members, the latter including the bulk of EU members, especially after the admission of Central and East European countries (CEEC) as full members. The emergence of a community within

the community will threaten the existence of the single market and jeopardise the programme of the economic union. The January 1996 intermediate report of EU says that EU economic policy regulations will be valid for all, and the two groups of members will maintain close links in currency regulation. The mechanism of foreign exchange rates will continue to function during the third stage of EMU until all EU members enter into it.

In case a single currency is impossible to be introduced, Deutsche Bank insists on a fixed DM/FRF parity negotiated between France and Germany in order to stabilise the European currency system.

The French view is that such an alliance will create a currency stabilization axis which will intensify the process of economic rapprochement among the remaining member-states. As far as the Dutch guilder and particularly the Belgian franc are pegged to the German mark, we can speak of the emergence of a currency zone of sorts including Germany, France and the Benelux countries. This alternative was opposed by EU bodies and other member-states since it meant the failure of the single currency and the formation of a zone of influence of the DM.

The outlining of the technical and economic conditions for transition to a single currency and the practical measures for the implementation of a common economic policy were the key issues of the two conferences of the Council of economic and finance ministers ECOFIN held on 15-16 April 1996 in Verona and on 3 June 1996 in Luxembourg. The Verona meeting ended with an agreement on principle for the transformation of the European Monetary System (EMS) introduced in March 1979.

The proposal is the new system to be known as the European system for solidarity and stability, which should be effective as of 01.01.1999 simultaneously with the transition to the third stage of EMU. It is designed as the main instrument for currency integration of these EU member-states that will not be able to introduce the single currency right from the start. The aim of the remodelled exchange rates mechanism is not only to help achieve a greater convergence between member-states, but also to shield their currencies from the fluctuations on the world markets.

The finalising of the project drafted by the EU Commission and the European

Currency Institute is conditional on the solution of some practical issues. The first relates to the participation in the new exchange rates mechanism. Under the Maastricht treaty, a key condition for introduction of the single currency is the participation in the new exchange rates mechanism for at least two previous years. The documents of the Luxembourg session of ECOFIN and the final declaration of the EU meeting in Florence propose voluntary (and advisable) participation in the exchange rates mechanism for those member-states which do not meet the convergence criteria. The legal framework of the new mechanism will be set by the agreements between the European Central Bank (ECB) and the national banks of issue.

The second issue concerns the range of fluctuation of the exchange rates against the EURO currency. Many members insist on the existing 15 % or a sufficiently wide range. In addition, the range may vary among participants.

The third key element of the new system is the mechanism of currency interventions. Interventions are expected to be automatic, and their initiation and implementation – the prerogative of ECB. Another ECB function will be to cushion the inflationary effect of interventions in the countries with depreciating national currency. Germany offered asymmetric interventions, i.e. the bulk of expenditures on sustaining the exchange rates to be assumed by the central banks of member-states.

Members which will not join the single currency from the start are advised to achieve financial and economic stabilization. According to the formula devised by the European Parliament, the future system of relations between the two groups of members should be flexible, and the incentives for good performance of members in the second group should be more important than sanctions. In addition, it is proposed that members in the second group be treated as associated members and be required to estimate their budget deficit in EURO.

France suggested the application of a special mechanism for preventing currency devaluation efforts by members outside the EURO zone for boosting the competitive edge of their national producers. Defaulters will receive aid from regional funds in EURO at exchange rates adjusted for the difference between inflation and devaluation rates, or in the devalued national currency. In addition, structural

funds financing may be deferred for countries failing to sustain the proper budget discipline. The countries are required to comply with their commitments under the national convergence programmes rather than with the Maastricht criteria.

EU member-states agreed on principle to set the maximum allowed budget deficit at 3 % of GDP in view of achieving balanced budgets in the medium term. The stabilization pact idea is gaining greater support. According to it participants in the third stage of EMU will be obliged to exert stricter control over government finances. However, these rules should not infringe on the interests of the other EU members, nor hamper the introduction of the single currency in these countries. In the forthcoming months ECOFIN will define the specific conditions for operation in the EURO zone and begin work on a system for multilateral control over economic indicators and a mechanism of sanctions. In the German view, sanctions should consist of interest-free deposits which will transform into fines in case the country fails to bring its budget deficit down to the required level till the negotiated deadline.

The issue of harmonisation of the tax systems of EU member-states was first raised at the Verona meeting. The substantial difference in taxation rates across members is incompatible with EMU objectives. The harmonisation of national legislations in that field is quite slow, due in part to the fact that all decisions on the matter may be taken unanimously.

The European Parliament recommended to the EU Commission to prepare a White Paper on the Union's role in IMF and the World Bank after the initiation of the third stage of EMU. The Paper should outline a system for stabilising the exchange rates of EURO, USD and the Japanese yen. To this aim, the possibilities for international control over national economic policies, as well as for devising a mechanism for forex crisis prevention will be discussed in the near future. In the long term, should the EURO become an international reserve currency, EU will have a much stronger say in the negotiations on the institutional reform in the international currency system. Until then EU members should have tackled the issues on EMU responsibilities to the outer world and its representation in the international organisations.

By the end of 1996 ECOFIN outlined the legislative framework for the use of

the single currency and devised the procedure for sustaining exchange rate stability and budget discipline. The Dublin EU summit adopted the respective decisions on these issues.

2.2. ECONOMIC SITUATION AND ECONOMIC POLICIES OF EU MEMBER-STATES

Some of the challenges EU is facing are economic regionalisation and globalization, the marginalisation of countries and groups of countries, the consequences of the fall of the Berlin Wall, the intentions for EU expansion in Central and South-Eastern Europe, world trade liberalization, internal economic problems, recession and the policy of economic restrictions in order to meet the Maastricht convergence criteria within the set deadlines.

EU will tackle present and future tasks at the backdrop of negative demographic trends: ageing population with a declining relative share in world population from 10 % in early 1960s to 6 % in the 1990s and projected 4 % in 2020. Forecasts indicate a falling (although at a lower rate than North America) relative share of Western European output volume in world output from 30 % in 1973 to 25 % at the end of the century.

ALTERNATIVE ESTIMATES ON GDP GROWTH IN 1996 BY EU COUNTRIES AND FOR EU AS A WHOLE

(%)

COUNTRIES	EU*	IMF**	LINK***
Germany	2.4	1.0	2.0
France	2.4	1.3	0.9
Italy	3.0	2.4	2.2
Great Britain	2.7	2.2	2.2
EU	2.6	1.8	2.0

Source: * Commission of the European Communities, *European Economy Supplement A* /December 1995/; ** IMF, *World Economic Outlook* /April 1996/; *** United Nations, University of Pennsylvania and University of Toronto, *Project Link World Outlook*, /mimes/, post-Link meeting forecast /May 1996/.

Estimates of leading international organisations such as IMF, OECD and the UN Economic Commission for Europe, indicate that the 1996 growth rates of EU economies will not exceed 1.5-2 % compared to the projected 2.8 % in 1995. The decline was mostly related to Germany, France, Austria, Spain, Great Britain and Italy. The pick-up in the second half of the year justifies expectations for 2.8 % growth in EU in 1997. It will be based on renewal of funds and favourable financial market conditions - the 2 % cut in interest on long-term credit, the high securities yield, the soft monetary policy and the reduction of interest on short-term credit by Central Banks in combination with moderate price growth.

On the other hand, the unpredictability of the economic situation intensified the debate on how applicable the uniform policy under the Maastricht treaty was to all EU members in view of its possible adverse impacts on business activity. This issue was discussed at the March 1996 ministerial meeting of OECD countries in Paris. The concern of British economists is that budget expenditure cuts might suppress business activity unless they are offset by monetary policy stimuli. Experts from continental Europe hold the opposite opinion, i.e. balanced budgets will keep inflation even and boost demand, and thus induce steady tax policies. The Bank for International Settlements has stated time and again that the one-sided use of deflationary and inflationary instruments is inadmissible. This may be the reason why EU institutions were more active in devising mixed economic policy methods in the second half of 1996.

Budgeted EU revenues for 1996 amounted to 86.2 bln ECU and budgeted expenditures - to 81.36 bln ECU. 40.8 bln ECU were earmarked for the common agricultural policy, 29.1 bln ECU for the structural funds, 5 bln ECU for domestic policy (R&D, the trans-European network, the energy sector), 5.1 bln ECU for foreign projects (including 1.147 bln ECU in aid to Central and East European countries, 583 mln ECU to Mediterranean states, and 435 mln ECU to former Soviet republics). The 1996 EU budget amounted to 1.19 % of total EU GDP. This share is projected to reach 1.27 % in 1999 by decision of the European Council.

Inflation in EU economies measured by the deflator of private consumption peaked at 5.1 % in 1991 against 4.7 % in 1990. Since 1992 it has been following a

downward trend measured by both the private consumption and GDP deflators. European Commission estimates put EU-area inflation at 2.9% in 1995, with 3.1% projected rate for 1996. Seven EU member-states register satisfactory levels of inflation (in the 2-3% range) while five other do not perform that well, with Greece being at the bottom.

More efforts are needed for balancing EU budgets which ran large deficits (6% of GDP) due to recession in 1993. Measures taken since 1994 should cut the deficit to 4% of GDP in 1996 which is a complex task. Government financing within the Union should drop to 3.9% of GDP in 1996.

Exchange rates are relatively stable after the floating mechanism within the +/- 15 % range was introduced in summer 1993. Considerable progress has been made in interest rate convergence.

Overall, since 1992 world economy has been recovering from one of the worst post-World War II recessions, but forecasts for sustained high economic growth have not fully materialised. We have rather witnessed a definite trend for moderate development against the backdrop of regional imbalances. UNCTAD estimates put global growth in 1991-1995 at 0.6; 1.4; 1.1; 2.8; 2.4 per cent by years. Developed market economies are expected to grow by 2 per cent in 1996. Within the EU area, France and Germany are expected to register lowest growth rates - at worst, up to 1% and 0.5% respectively.

Dampening growth rates in the EU are mainly rooted in falling domestic demand, cuts in investment which stagnated at the level in the early 1990s, the unexpected relative shrinking of world trade in 1995 compared to its high levels a year before, the weak US dollar which curbed the exports of countries which pegged their national currency to the German mark. We should also note the weakening dynamics of trade within the EU. These factors are directly related to the lower growth rates. Some of them are consequences which have an additional negative effect on French and German policies of restrictions, of curbing government spending in order to reduce their budget deficits combined with sustained high real interests over an extremely long period of time.

For 35 years the economic policy efforts of the Community have been mainly

confined to economic policy coordination and financial support among member-states. The stress has been mainly laid on monetary policy. The EU treaty put these issues in a new light with requirements for upward economic development and sustained non-inflationary economic growth complying with environmental protection norms and guaranteeing high level of economic convergence, including employment and social protection. EU is presumed to outline and implement common policies and initiatives in view of the formation of the economic and currency union parallel to the creation of the single market.

EU trade policy vis-a-vis third countries remained unchanged in the wake of the Maastricht treaty. It is founded on common principles as to tariff changes, customs and trade agreements, standardisation of liberalization measures, export policies, and trade protection measures including dumping and subsidies. The strong competitive edge of industry in EU member-states and the direct dependence of employment on foreign trade justify the insistence of official EU representatives on forsaking the defensive stand against liberalization and on the need for directed efforts for expansion into markets with restricted access for EU goods and investments. The European Commission has mapped out a series of measures to that effect, viz. to accurately define obstacles, improve coordination on institutional level, and attract producers using their feedback.

GATT is the international framework for outlining and implementing EU trade policies. The Uruguay round of talks resulted in an agreement on global reduction of customs duties by 37%, which for EU meant a reduction from an overall average of 6.8% to 4.1%. Tariff restrictions were lifted in eight sectors of the economy.

12 million jobs (every tenth) in EU are directly related to exports. The Union accounts for 20% of world trade, increasing its share in services and telecommunications. EU support for international trade is grounded in the understanding that domestic consumer demand within EU and in industrialized countries would hardly ensure long-term economic growth. Taking into consideration the fact that 80% of the world population is outside the OECD area, efforts will obviously be directed at Central and Eastern Europe, Latin America, and Southeast Asia. We should also note the moderate (5%-9%) economic growth in some developing countries as a

steady trend which will encourage EU exporters. The Union expects the Uruguay round of GATT talks to give rise to some 180 m ECU annual additional revenue as at 2005.

Presently 40% of imports in the EU area are duty-free. In 6 years subsidies for farmers will be reduced by 20%, subsidies for food exports - by 36%, and subsidised exports - by 21% overall.

EU intentions for expansion eastwards are an unprecedented challenge to both member-states and aspiring members. This is mainly due to the nature of transformation processes and the relatively weak (to a different degree) development of economies in East-Central Europe. There are various scenarios for a future united Europe, ranging from extending the Maastricht treaty to politically outlined zone of free trade or structural integration policy.

EU pursues a new economic policy to North African countries. It is based on the intention for establishing a free trade zone between the EU and each of the countries in the region and within the region itself by 2010.

EU initiated a new stage in relations with Asian countries at the first Asia-Europe (ASSUME) meeting in March 1996 in Bangkok. The sides agreed to meet every two years. The forum outlined the frameworks of a broad political, economic and social cooperation in the future, including the development of the Mekong river area.

EU relations with Latin America will achieve new dimensions by the year 2000. The Union has earmarked funds for cooperation in finance, technologies, science, and economy as a whole.

EU gives precedence to economic relations with the Cooperation Council in the Persian Gulf (Saudi Arabia, Kuwait, Bahrain, Qatar, UAE and Oman). Its trade with the region exceeds 30 billion ECU. The Union is attempting to revive negotiations on a free trade agreement which began in 1990.

Relations between EU and North American countries are increasing in significance. The settlement of economic disputes between the EU and USA (mainly on issues of agrarian policy and agricultural exports) cleared the way to the signing of the agreement of the Uruguay round of GATT talks. Cooperation between both

groups of countries within WTO will further affect the liberalization of world trade and expand the range of problems treated by WTO.

EU maintains broad cooperation with 69 countries from Africa, the Caribbean and the Pacific region (ACP) within the frameworks of the Lome IV convention for the period 1991-2000. The intermediate agreement and financial protocol for the second 5-year period, signed in 1995, foresee an increasing amount of EU development aid by 22%. Adjusted for inflation, aid for these countries, however, will not increase. Nevertheless, the Lome convention is the most important instrument of North-South cooperation. 14 625 million ECU, 12 967 million of which from the European development funds, will be earmarked for that purpose by the end of the century. □

III. TRANSITION ECONOMIES

FORECASTS AND RESULTS

In 1995 and the beginning of 1996 the economic situation in Eastern Europe improved considerably and sustained some of the positive trends that emerged in 1994. The Commonwealth of Independent States (CIS) economies also registered some positive changes, however, they were still suffering the consequences of the recession in the transition period. In spite of the progress in institutional reforms the economic environment in the Baltic states was rather chaotic.

The speed of economic recovery in Eastern Europe exceeded all expectations. GDP in most Eastern European countries either grew faster than expected or its growth rate confirmed the initial forecasts. Croatia and the Former Yugoslav Republic of Macedonia were the only exceptions as production in them further declined in 1995 mainly due to the political instability in the region. GDP growth rate in Bosnia and Herzegovina declined as a result of the same reasons. As a whole, GDP growth in Eastern Europe in 1995 reached almost 5.5%.

The transition economies in Central Europe recorded the largest real GDP growth exceeding forecast rates by 1-2%. Notwithstanding the relatively high growth rate expected in the Czech Republic and Poland, preliminary forecasts proved to be moderate compared to the actual results. GDP growth in Albania, Rumania and Slovakia was unexpectedly large and surpassed all expectations. Registered GDP growth in Hungary was moderate relative to the other Eastern European states but it also exceeded initial forecasts. Production growth in Bulgaria, Slovenia and Yugoslavia was more or less close to the expected rate.

The impressive economic recovery in Eastern Europe reflected the positive developments in supply and demand. Increased demand for exports mainly from Western Europe which became the main trade partner of all Eastern Europe and the Baltic states probably played the major role in the economic recovery of the transition economies. Domestic demand (mostly capital investments and household consumption) also grew considerably in some countries (the Czech Republic, Po-

land, Rumania, Slovakia and Slovenia).

Industrial growth, on the other hand, also contributed to the recovery in the CEE states. Gross industrial output in most of these countries (again excluding Croatia and Macedonia) in 1995 and the first months of 1996 rose significantly.

The intensifying commercial links between Eastern and Western Europe are indicative to the increasing inter-dependence between the economies in both parts of the continent. At present this inter-dependence is quite asymmetrical since the significance of Western Europe as a trade partner to Eastern Europe is much greater than the opposite. Therefore, this could result in greater vulnerability of the transition economies and dependency on the cyclical development of the countries in Western Europe.

The CEE countries as a whole are already overcoming the transition period recession. This progress, however, was still insufficient to reach production volume in the pre-transition period. Thus, in 1995 GDP in Eastern Europe as a whole was 15% below its 1989 level. It is evident that complete economic recovery is anything but near.

The dynamics of supply in most of the CIS countries was close to the expected continuous decline in the region. The decline of production in certain countries, including Russia, slowed down distinctly. Some of the CIS countries (notably Armenia and Georgia) probably reached the lowest level of recession. The eventual positive impact on the CIS countries of the increasing demand for exports was relatively low owing to the fact that the CIS economies were still not as open as the other CEE and Baltic states. Therefore, weak domestic demand remained the only way to recovery in the CIS countries.

Expectations for the development of the economic environment in Russia underwent some changes throughout the course of the year. In the first half of 1995 production output decreased whereas in the second half of the year it registered modest growth. This fact was regarded as a sign that the Russian economy had probably started overcoming recession. However, the last four months of 1995 again saw a downward trend in industrial production. This negative course did not reverse substantially in the first months of 1996.

Among the Baltic states Lithuania was the only one to register unexpected decline of production while Estonia and Latvia displayed moderate progress in their economic recovery.

The continuing increase of investment in most Eastern European countries represented a major aspect of their macroeconomic development in 1995 with positive implications for their future restructuring. The CIS countries saw the opposite trend as investment dropped in 1995.

Most analyses expected the long-awaited economic recovery of the transition economies to influence positively the situation on the labour markets. It turned out, however, that the achieved progress in recovery was insufficient to trigger major positive changes in unemployment and contribute to a labour market upturn. With the obvious exception of the Czech Republic, the decline of the rate of unemployment and the creation of new jobs in all other CEE states fell short of all expectations. These modest results come to show the complex nature of the process of economic restructuring in the transition economies and the difficulties in balancing the labour market in particular.

In principle, the process of balancing the labour markets in the transition economies is advancing much slower than expected. It turned out that in spite of the high unemployment rate in some CEE countries redundant workforce was not completely eliminated even in the states which have advanced with economic transformation. Therefore, the process of rejection of labour force continued though it was closely linked to the opening of new jobs by companies undergoing restructuring and/or enlargement.

Most CEE countries (the Czech Republic excepted) went through a great initial shock at the beginning of transition resulting in a sharp increase of unemployment. Some specific and largely unexpected features characterised the process of labour force restructuring in Eastern Europe. One of them, according to recent analyses, was that private companies preferred to hire employees already having another job instead of to appoint unemployed people. That resulted in a dynamic movement of workforce across branches and sectors thus decreasing the chances of unemployed to find new jobs. Therefore, unemployment in Eastern Europe may

become lasting and massive.

The high rate of unemployment and the relatively large share of unemployed young people suggests that unemployment in the transition economies will remain constant and will become (as in Western Europe) one of the major concerns of the governments in the near future.

The situation on the labour markets in the CIS countries was somewhat different. Though the rate of employment in most of them has been constantly dropping its pace has been still lagging behind the decline in production. This suggests that there is a great and even increasing potential number of redundant workforce. Though total unemployment in the CIS countries was relatively low compared to that in Eastern Europe the accelerating pace of economic reforms could result in higher rates of unemployment.

The situation on the labour markets in the Baltic states was similar to that in the CIS countries. Lithuania, Estonia and Latvia, however, are advancing quite steadily with economic transformation and therefore their labour markets could soon acquire the same characteristic features of the other CEE countries.

It is noteworthy that official data about registered unemployment in the CIS countries as well as in some Eastern European states do not fully illustrate the actual unemployment rates due to the imperfect systems of registration, the lack of personal incentives for registration and the different ways for hiding unemployment. The analyses of reported data on the status of labour force in some transition economies reveal that the actual level of unemployment is several percentage points higher than registered.

In 1995 and the beginning of 1996 the economies in transition made substantial progress in prices stabilisation and the final results exceeded the initial expectations. In 1995 consumer prices and producer prices inflation decreased relative to 1994 in most CEE states. The only exceptions were Yugoslavia which failed to carry out a successful stabilisation programme in 1994 and Tadjikistan where 1995 saw again a record high rate of inflation. Prices in Hungary in 1995 also saw an upward trend though this coincided more or less with the aims of the stabilisation programme.

There were certain differences in the political approaches to prices stabilisation and the factors determining that process. The Visegrad four and some Baltic states successfully accomplished the first stage of macroeconomic stabilisation and entered the second one - the curbing of inflation. Apparently inflation in these countries will be low though permanent since it is inherent to most of the transition economies.

Two factors contributed to the progress achieved in the prices stabilisation in these countries: the relatively stable nominal exchange rates which acted as a nominal anchor and the unexpectedly high labour productivity due to the successful restructuring reforms. Recent high rates of industrial labour productivity offset to a great extent the increasing cost per unit of produce which was due to the appreciation of the local currencies. Thus export from these countries preserved and even increased its competitiveness.

The CIS countries implemented in 1995 their initial macroeconomic stabilisation programmes with the determining support of the international financial institutions. Most of the results achieved were encouraging, however, prices stabilisation remained far from being achieved.

The Russian stabilisation programme in 1995 attracted close attention due to its scheme and ways and means of accomplishment. The news was the way in which the stabilisation loan from the IMF amounting to 6.25 bln dollars was to be paid in monthly instalments and the strict supervision over the implementation of the conditions under which the loan was extended. Though the programme failed to curb monthly inflation in Russia down to 1% by the end of 1995 it was declared successful allowing for a second IMF loan of 10.1 bln dollars in the first months of 1996.

Foreign trade operations in all transition economies increased in 1995 and the beginning of 1996 both in volume and value. The volume of exports from the CEE countries grew by 9-10% and the value of imports into them - by 10-12%.

Export growth contributed to the initial start of recovery in the countries in Central Europe as well as to the positive changes in the other economies in transition. In 1995 the economic environment in these countries was shaped to a great extent by the accelerated growth of exports. The largest increase was registered by

the export of raw materials and some standard and semi-processed goods. Only the most advanced transition economies from Central Europe increased their export of processed end-products.

In 1995 the trade balance deficits of some CEE countries exceeded their 1994 levels and were larger than expected. Apparently, increased deficits were commensurate to the registered greater rates of economic growth. Higher trade balance deficits might well be the price for larger than foreseen production growth. In principle, however, the financing of these deficits did not present any serious problems to these countries due to the increasing volume of capital inflows and the growing availability of new credits. Vice versa, gross surplus in the trade balances of the CIS members grew considerably as a result of the increased trade surplus of the Russian Federation.

Apart from the registered growth of foreign trade, its directions also saw some positive changes. Though Western Europe (and the European Union in particular) remained the main economic partner of the economies in transition, 1995 saw for the first time since the onset of reforms major recovery of bilateral trade between them.

In 1995 the CIS countries registered increasing volumes of exports to and imports from the developed industrialised states as well as from the developing countries. On the other hand, domestic markets in the CIS shrank further due to the low level of effective domestic demand and the existing pecuniary difficulties.

1995 and the beginning of 1996 saw substantial positive changes in the attitude of external capital towards the economies in transition. Foreign capital flows into the CEE countries were modest in the first year of economic reforms and foreign investors continued to be circumspect about some of them. Yet, the success of economic adjustments and the recovery of some of the Central European states created favourable investment-inducing environment in them. At the beginning of 1996 five transition economies received estimates of their creditworthiness by international rating agencies and three countries (the Czech Republic, Hungary and Slovenia) received high rating for investment. Foreign capital, however, was quite „selective“ in 1995: out of 31 bln USD net capital inflow to Eastern Europe (an

amount exceeding all forecasts) 29 bln dollars were invested in four countries - Poland, Hungary, the Czech Republic and Croatia (listed according to the magnitude of inflows).

The structure of foreign capital inflow also registered considerable changes. The largest part of the capital flow to Eastern Europe was diversified private capital in the form of foreign direct investment, government securities, long- and short-term credits. At the same time, in 1995 a number of East European states succeeded in their attempt to re-enter the international capital markets as sovereign credit-borrowers.

Borrowing from international institutions was still essential to the CIS member states and some Southeast European countries. The support of the international financial institutions contributed to the devising in 1995 of stabilisation programmes in Russia and in some other republics from the former Soviet Union.

The flow of foreign capital to Eastern Europe in most cases offset the impact of trade deficit and in practice not a single transition economy had any problems with its balance of payments. The investment rating of each CEE country in the future will depend on its ability to attract foreign capital which is entirely subject to the success and progress of economic reforms. □

IV. THE STATE OF THE BULGARIAN ECONOMY IN 1996

4.1. OUTPUT

Estimates of the National Statistical Institute (NSI) indicate negative real output growth in 1996 between -8% and -10%. Output decline in 1996 is in sharp contrast to real growth in 1994 and 1995. AECD estimates suggest, however, that growth in the previous two years cannot be defined as self-sustained.

In 1994 real output growth amounted to 1.4%. The Bulgarian government negotiated an agreement with the external creditors which put the country under tight budget constraints in relation to the outside world. At the same time, enterprises continued to function under soft budget constraints. Also, the budget took on 26 billion leva in enterprise debt to the banking system and 1 billion leva in bad debt bonds. The actual writing-off of bad debt bonds improved the financial position of enterprises and intensified their economic activity.

In 1995 the large interest differential attracted short-term foreign capital into the country. Net Central Bank purchases during the year amounted to 500 million USD.

The increase in foreign exchange reserves was not paralleled by adequate sterilization. The open market operations of BNB were ineffective. The other sterilization instrument - required reserves - was actively used only in the first half of 1995. This resulted in a more rapid increase in the money supply and commercial bank refinancing in the second half of 1995, and especially in early 1996.

There are two main reasons for the economic slump in 1996. First, the influence of the cyclic decline in Western Europe, most pronounced in late 1995 and early 1996. The second and key reason is the loss of confidence in the banking system, most strongly felt in the second half of 1996. The dynamics in the industrial sector as a whole is illustrated in the figure.

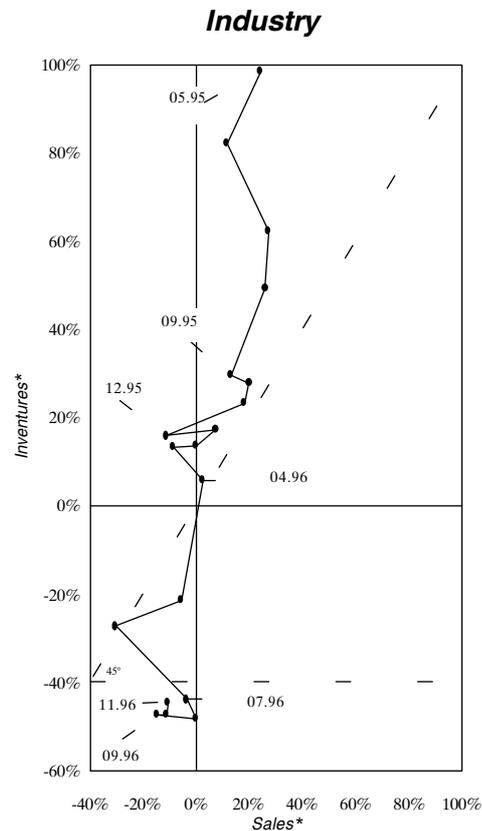
As the figure shows, until July 1996 the industrial sector had been following the natural trend from decline to recovery and another decline (viz. simultaneous reduction in output and inventories).

Econometric analyses indicate that over 90% of the output decline can be attributed to the bank sector collapse measured by the sharp changes in the velocity of money supply circulation and commercial bank refinancing. Both variables relate to the confidence in the banking sector which, in turn, depends on decisions for closing down, placement of banks in receivership, or reducing their refinancing.

A direct outcome of the unstable economic situation is the extremely low volume of investments in the real sector. Investments registered the largest drop in GDP's final consumption. Their real-term decline amounted to 26.4% in the first half of 1996 relative to the same period in 1995. Net exports are not expected to differ substantially from the 1995 level.

There are three key factors for the huge decline in demand for investment goods. The first is the high risk generated by the economic destabilization. Under these conditions it is very hard to devise a sensible credit project. Producers cannot plan their interest expenditures when payments are due, as well as their leva expenditures on imported factors of production. Some 60% of imports go for intermediate consumption. The rapid leva depreciation since the turn of the year generated great uncertainty and high inflationary expectations among producers. This, in turn, induced higher current inflation rates.

The second key factor of weak investment demand is the outflow of domestic savings from the banking system. Given the almost non-existent capital market, bank savings are the only source of investment financing. The trend for hoarding



* % change against the same month of the previous year.

Source: NSI, AECD

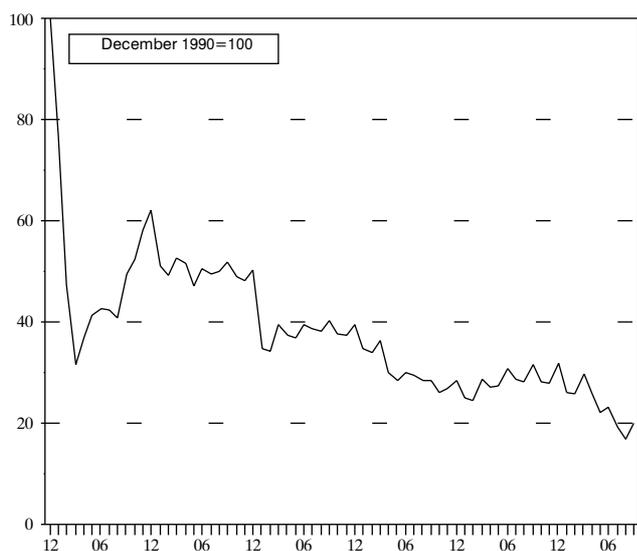
savings „under the mattress“ (nearly all in foreign currency) cut short the credit resource of the banking system.

Table 1

GDP by elements of final consumption

	June 1996 (million leva)	Index of physical volume relative to the first 6m. of 1995
Final consumption	441467	99.7%
Gross capital formation	46005	
Gross fixed capital formation	629000	73.6%
Inventories change	-16895	
Net exports	9734	
GDP - total	497206	93.8%

Real Average Wage Rate
in the public sector



The third key factor is the draining of bank resources for budget deficit financing. Commercial banks were the main buyers of government bonds through most of the year. The purchases of government securities mobilized a considerable share of commercial bank resources and reduced the credit to the non-government sector.

High inflation in 1996 pushed incomes to their lowest real level since 1990. Budget-financed incomes

were hardest hit by the restrictive incomes policies. Despite their 20% increase in July, they lagged considerably behind the average wage. In September the average wage in the public real sector was about twice higher than the average wage in the

budget-financed sector. The minimum wage underwent three adjustments in the course of the year. However, in end-September it amounted to 19.07% of the December 1990 level in real terms.

Considerable decline was also observed in other household incomes financed by the budget. The strict government debt servicing curbed all non-debt payments, including pensions and social security.

Table 2

Current Financial Position of State-owned Enterprises

		9m.96	9m.95
Operating profitability	%	9.2	4.8
Pre-tax profitability	%	4.2	-0.4
After-tax profitability	%	-0.0	-3.7
Coefficient of current liquidity		0.7	1.0
Inventory turnover	days	61.8	71.6
Period of receivables collection	days	69.9	62.7

Real-term industrial output in the state-owned sector plunged by 5.2% in the nine-month period of 1996 relative to the same period in 1995. At the same time, the current financial position of non-financial state-owned enterprises improved relative to the same period.

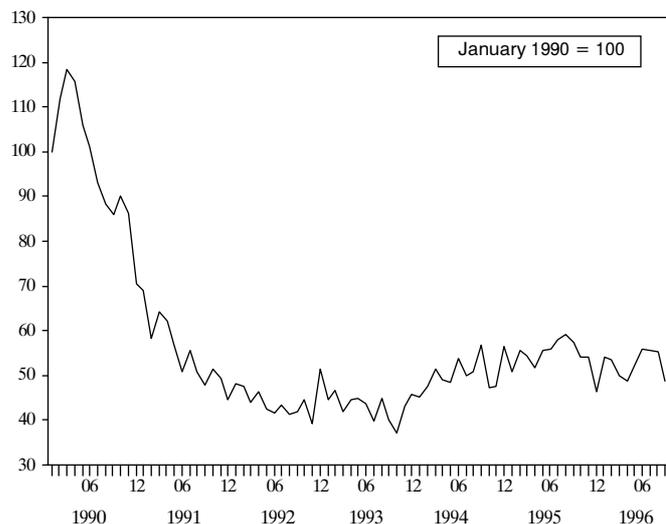
The decline in net losses of the real public sector was due to government efforts to impose tougher financial discipline by liquidation and isolation of enterprises.

The improved financial position of enterprises was paralleled by cutbacks in financ-

Industrial Output

State-owned Sector

(Base Indices, January 1992 Prices)



Source: NSI, AECD

ing and output. The reduction in commercial credits is a key factor for output decline. The commercial banks refrained from extending enterprise credits; they focused on collecting and re-negotiating old debts. The cash flow from banks to enterprises was much lower than in 1995, strongly influencing the decline in production activity. The reduction in bank credits was mainly offset by own resources and increase in interfirm credit.

The quick lev depreciation, mainly in the third quarter of 1996, was another factor for the improved financial performance of the public real sector. Enterprises bought input materials at much lower exchange rates compared to their sales. Regular investment in inventories would diminish the impact of this factor. Practically, enterprises will lose the dummy profits from exchange rate arbitrage when they begin re-investing in inventories after their reduction. Moreover, there is a danger of decapitalization of enterprises due to taxes on book profits if re-investment in inventories is done in the next fiscal period.

4.2. INFLATION

In 1996 prices registered their largest growth since their partial liberalization in 1991. Cumulative inflation in 1996 amounted to 310.8% - the absolute high to-date. It should be noted that this immediately followed the 1995 absolute low of the indicator since 1990 - registered inflation was 10 times lower.

The slackening control over the money supply in 1995 indicated future price growth acceleration. In 1996 the money supply growth was not so drastic as previous years. However, the lev component continued its steep rise at the expense of the forex component. These circumstances together with the transformation of real and bank sector deficits into government debt and the lack of adequate budget revenues for its servicing made it impossible to sustain inflation at its 1995 level. In actual fact, the bulk of deficits generated in the economy over the period were monetarized, thus becoming the strongest pro-inflationary factor.

Relatively low controlled prices acted as another price growth deterrent in 1995. Their rise lagged behind free price growth. In other words, the low rates of registered inflation in 1995 were also due to suppressed inflation which surfaced in

1996. The latter, however, was more than a simple arithmetical addition to the 1996 monthly indices; it multiplied the 1996 inflation dynamics. On one hand, the adjustment of fixed prices followed the acceleration of lev depreciation and the introduction of a higher VAT rate. On the other, the long suppression of controlled price growth naturally generated an overshooting effect and hence, influenced the change in the remaining price levels. On these grounds we can assume that without the artificial sustaining of controlled prices overall inflation in 1995 and 1996 would have been lower and monthly fluctuations weaker.

1996 may be divided into three sub-periods in relation to the factors influencing the price dynamics.

In the first quarter USD appreciation was about 1.6 times higher than in 1995; inflation, however, sustained its 1995 levels. This may be attributed to the long stagnation of energy prices and the „backlook“ price formation by producers and traders.

April and May signalled the acceleration of inflation. In these months only price changes may be attributed to inflation of costs. The contribution of separate expenditure items was clearer in May when 46% of wholesale price growth was due to the exchange rate appreciation, 15.5% - to adjusted energy prices, 38% - to the change in interest levels. and less than 1% - to the wage bill dynamics.

June was the first month of calculated macroeconomic risk in prices. Only 65% of wholesale price growth was rooted in the expenditure items valid for May. A relatively stable ratio of contribution of pro-inflationary factors to CPI emerged in the following months. On average, monthly forex rate dynamics generated 4-5 percentage points inflation in the same month, the immediate calculation of new energy prices - 2-3 percentage points, and about 10 percentage points were due to economic insecurity, price structure adjustment, and calculation of inflationary expectations. Interest rate changes were an erratic factor whose influence was strongest in May and October.

Inflationary expectations were fueled by uncertainty as to exchange rate appreciations and the dynamics of remaining prices. As figures indicate, the controlled components had the biggest contribution to inflation fluctuations (May 1992 - April 1996):

Table 3

	<i>free prices</i>	<i>monitored prices</i>	<i>fixed and limit prices</i>
<i>average monthly rate [%]</i>	4.478	4.249	4.384
<i>standard deviation</i>	3.408	4.540	7.760
<i>coefficient of variation [%]</i>	76.100	106.800	177.000

In relation to this we should note the fundamental difference in energy price changes before and after the enactment of Council of Ministers Decree № 153 (State Gazette № 57/1996). Before energy prices were an instrument for more or less successful elimination of macroeconomic imbalances; the methodology introduced by the Decree aimed at sustaining relative energy prices. The practical outcome of the first approach is nearly always destabilizing¹ since the response to economic environment changes is too slow under a fixed price regime. Conversely, destabilization is impossible if relative prices are stable under equal conditions. Bulgarian data corroborate this conclusion: in the months of application of the methodology monthly inflation ranged within 15-20%, concentrating around the middle values. These were stable, though high, inflation rates. Their value, however, was not a function of the monthly application of the methodology. The starting adjustment of energy prices in July was a stronger, although indirect, inflationary factor for the following months than current monthly adjustments.

This is due to the fact that the energy price adjustment in July set off a large-scale re-adjustment of the price system. To catch up with the overall price level, electricity prices rose by over 200% in July, tilting the price system to the other extreme. From a relatively cheap product, energy turned into the most expensive one in relative terms, pushing the remaining prices of goods and services upwards. The shock change at the entrance determined the scope of price growth and its contribu-

¹ See Commander S., F. Coricelli, „Levels, Rates and Sources of Inflation in Socialist Economies: A Dynamic Framework“ in *Managing Inflation in Socialist Economies in Transition*, Edited by S. Commander, EDI Seminar Series.

tion to CPI. The big monthly inflation lags and the shrinking of real incomes set the background to price structure adjustments. The latter lasted longer and deviated from effective price changes due to poor orientation and demand restrictions.

Food prices restored their relative level in the course of 2 months. Despite their absolute growth, non-food prices fell to record low levels in relative terms. Effective demand may not be able to respond to a full recovery of relative non-food prices to their previous levels in the short and medium term. Thus, a new price structure was formed by the end of October. Its efficiency is questionable having in mind the tight restrictions under which it emerged. The latter would have been weaker if regular adjustments of energy prices began a year earlier.

The trend for parallel dynamics of basic producer and consumer price indices noted in AECD's 1995 Annual Economic Survey was sustained in 1996. Relative price adjustments began on the wholesale level, followed by consumer prices. In the months when energy price inflation determined overall price growth, producer prices grew faster than consumer prices. Through most of the year producer price dynamics had a larger direct contribution to inflation (without adjustment for delayed and indirect backlash) than the lev depreciation.

4.3. BALANCE OF PAYMENTS AND EXCHANGE RATE

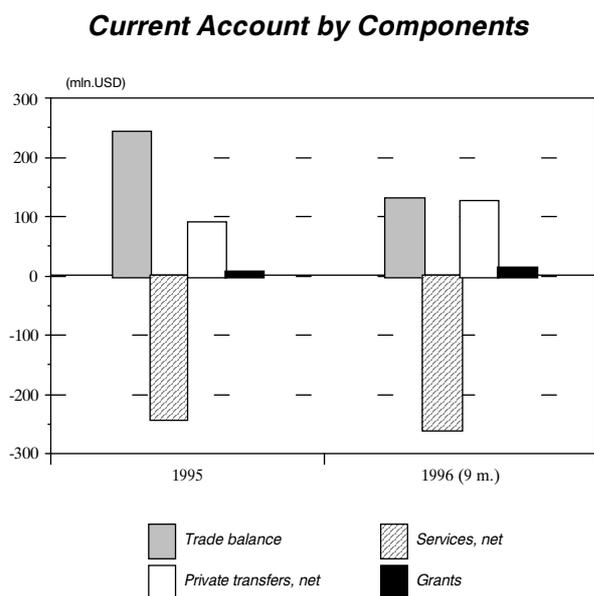
The key factor for the financial destabilization in 1996 was the steep exchange rate depreciation to 487 BGL/USD in end-December.

There are several reasons for the gravest crisis on the forex market since its emergence in 1991. The first is rooted in the balance of payments.

Exports grew considerably in 1995, generating a trade surplus, while the 25.6 million USD current account deficit was comparable to the 1994 level. The inflow of short-term capital generated 327 million USD surplus in the current account. Higher forex supply in the first half of 1995 allowed the BNB to increase its reserve to 1.5 billion USD in end-June. In the second half of 1995 the reserve fell by some 140 million USD as a result of BNB interventions in support of the lev.

The analysis of the balance of payments indicates no external deficit pressure on the lev in end-1995.

The current account balance deteriorated in the nine-month period of 1996 mainly due to lower transport and tourism revenues. The trade balanced remained positive despite the fall in export and import volumes by 15.6% and 13.7% respectively. Similar to 1995, external interest payments were the largest current expenditure item in the nine-month period of 1996.



The exchange rate remained relatively stable throughout 1995, leading to 18% real BGL appreciation. The first signs of forex market instability surfaced in early 1996 when foreign exchange demand rose and the average monthly USD appreciation amounted to 3-5%.

The crisis of the banking system and the increasing lack of confidence in the lev accelerated the process of currency substitution. In May alone the BGL/USD rate appreciated by 46.6%. The national currency ceased to perform its main functions as means of value preservation and unit of account. Despite its massive interventions in early 1996, BNB could not stop the upward trend of the exchange rate. Gradually, the Central bank share in the forex market declined due to its depleting reserves.

The lev depreciation ran parallel to the wave of withdrawals of commercial bank deposits. In May alone the withdrawal of forex-denominated deposits from commercial banks amounted to 276 million USD. The depletion continued in subsequent months, reaching a second peak in September. Part of the lev-denominated deposits were also drawn out to be converted into foreign currency.

In October the shock base interest rate increase brought the exchange rate appreciation to a temporary standstill at its September level. However, this measure had a short-term effect as it could not restore the public confidence in the lev. Interest rates on commercial bank lev deposits were not sufficiently high to offset the

profitability of dollar-denominated assets. In addition, the placement of nine other banks in receivership was another factor feeding distrust in the banking system. Expectations for a new forex market crisis became reality in December when exchange rate appreciation reached the record high 62.7%.

BGL depreciation in 1996 was paralleled by a sharp fall in the volumes of traded currency. Average monthly purchases and sales declined almost twice to about 350 million USD. At the backdrop of insufficient demand, purchase orders for small forex quantities strongly influenced the exchange rate dynamics.

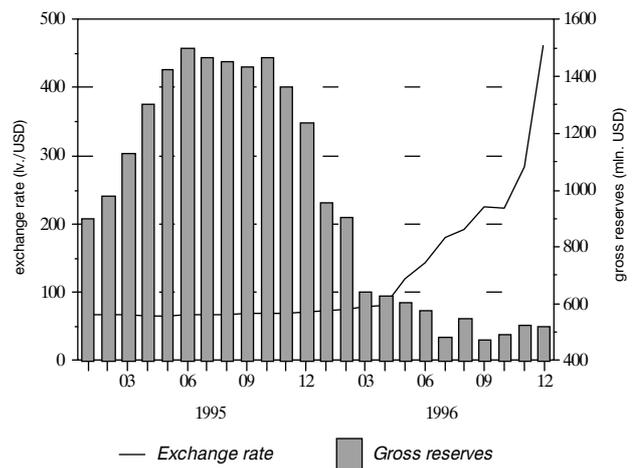
The dollarization of the economy and the flight of short-term capital were the main reasons for the sharply deteriorating current account in the balance of payments. Its deficit reached 797 million USD.

Foreign investments declined by 28% on a year earlier. In the nine-month period of 1996 direct investments in the country amounted to only 61 million USD. The weak investment interest in Bulgaria is rooted in the extremely unstable economic environment. Economic and political developments in the country generate negative expectations for an investment climate change; therefore, no sizable capital inflow should be expected in this item of the balance of payments.

BNB forex market interventions in support of the national currency, as well as external debt servicing reduced its reserve to 518 million USD in December. In the period January - December 1996 BNB forex purchases amounted to 652 million USD and sales - to 1270 million USD. The largest purchases were in January and July due to interest payments to the London Club.

BNB's forex reserve at the year-end covered only 1.2 months of imports. The standard level of reserves is assumed to cover at least 3 months of imports. This indicator, however, is rather provisional, especially in countries with unstable capital

Exchange Rate and Gross Foreign Exchange Reserves

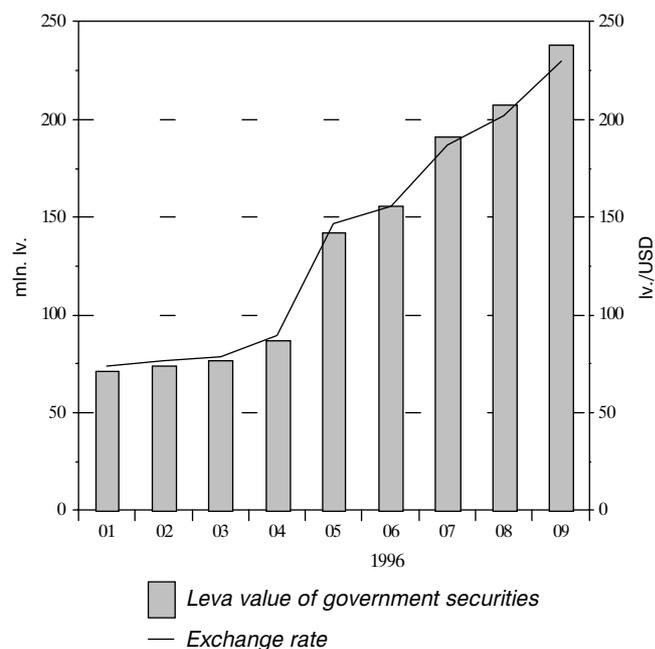


flows due to crises of confidence as in the Bulgarian case. Other factors should also be taken into account, viz. forthcoming payments and access to foreign financing. Therefore, BNB's reserves are extremely insufficient to sustain a stable lev and raise doubt in the country's ability to service its external debts in the following year. Due to its low credit rating, Bulgaria may rely only on the international financial institutions for financial support in 1997.

4.4. FISCAL POLICY

Fiscal policy in 1996 may be summarized as failure of the macroeconomic framework of the budget, restrictive policy and intervention in spheres beyond the scope of fiscal policy. The cumulative outcome was a substantial increase in the domestic debt.

Nominal Growth of the Exchange Rate and Government Securities Denominated in Foreign Currency



The failure of the macroeconomic framework of the government budget was mainly due to the highly underrated values of the exchange rate and the base interest rate. Both had a strong negative direct and indirect effect on government finance. Their joint impact prompted adjustments of the budget in August and December (and a hidden adjustment in May related to the Deposit Protection Act). The exchange and interest rates additionally burdened the already grave domestic debt situa-

tion. On one hand, as a result of higher interest levels and exchange rate appreciation interest payments surged both in absolute terms and as share of total budget expenditures (cf. Table 4). On the other, rising expenditures boosted the budget needs for fresh resource, which in turn fueled another government debt increase. (The lack of international financial market access transferred the whole weight onto

the domestic debt as part of its growth may be attributed to external debt servicing.)

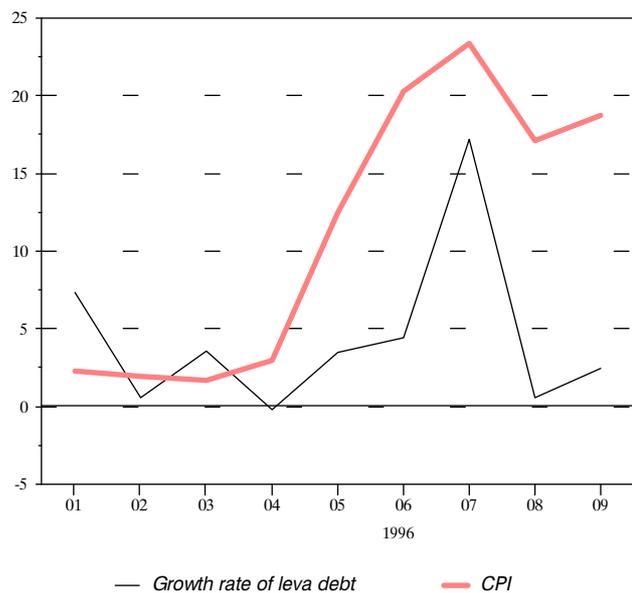
Table 4

**Structure of State Budget Revenues and Expenditures
January-September 1993-1996**

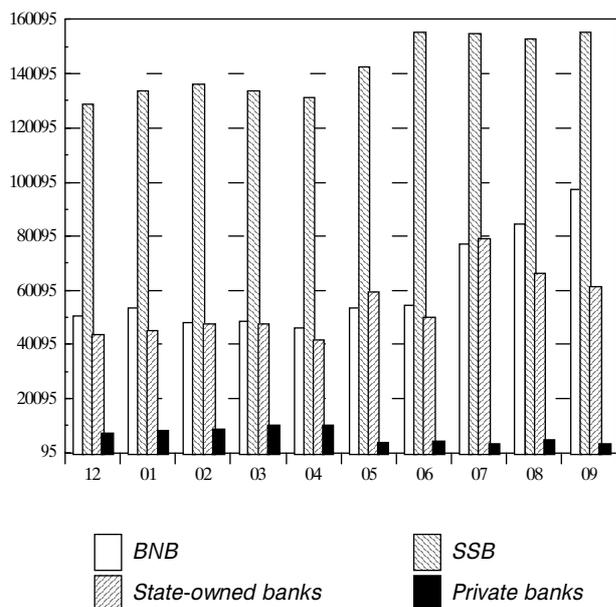
	1993	1994	1995	1996
Total revenue	100.0%	100.0%	100.0%	100.0%
<i>Tax revenue</i>	92.3%	91.9%	80.5%	78.3%
<i>Direct revenue</i>	44.0%	40.1%	27.9%	27.2%
<i>Indirect revenue</i>	48.3%	51.9%	52.6%	51.1%
<i>BNB remittance</i>	17.5%	17.1%	8.9%	10.3%
Total expenditures	100.0%	100.0%	100.0%	100.0%
<i>Interest expenditures</i>	30.2%	41.1%	51.1%	59.7%
<i>Domestic</i>	26.6%	35.8%	38.0%	43.6%
<i>External</i>	3.7%	5.3%	13.1%	16.1%
<i>Non-interest expenditures</i>	69.8%	58.9%	48.9%	40.3%
<i>Capital expenditures</i>	0.4%	0.4%	0.3%	0.4%

The restrictive fiscal policy involved increasing taxation, cuts in budget-related incomes and shrinking non-interest expenditures. This was the only possible option, not an expression of real intentions to curb non-debt expenditures. The changes in taxation (raising VAT rate from 18% to 22%, the new profits tax legislation, the adjustment of the incomes tax scale) and the curbing of incomes growth in the budget-financed sector were prompted by the enor-

Growth Rate of Leva-denominated Debt and Inflation

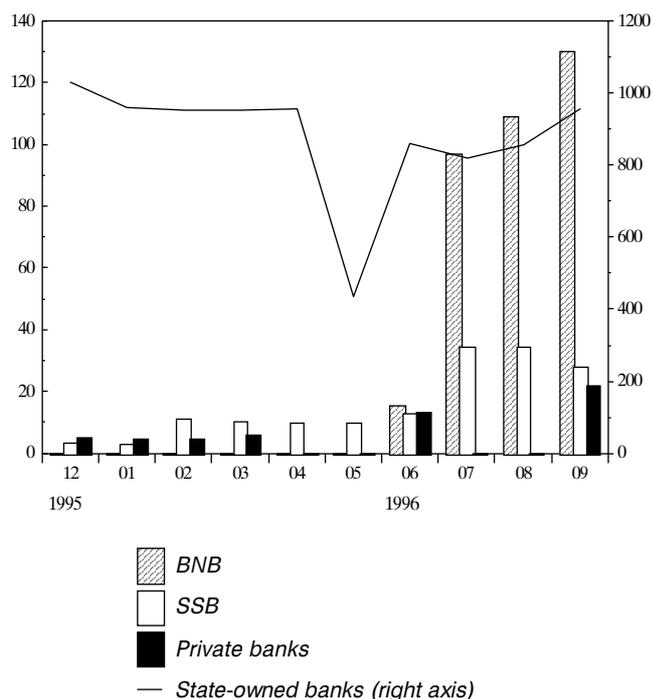


Distribution of Leva Government Securities by Owners



mous government debt expenditures. Article 9, paragraph 2, section 1 of the 1996 Government Budget Act stated the priority of government securities payments. As a rule, the existence of a budget deficit is attributed to an expansionist fiscal policy. In Bulgaria, however, the cash budget deficit is due only to the extremely high interest expenditures, sustaining a large primary budget surplus. In other words, government expenditures on goods and services are less than revenues which is tantamount to output restriction.

Distribution of Dollar-denominated Government Securities by Owners



1995 initiated the practice of direct fiscal intervention into the problems of the banking system, mainly by issuing some 60 billion lev worth of new securities on the Mineralbank and Economic Bank operations. 1996 sustained the practice in the form of the *Act on government protection of deposits and accounts in commercial banks placed in receivership by the BNB*. By the end of September government securities worth over 36.6 billion lev were issued under this legislation. Apart from failing to reach a key objective - reviving the confidence in the bank-

ing system - similar measures are unusual for the budget and incur additional burden. The servicing of these securities required a budget adjustment in 1995; 1996 saw an aggravation of the problems due to high base interest rate levels. In the future the budget should be relieved from unusual functions.

In 1996 the economic role of the government budget was considerably downgraded. As the table indicates, the real-term amounts of state budget revenues and expenditures decreased almost twice on a year earlier, falling below their 1993 level.

Despite the large real-term decline, the 1995 budget revenue structure underwent minor changes (Cf. Table 5).

Indirect taxes (VAT, excise and customs duties, customs fees) were the main revenue item, contributing over half of overall budget revenues in the nine-month period. The share of direct taxes fell considerably, while the share of BNB profit remittance increased on a year ago, yet remaining quite below its 1993/1994 levels. This is a negative trend in view of the talks on the introduction of a currency board (in which case BNB's profit remittance into the budget will be terminated).

The similar dynamics by revenue categories may be attributed to a tendency for indirect taxation (VAT bearing the main burden), as well as to the economic crisis in the country. Profits in these sectors (hence, profits tax revenues and the tax base) were severely eroded by the real output drop and the problems of the banking system. The decline in real household incomes reflected on VAT revenues despite the new, steeper tax scale. At the same time, the multi-fold increase in excise duties and the 4% rise in VAT rate (from 18% to 22%) sustained the relative share of these taxes despite their two-fold real drop.

The nine-month period of 1996 strengthened the trend for structural changes in budget expenditures. The weight clearly shifted over to interest payments which rose from 30.2% in 1993 to 59.7% in 1996 mainly due to higher domestic and foreign debt payments. Debt servicing is essentially a „fixed“ expenditure item free from government control (is not directly influenced by the government policy) and therefore leads to inevitable curbing of other government expenditures.

Government debt and its servicing were the main problem for the budget in 1996. Although real-term domestic debt (deflated by CPI) and the ratio of overall

Table 5

State Budget Revenues and Expenditures

as at end-September 1996
(mln. lv.)

	1993	1994	1995	1996	1993	1994	1995	1996
	deflated by CPI, September 1993 = 100							
1. Overall revenues	36 332.0	89 298.0	135 477.0	200 704.8	36 332.0	42 107.2	43 769.9	23 758.3
1.1 Tax	33 529.8	82 103.7	109 015.6	157 201.2	33 529.8	38 714.8	35 220.8	18 608.6
1.1.1 Direct	15 982.0	35 795.3	37 794.7	54 669.1	15 982.0	16 878.8	12 210.7	6 471.4
1.1.2 Indirect	17 547.8	46 308.4	71 220.9	102 532.1	17 547.8	21 836.0	23 010.0	12 137.2
1.2 Non-tax								
1.2.1 BNB profit remittance	6 367.6	15 265.5	12 006.2	20 668.1	6 367.6	7 198.2	3 879.0	2 446.6
2. Overall expenditures	62 078.5	114 057.0	183 098.1	282 975.3	62 078.5	53 781.9	59 155.3	33 497.1
2.1 Interest	18 775.8	46 928.6	93 565.2	168 898.8	18 775.8	22 128.5	30 229.1	19 993.3
2.1.1 Domestic	16 494.9	40 879.8	69 621.2	123 474.9	16 494.9	19 276.3	22 493.2	14 616.3
2.1.2 Foreign	2 281.0	6 048.7	23 944.1	45 424.0	2 281.0	2 852.2	7 735.8	5 377.0
2.2 Non-interest	43 302.7	67 128.4	89 532.9	114 076.5	43 302.7	31 653.4	28 926.3	13 503.8
2.2.1 Capital	271.3	479.4	474.2	1 025.4	271.3	226.1	153.2	121.4
Balances								
Primary	-6 970.7	22 169.6	45 944.2	86 628.2	-6 970.7	10 453.7	14 843.6	10 254.6
Domestic	-23 465.6	-18 710.2	-23 677.0	-36 846.6	-23 465.6	-8 822.5	-7 649.6	-4 361.7
Cash	-25 746.5	-24 759.0	-47 621.0	-82 270.6	-25 746.5	-11 674.7	-15 385.4	-9 738.7

revenues to the domestic debt fell (cf. Table 6), the high interest levels severely restricted debt servicing.

Table 6

by end-September 1996

	1994	1995	1996
Domestic debt (by end-September, mln.lv.)	250 766.2	328 837.8	640 654.8
Revenue/Domestic debt	35.6%	41.2%	31.3%

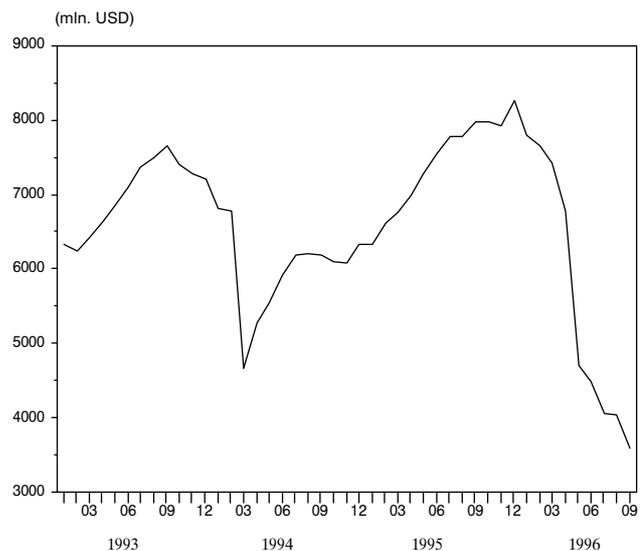
4.5. MONETARY POLICY

In 1996 monetary policy exhausted its potentials for macroeconomic stabilization. Part of them related to BNB's ad hoc policy irrespective of its long-term anti-inflationary objective, while others were beyond BNB's sphere of competence. The delay in ownership restructuring and hence low accountability of economic agents facilitated the amassing of enormous deficits to which BNB was an indiscriminate creditor of last resort.

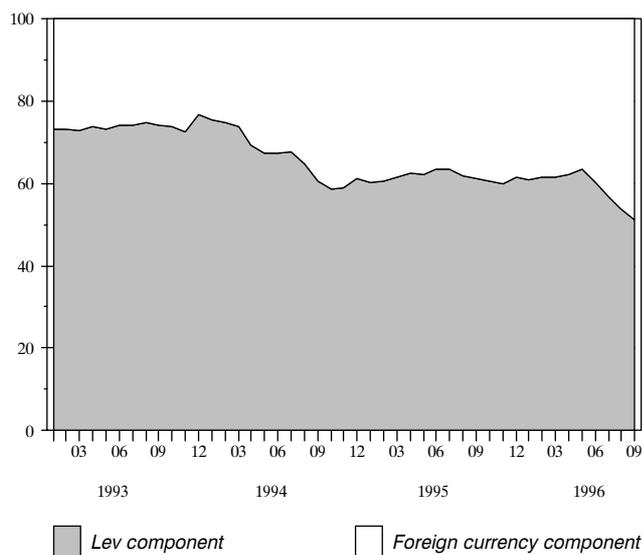
The softening of monetary restrictions in 1995 resulted in positive growth in the money supply which was a strong pressure on the exchange rate and inflation. Foreign assets were the biggest source of reserve money growth in 1995. Given the inflow of short-term capital, BNB's foreign currency purchases by mid-1995 were not sterilized with sales of government securities thus increasing the leva liquidity.

The reverse flow of foreign portfolio investments which began in the last quarter of 1995 and accelerated in 1996 forced the BNB to sell reserve currency. As a result, analytic estimates indicate that BNB's net foreign assets declined by 84% in dollar terms for the nine-month period

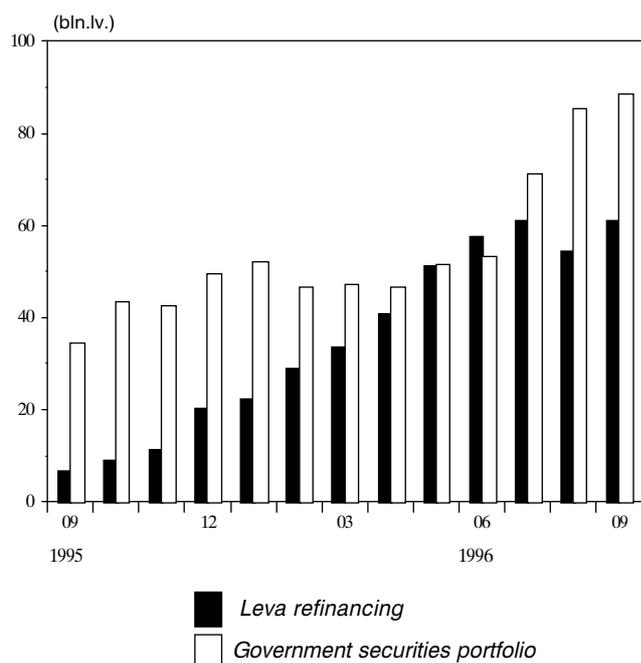
Dollar Value of Board Money



Board Money Structure



BNB Refinancing of the Commercial Banks and BNB Portfolio of Government Securities



of 1996. Over the same period claims on the government and commercial banks had the largest contribution to reserve money growth.

The budget emerged as the biggest generator of deficits in the economy. The legislative framework of deficit financing was formally side-stepped. After the limit for direct credit was reached, the BNB began direct buy-outs of government bonds. Its government securities portfolio amounted to 89.6 billion leva in the nine-month period, 2.5 times over the level on a year earlier. Thus, total budget liabilities to BNB on government securities and direct credits reached 130 billion leva.

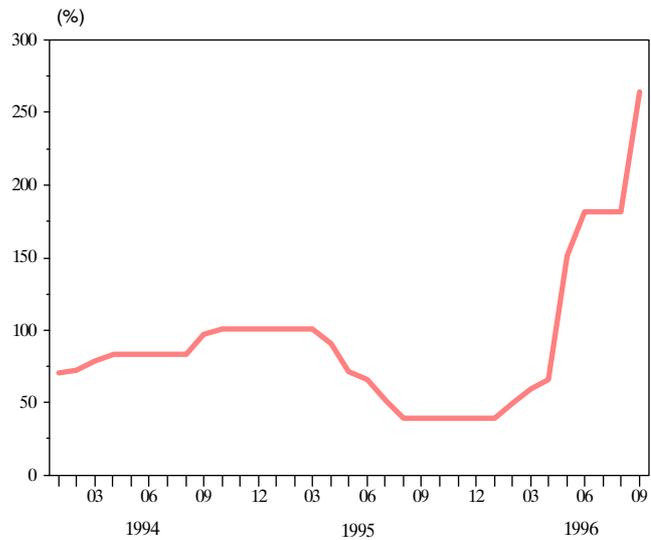
The policy of commercial bank refinancing (the second largest source of reserve money growth) was inconsistent and economically ill-founded. Large-scale refinancing was available to banks whose difficulties were clearly not due to temporary liquidity problems. Over 75% of deposits and credits were extended by BNB to banks which were

subsequently placed in receivership. Outstanding refinancing total at the end of the nine-month period was 8 times larger on a year ago, with uncollateralized deposits having the biggest share in overall credits and deposits - about 90%.

BNB's inconsistent policy was corroborated by the closure of banks (Mineralbank, the Economic Bank) whose debts were re-scheduled and written off several times during the last few years, or which were recapitalized three months prior to closure by dollar-denominated bad debt bonds under the Bulbank scheme (Balkanbank and the Economic bank)².

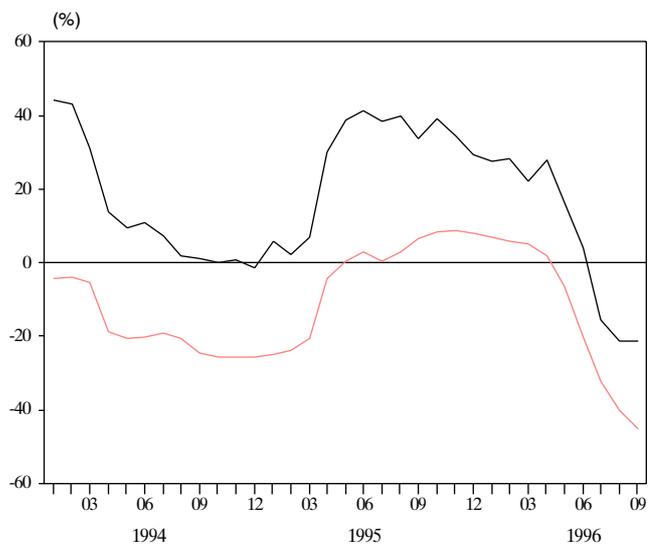
The lack of expedient policy was evident in the simultaneous use of instruments with contradictory effect. The influx of enormous liquidity in the economy was paralleled by monetary restrictions. Following 6 months of sustained base interest rate level, BNB raised it several times since the turn of the year until it reached the record high level of 300% simple annual interest. This was a breakneck decision for a temporary stabilization of the exchange rate relying on a second tranche by IMF. However, its extension was questionable even then due to the

Base Interest Rate Dynamics*



* Annual capitalised interest rate

Real Interest Rates *



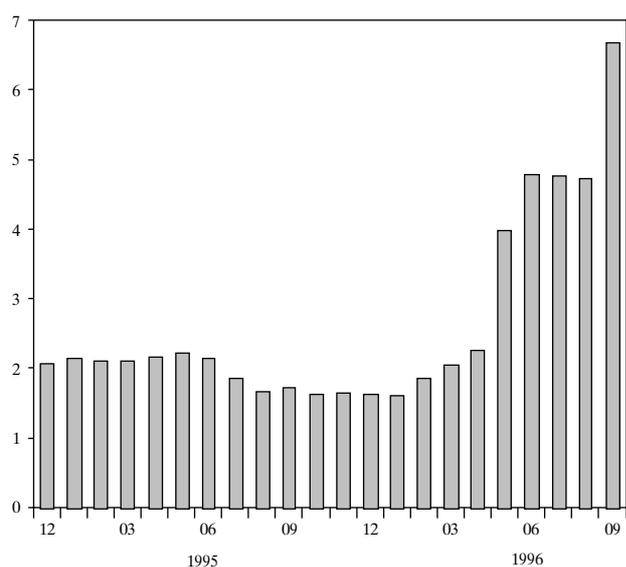
— Short-term credits — Time deposits

* Capitalised on an annual basis. Interest on time deposits is deflated by the consumer price index, interest on short-term credits – by the producer price index.

² State-owned commercial banks were recapitalized under the Bulbank scheme in May 1996. Resources from the State Fund for Reconstruction and Development were used to buy out dollar-denominated bad debt bonds worth 400 million dollars from the Bulbank portfolio at a 50% discount from the face value. The bonds were distributed among 6 state-owned banks with negative capital adequacy and their value was used to raise their fixed capital.

large deviations of programmed parameters from their actual values. This flagrant policy blunder did not stabilize the forex market; on the contrary, it had an opposite effect.

Interest Rate Differential *



* Spread between monthly interest rates on short-term credits and time deposits.

The base interest rate rise increased the interest differential between lev-denominated credits and deposits. Whereas at the end of 1995 average weighted interests on commercial bank credits twice exceeded those on deposits, in September 1996 this ratio was 3:1. The growth rates of producer and consumer prices were higher compared to interest levels, inducing negative real interest rates. As a result, lev-denominated assets depreciated by some 200 billion leva in the nine-

month period of 1996. Thus, similar to 1994, 1996 was characterized by capital redistribution from households as net savers to debtors.

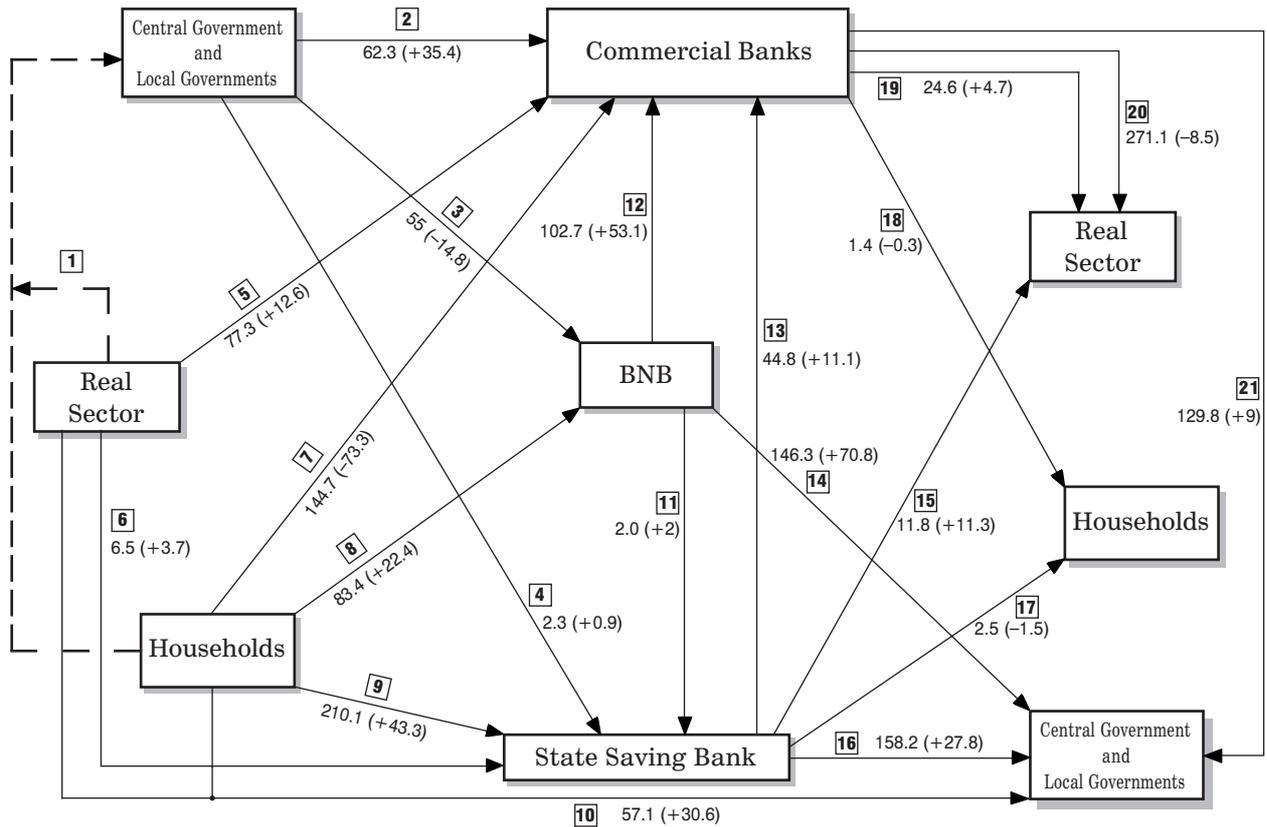
High inflation increased the inflation tax on holders of non-interest assets (banknotes and coins in circulation and commercial bank reserves). In 1995 it reached its post-reform lowest at 3.2% of GDP. However, since the second quarter of 1996 it followed an upward trend, reaching 8.6% of GDP for the six-month period.

Unlike 1994, currency substitution in 1996 was paralleled by a massive outflow of savings from the banking system. The flight of deposits from commercial banks and the rapid lev depreciation eroded the money base. The dollar equivalent of broad money declined sharply and rapidly to record low levels since the onset of economic reforms in the country. The dynamics of monetary aggregates in recent months exhibited typical hyperinflationary trends such as much higher rates of price and exchange rate growth compared to the nominal money supply.

BNB continued to use commercial bank required reserves as a monetary

Financial Flows

(31 Dec 1995 – 30 Sep 1996)



- 1 Tax, fees, social security payments as current transactions between the government, the real sector and households.
- 2 Deposits, lev and currency-denominated current accounts, (including 32.5 billion lev budget claims to the First Private Bank, Agrobiznesbank and Mineralbank under the Deposits Protection Act).
- 3 Deposits, lev and currency-denominated current accounts (including the State Fund for Reconstruction and Development).
- 4 Deposits, lev-denominated current accounts.
- 5 Deposits, lev and currency-denominated current accounts.
- 6 Deposits, lev-denominated current accounts.
- 7 Deposits, savings accounts, lev and currency-denominated current accounts.
- 8 Money in circulation.
- 9 Deposits, savings accounts, lev and currency-denominated current accounts.
- 10 Government securities.
- 11 Lombard loans, discount loans, deposits.
- 12 Lombard loans, discount loans, overdrafts, deposits, foreign currency loans.
- 13 Deposits and accounts in other banks.
- 14 Government securities and loans.
- 15 Loans.
- 16 Government securities and loans.
- 17 Loans.
- 18 Loans.
- 19 Shares, bonds, bills of exchange.
- 20 Loans.
- 21 Government securities.

* Figures quoted are in billion lev, figures in parentheses represent the change on a year earlier.

** The forex component in the flows is recalculated in BGL at end-1995 exchange rate (70.704 BGL/USD)

policy instrument. Their amount and the ceiling available to banks for settlements were subject to frequent changes, often several times a month. In August the ceiling was lowered twice - from 50% to 20%, and then to 10%. In September the banks were allowed to keep their reserves on attracted currency resources in foreign currency against their lev worth in long-term government securities.

The need for domestic credit to the government crowded out the credit to the non-government sector. In end-September outstanding lev claims of the banking system to the real sector grew only 10% in nominal terms relative to December 1995. Over the same period outstanding forex credits in dollar terms dropped by 14%. Apart from economic factors restricting credit demand and supply (output decline, high interests, lev depreciation, outflow of resources from banks), the credit policy of commercial banks was suppressed by administrative measures. BNB signed memorandums with 19 commercial banks under which new credits are extended only after the payoff of old principals, and the amount of new credits should not exceed 50% of paid off credits.

Ultimately, the monetary policy implemented discredited the BNB. This was made obvious by the idea for introduction of a currency board - viz. BNB's monetary policy is worse than the lack of it.

4.6. THE BANKING SYSTEM

In 1996 the capital adequacy problems of commercial banks piled up over the last few years translated into a steady liquidity crisis of the entire banking system. In 1995 commercial banks pursued an expansionist credit policy under high real interest rates on credits. This frustrated the servicing of enterprise debts. In 1996 the rapid accumulation of arrears on (private and state-owned) commercial bank credit portfolios was paralleled by massive withdrawals of deposits. The simultaneous decline in revenues from active operations and the need to service liabilities generated a steady liquidity crisis. In this context, BNB refinancing evolved from an instrument for overcoming temporary liquidity problems into a mechanism for financing growing quazi-fiscal deficits which was highly detrimental to the money supply and inflation.

In 1995 BNB and the government tried to prevent the looming crisis of the banking system and the placing of certain commercial banks into receivership. First, part of the debts of Mineralbank and the Economic Bank were transformed into government debt. At the end of the year BNB practically took on the debt of Agrobiznesbank, and later, of the Bank for Agricultural Credit. When other commercial banks collapsed under the weight of debt and BNB placed them in receivership, Parliament adopted a law which provided 100% insurance on household deposits and accounts. Thus the government budget assumed an enormous burden and government debt skyrocketed. At the same time, these measures proved ineffective and unable to prevent the panic among depositors and the massive withdrawal of savings from banks. Confidence in the banking system plunged drastically and the liquidity crisis in the system as a whole was inevitable.

In May BNB placed 5 banks in receivership and subsequent insolvency suits were initiated. In September another 9 banks were placed in receivership, for 8 of which insolvency suits were initiated in November. The 13 commercial banks account for 28% of banking sector assets (BNB and the State Savings Bank excluded), 57% of leva credit arrears and 61% of forex credit arrears.

Troubled commercial banks continued to function despite these measures. Under Regulation No. 9 capital adequacy as a ratio of capital base and capital risk was positive for each troubled bank. However, 5 state-owned and 3 private banks with negative net capital remained on the financial market. Net capital is calculated as a ratio of fixed capital plus reserves less losses and required provisions as collateral for doubtful and bad debts which should be transformed under Regulation No.9. Total net negative capital of banks operating on the market amounted to 25 billion lev in end-September.

The discrepancy between provisions subject to Regulation No.9 and actual equity was due to the large share of arrears in credit portfolios. Even adjusting for the receivables of banks in receivership, this share remained substantial, well over the end-1995 level. In end-September arrears amounted to 60% of the lev credit and 26% of forex-denominated credit to the non-government sector. Total outstanding credit arrears amounted to 430 million USD, or 4% of GDP. In subsequent months

the situation should have deteriorated due to high interests: 24.2% monthly interest on short-term credit in October earning 1246% capitalized annual interest. This situation encouraged even strict payers to go in default. The above estimates may even be undervalued due to the bank practice of extending roll-over credits, with new credits being accounted as regular.

The solution of the problem for asset quality is of particular importance; otherwise it would generate liquidity difficulties which will not be financed by BNB if a currency board is introduced (a regime much discussed towards the end of the year). Resources for commercial bank recapitalization and a parallel re-scheduling and re-negotiating of irregularly serviced credits.

Table 7

Share of Credit Arrears

	December'94	December'95	September'96
lev	45%	48%	60%
foreign currency	21%	25%	26%

The massive withdrawal of deposits in 1996 was prompted by the sharp plunge of economic agents' confidence in the stability of the banking system. This, in turn, was rooted in the danger of bank closures, rumours for blocking of foreign currency accounts and the quick lev depreciation. Net forex withdrawals in the nine-month period amounted to 710 million USD. Over the same period outstanding lev deposits adjusted for interest accrued fell by 23%.

The loss of confidence in the Bulgarian financial institutions boosted the interest in foreign banks and their local branches. Although their market share is still negligible, they attract money resources at very high rates. Outstanding forex deposits and accounts of households and enterprises in these banks rose 2,5 times in the nine-month period. Due to the pervasive macroeconomic insecurity a small share of this resource is used to finance Bulgarian enterprises, whereas the bulk of active operations are targeted outside the country. For example, in end-September 1996 deposits and credits outside the country amounted to 35 million USD compared to

a 3-times lower amount (12 million USD) in end-1995.

The forex crisis and expectations for a further lev depreciation determined the behaviour of commercial banks. In violation of Regulation No.4 on open forex positions the ratio of forex liabilities to forex assets was disproportionately increased. In end-1995 the ratio of forex commercial bank liabilities to all liabilities approximated the share of their forex assets in assets total, amounting to some 50%. In the nine-month period of 1996 77% of their assets and 66% of their liabilities were denominated in foreign currency.

4.7. PRIVATIZATION

1996 witnessed the start of mass privatization in which all Bulgarian citizens over 18 years of age (some 6.5 million) were eligible to participate. 46% of all entitled bought voucher books. Interest in voucher privatization was below the expected. The low public confidence in mass privatization was due to several factors, the most important of which are:

1) the collapse of financial pyramid schemes in 1995 and the crisis in the banking system and subsequent bankruptcy suits against some commercial banks. This eroded public confidence not only in the mass privatization campaign but also in the economic system as a whole;

2) the underdeveloped stock market. Investment in corporative securities is still terra incognita to individual investors, and experience so far discourages rather than stimulates households to invest their savings in similar assets. The late start of the privatization funds was another reason for the low popularity of the process of mass privatization.

The Securities and Stock Market Committee licensed 81 privatization funds which attracted investment voucher capital worth 60.210 billion investment lev. The first ten funds managed to attract some 55% of transferred vouchers. Their success was rooted mainly in the popularity of the founding institutions: United Bulgarian Bank, State Insurance Institute, Neftohim, Petrol, Post Bank, ING Bank, Multigroup, etc. In most of these firms the government owns the largest stake, hence the paradox that state-owned institutions became the main agents of the privatization proc-

ess. Some funds (AKB 4C Social, Aktzioner Favorit, Zlaten Lev, Melininvest) managed to attract vouchers on the strength of aggressive promotional campaigns.

The Privatization Agency closed 1386 deals by 25 October 1996 (compared to 1522 for 1995). The dynamics of cash privatization in 1996 may be divided into two periods:

– until August 1996: The period was characterized by extremely low volume of closed privatization deals and strong past-year inertia. It can be argued that the delay in economic restructuring, including the process of cash privatization, is the key source of the current economic crisis. Moreover, if external financing in the period 1995 - August 1996 was larger, the possibility to avoid the economic destabilization might have been quite strong.

– since August 1996: The period was characterized by much more active cash sales. Several relatively large privatization deals were finalized. Pressured by the need to service its debt, the government adopted a programme to speed up the privatization of large state-owned firms. The programme could not meet the deadlines due to the required technological time-frame for the finalization of deals, so that other measures were sought to solve the problems.

The low speed of cash privatization in the first half of 1996 may be attributed to:

■ The „package“ offered to potential investors was not made sufficiently attractive. No measures to impose tougher financial discipline and ensure better financial performance of enterprises in view of attracting potential buyers were taken.

■ The private sector in the country remains underdeveloped so that Bulgarian investors are not expected to show strong interest in privatization. Currently the bulk of privatization deals involves employee and management buy-outs (as at 31.10.1996 they amount to 99% of all deals). This is hardly the best privatization method as enterprises urgently need financing for investment and production innovations. The marginal share of foreign natural and legal persons (barely 1%) involved in privatization deals may also be due to the macroeconomic instability and insecurity and the ongoing changes in legislation which characterized Bulgaria as a high-risk country for foreign investors.

Privatization proceeds since the onset of the privatization process (1993-

1996) totalled 152.144 billion lev, with direct revenues accounting for nearly two-thirds of the overall amount. Liability settlements form a tiny share (barely 2.37%) of all negotiated proceeds, indicating that the real effect of privatization should be expected in future periods when buyers will have paid off assumed liabilities and made the negotiated investments.

The structure of negotiated prices and future investments underwent certain changes in 1996. The amount of negotiated investments total is substantially lower as a share of total annual profit (10.07% against 34.5% for the period 1993-1996) and as a share of all negotiated investments in 1993-1996 (below one-fifth of the total for the period). On the other hand, the direct financial effect is largest in 1996, amounting to 73.3 billion lev. The bulk of negotiated payments and assumed and paid-off liabilities have come from deals concluded in 1996. This has also been influenced by the problems in external debt payments in 1996 and beyond.

In summary, despite the progress in both mass and cash privatization, the scope of the process remains insufficient as state ownership is largely preserved. In this way it will be very difficult to achieve the main objectives of the privatization programme:

- economy as a whole is still ineffective
- enterprise debt continues to burden the government budget
- cash privatization proceeds are insufficient to ensure the payment of government debt and contributions in the deposit insurance fund.

Privatization should be expanded with the inclusion of large state-owned enterprises with monopoly position on the Bulgarian market such as the State Railways, Neftohim, etc. Parallel to that, the economic and legislative environment should be stabilized to create conditions for efficient management of restructured enterprises. In this way the state will divest itself of superfluous activities and will concentrate its efforts on education, health care, social security, social infrastructure, national defense and public security. □

V. FUNCTIONING OF THE BULGARIAN ECONOMY UNDER A CURRENCY BOARD ARRANGEMENT

TWO SCENARIOS FOR MACROECONOMIC STABILIZATION OF THE BULGARIAN ECONOMY

The implementation of the currency board rule is practically a return to automatic balancing of payments using the relative prices mechanism and the change in the quantity of money in circulation analyzed by David Hume (1752) more than two centuries ago. The use of such instruments under present conditions presumes the reserve money issued by the Central bank to be at least equal to convertible currency reserves. In this case the body responsible for monetary circulation will be able to guarantee the free exchange of reserve money at a fixed exchange rate. The latter is an average value around which the real market rate of exchange of the national currency will fluctuate.

In principle, modern central banks, BNB included, are bound by national legislation to sustain the stable domestic and foreign purchasing power of the national currency using monetary and credit policy instruments. Therefore, the difference between the monetary system based on the currency board rule and a monetary system managed by the Central bank, boils down to the mechanisms for achieving the objective, namely internal and external equilibrium at a stable domestic and foreign value of the national currency.

In small open economies like Bulgaria, the basic difference between the currency board and the active monetary policy is rooted in the so-called sterilization. The latter is necessary when the growth of convertible currency reserves threatens to spur an unwanted increase in the money supply and high inflation. The classic market-oriented sterilization instruments are the so-called open market operations, the increase in the rate of commercial bank required reserves in the Central bank, and, to a degree, interest rate policy. Under a currency board it is assumed that the fixed exchange rate in combination with inflation (resp. changes in international relative prices) and the liberalization of capital account, operations automatically ensure internal and external monetary equilibrium.

The choice between stabilization with sterilization (the classic monetary policy) or without sterilization (currency board), depends on the efficiency of sterilization instruments in the concrete situation.

Seeking an answer to this question, AECD experts tested the existence of causality (in the sense of the so-called Granger Causality or Non-Causality) between the basic sterilization instruments used by BNB and the dynamics of the BGL/USD exchange rate.

The analysis based on time series in the period 1991 - 1996 yielded interesting and significant results.

First, it clearly indicated that open market operations (mainly BNB's REPO-deals with the State Savings Bank and other Commercial Banks) did not influence the exchange rate. The key objective of REPO-deals - pumping liquidity out of the banking system to stabilize the exchange rate - could not be achieved since the strongly non-competitive government securities market responded by increasing the interest rate (yield) and in a short while accelerated the inflow of liquidity into the economy through larger domestic government debt payments.

The issue of the base interest rate is more complex. There is causality between the base interest rate and the exchange rate of the lev which, however, is distributed over four lags. The signs of the ratio change in alternation, so that their cumulative influence is neutralized. Therefore, the base interest rate may only be used as a short-term instrument for exchange rate stabilization; interest does not influence the exchange rate in the long term.

The relation between the exchange rate and M1 is much more complex. On one hand, the change in basic money supply influences the exchange rate with a certain lag. Reverse causality, however, also exists - M1 is influenced by exchange rate changes. The reverse causality allows the stable exchange rate to be used as an instrument for stabilization of money demand and supply.

The clearest causality exists between the rate of required reserves and the BGL exchange rate. The Granger causality is unequivocal - the active use of the rate of required reserves weakens exchange rate fluctuations. This stable correlation allows the Central bank to implement its stabilization policy. AECD's computer-

simulated model based on the active use of the rate of required reserves in tight coordination with the base interest rate policy indicates that the currency crisis in 1996 and hyperinflation in early 1997 might have been avoided by well-timed and adequately proportioned measures. The figures illustrating different monetary-credit policy scenarios are published in AECD's six-month economic survey for 1996, p.63.

On the other hand, the fiscal and monetary policies implemented in Bulgaria indicate that the efficiency of stabilization measures depends most of all on the will for applying a consistent system of measures. The implementation of a stabilization policy based on required reserves was running contrary to commercial bank interests and as a result was abandoned for a policy oriented towards open market operations and the base interest rate. As was already mentioned, REPO-deals and interest rate policy proved to be ineffective, with the exchange rate and inflation getting out of control.

The following conclusions can be drawn regarding the currency board issue:

- a stabilization policy based on active Central bank measures is possible in principle, but requires focused political will and transparency of objectives and instruments, regardless of any private interests;

- the transition to a system based on the currency board rule is rather a means for shielding monetary policy from negative influences by reducing it to a set of several simple and hard-to-bend rules;

- the main problem of waiving monetary policy measures (the implementation of a currency board) concerns the short-term economic response, the medium-term evolution and the minimum necessary foreign support to ensure the successful start of the system.

THE TRANSITION TO A CURRENCY BOARD FROM THE VIEWPOINT OF ECONOMIC GROWTH, THE BALANCE OF TRADE AND POLITICAL STABILITY IN BULGARIA

In the wake of the nearly 10% real-term decline in GDP in 1996, economic recovery and growth is among the prime objectives of economic policy. To this aim AECD has constructed a model registering the specific factors of growth related to the functioning of the monetary-credit system. In particular, real GDP growth is

represented as function of the velocity of money circulation, the relative intensity of commercial bank refinancing by BNB, and the real interest rate level.

In addition, computer simulations based on this model presuppose: gradual restoration of confidence in the banking sector measured by a stage-by-stage slowdown in the velocity of money circulation to offset the acceleration in 1996; freezing of commercial bank refinancing; real interest rate determined by market price fluctuations and a tighter correlation between domestic and international interest levels. Under these conditions, a moderate growth of some 2% may be expected in the first year of the currency board.

The trade balance is not expected to improve substantially. This is due to the fact, that exports depend on the real exchange rate. The latter is expected to appreciate under a currency board and thus reduce the relative competitive edge of Bulgarian exports. This trend may be offset by a drastic increase in the customs duties collection rate and urgent implementation of mechanisms for export promotion, including export credit and credit guarantee schemes.

Similarly, the financial conditions of industrial enterprises will not improve at once. Initially, the drop in interest rates will alleviate their situation. However, ensuing high real interests and BGL appreciation will be a negative factors. We may expect a trend for a gradual stable improvement in the financial conditions of the real sector as late as the end of the first year of the currency board.

Economic and political instability has characterized the entire period of radical political and economic reforms in Bulgaria. GALLUP data supplied to AECD made possible the computer simulation of correlations between variables, reflecting the economic and political dynamics. In particular, the low confidence in the Bulgarian Government, measured as percentage of the people of the respective sample, who do not approve the cabinet's policy, is function of its previous trends and one economic variable - the real BGL exchange rate.

On the basis of the above assumptions, and on the hypothesis, that the currency board will be implemented by a new government, the dynamics of confidence/mistrust in the executive power may be projected using the real BGL exchange rate forecast. Computer simulations indicate that mistrust will stabilize at 40-

44% at the end of the first year of the currency board. This is extremely favourable having in mind the rapid „wear and tear“ of Bulgarian cabinets, since 1989 since mistrust in their actions quickly exceeded the 50%-benchmark.

In summary, the introduction of a currency board will have a predominantly positive impact on economic growth, including savings and investments, as well as bring political stabilization to the country. On the other hand, we may expect deterioration of the real sector financial conditions and of the balance of payments with possible negative consequences for the banking system. This would signify, that the successful start of the currency board will be conditional upon foreign financing, both private and official.

SCENARIOS OF A CURRENCY BOARD ARRANGEMENT

Market reforms in Bulgaria over the past few years have been largely inconsistent. In fact, after the initial liberalisation of prices and the foreign exchange rate there have been no other decisive steps supporting the transition from command to a genuinely market economy. As there were no large-scale privatisation, liquidation of loss-making enterprises and prudential supervision of the banking system, the better part of the economic agents continued to behave within the well-known old patterns. The soft budget constraints and weak government control on the public sector provided no incentives for the national economy (90% state ownership), and it continued to generate deficits.

The fragile macroeconomic stabilisation and shaky growth over the 1994-1995 period were mainly due to the transformation of enterprises' bad debts into a government debt (1994), or the inflow of short-term foreign capital attracted by the interest rate differential. As there were no such conditions available in 1996, the economy proved to be unable to sustain real growth by itself. The loss of confidence in the lev due to the unstable monetary policies and the absence of finalised agreements with the international financial institutions brought about a drawback of short-term foreign capital from Bulgaria. The lack of sizeable capital inflows (foreign credits or direct investments) in 1996 coincided with vast payments on Bulgaria's foreign debt which further undermined BNB foreign exchange reserves and created expect-

tations of a weakened national currency. This process was further underpinned by the panic withdrawal of deposits (both in leva and foreign currency), triggered by the acute crisis in the banking system since early-1996.

At the end of 1996 the Bulgarian economy reached a phase when short-term decisive steps had to be taken immediately. Obviously, any further delay in solving the pressing economic problems has been impossible.

A major measure is the decisive and urgent restructuring of the system, associated with a speedy and large-scale privatisation as well as the liquidation of the loss-making enterprises. Yet, this measure cannot be implemented overnight and requires a longer period of time. Unfortunately, the Bulgarian government has to face three key economic problems, which are definitely of a short-term nature. Macroeconomic stabilisation and domestic and foreign debt servicing are now the pressing issues at hand. Solutions must be found within the next few weeks.

Macroeconomic stabilisation is largely dependent on the variants of debt servicing (domestic and foreign). The instability of the macroeconomic parameters has to do with the lack of confidence in the Central Bank, government, other political institutions and, last but not least, confidence in the national currency, which in turn is associated with the potential capacity of the government to meet the forthcoming vast payments on the country's debt.

The major question we have to answer is: Is the government able to carry out debt servicing on its own in the next couple of months and, if so, what would the consequences be? This variant has to be referred to the possibilities for external borrowing which will shoulder the government in the following months when solutions to the problem will be most restricted.

In principle, there are two basic solutions to the problem of government debt (domestic and foreign): either servicing or a moratorium on its servicing. The second solution will have grave consequences for the Bulgarian economy in the long-run and, therefore, has to be ruled out. Deferred servicing of both domestic and foreign debt is not a rejection to service the debts. It is a possible variant, entirely contingent upon foreign creditors' good will to agree on such a measure, however.

Hence, debt servicing is the only acceptable solution. The present state of

government finances and BNB foreign exchange reserves questions the feasibility of a variant without foreign capital inflow. Against the present largely distorted background we can hardly expect any substantial foreign direct investments. As experience in cash privatisation shows, large capital inflows in privatisation projects over the next couple of months cannot be expected either. There will be, too, no inflow of foreign portfolio investments unless the lev's galloping depreciation is contained or there are signs that this not a steady trend. Therefore, external borrowing remains the only possible way of foreign financial aid. Bulgaria has such a credit rating that its access to medium- and long-term credits depends on the finalisation of another stand-by agreement with the IMF. The IMF, however, sets a currency board arrangement as the main precondition of a new finalised agreement with the institution. In the final analysis, the main issue at hand is whether the nation will be able to continue servicing its debt without a currency board arrangement, i.e. without foreign financial aid in the following months.

A CURRENCY BOARD ARRANGEMENT BY END-MARCH

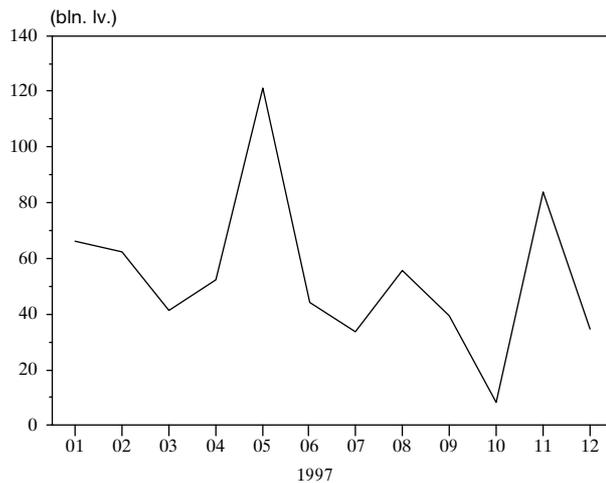
November 1996 witnessed the first hot debates on currency board issues. It has been assumed that this measure could be implemented in February 1997 at the latest. Today, however, February seems an unrealistic deadline. The earliest possible date of the establishment of a currency board is the end of March. But as time goes on the prospects for a currency board in end-March are growing bleaker and bleaker.

Fiscal policy implementation is in the utmost degree dependent on the deadline of a currency board arrangement. Government finance are intimately related to the acceptance of the 1997 Government Budget. The Budget, however, stands little chance to be passed in Parliament by end-March for two reasons. The first one is purely political and bears upon technical and legal matters in adopting the budget law. The adoption of the law has been accomplished as stipulated by the 1996 Law on Budget Structuring and accompanied by reports on the implementation of the government budgets throughout the four-year period from 1992 to 1996 including. The second reason is directly linked with the difficulties to make a

credible budget under a political and economic crisis. Also, it is obvious that a consistent macroeconomic framework, which budget forecasts can rely on, cannot be worked out at present.

Due to the fact that the Government Budget Law has not been hitherto enforced and the absence of any other similar law the Ministry of Finance is limited in its expenditures up to 1/12 of the last year's budget expenditures, i.e. about Lv 44-45 bln monthly. At the same time, vast payments on the country's domestic debt will have to be made within the coming months. Interest payments on government securities issued by end-1996 alone surpass Lv

Interest Expenditures on Domestic Debt*



* Dollar ZUNK payments excluded

60bln on a monthly basis in the first quarter of 1997 (expenditures on coupons of foreign exchange ZUNKs excluded). Thus, interest payments on the domestic debt alone exceed the amounts allowed by the normative basis. If even normative problems have been dealt with, budget expenditures could hardly be covered via budget revenues only. The hardest possible budget constraints given, non-interest expenditures are unlikely to step down below Lv 20bln on a monthly basis. Thus, budget expenditures will total no less than Lv 80 bln monthly. The new mechanism of BIR calculation will lead to another BIR increase at the end of January, which further heightens the importance of domestic debt servicing for the government budget. Due to the economic slump and weak tax system monthly budget revenues will hardly step up above Lv 40bln.

Thus, a budget-generated deficit (as yet, payments on foreign debts have not been taken into account) is emerging which will have to be covered in one way or another (a debt moratorium has already been discarded). At present, the instruments of BNB monetary policy are highly restricted. Repos with an over-two-days'

maturity (whose volume in the week to January 17th amounted Lv 778,44 bln) have been suspended, followed by the close of BIR setting. Thus, BNB policy instruments have been reduced to credits extended to the government and commercial banks, the level of the minimum required reserves and overnight Repos with a up-to-two-days' term. Reducing BNB possibility to be the decision-maker in monetary policies is half-way through to a currency board operation. At the same time, BNB is experiencing hard budget constraints and the implementation of routine monetary policy instruments will hardly influence the dynamics of both the foreign exchange rate and inflation considerably. However, the following decisive steps are advisable:

- banks are obliged to keep all their minimum required reserves in leva;
- minimum required reserves should be raised to the 15%-maximum;
- both the Central Bank and the Government should declare that no banks will be closed within the next year;
- tough measures against and strict control over banks' long foreign exchange positions.

In the period to end-March, crediting for the budget will bring enormous pressure to bear on BNB. Fighting hyper-inflation means reducing credit to the government. By the time the Government Budget Law is enforced BNB will have to deal with real restraints, for without an operative law the maximum amounts of direct credit allowed is Lv 24.7 bln. Formally, BNB can avoid purchases of government securities on the primary market - the Ministry of Finance has switched to issues of discount securities without announcing beforehand the volume of issues, thus providing BNB with a way out from buying the quoted but untraded quantities.

In response to reduced credit, the government may exert pressure on BNB and force it to suspend Repos (Lv 504.6bln turning over in one- or two-day termed transactions in the week to January 24th) and replace them with government securities collateralised Lombard loans. Thus, the Lombard interest rate will be assigned a more important role. Taking indirectly over transactions related to banks' short-term liquidity, the Ministry of Finance will have to put off its intention to quickly improve the term structure of its debt, especially if hyper-inflation results in another round of panic withdrawal of deposits. It can be assumed that commercial banks will resort to some

precautionary measures such as raising interest rates on the resources attracted and seeking a higher yield at the auctions of government securities.

Monetising the budget deficit will have a direct influence on inflation acceleration. Due to this only, inflation in the first quarter of 1997 is expected to amount to about 60%.

During the same period the balance of payments will have to face a major hardship, viz. the US\$ 130 mln worth of payments on the country's foreign debt in January. The position of the balance of payments in 1997 will be influenced by a couple of factors: export and import, the inflow of foreign investments and possibilities for Bulgaria to get financial aid from international financial organisations. It can be said that the last two factors will have no effect.

The inflation tax has been an important source of revenues in almost all CEECs since the beginning of the transition period to a market economy and it has maintained its significance even after the initial high levels of inflation. From a purely theoretical point of view, the inflation tax may prove a better instrument of control over the economy, as compared to traditional taxes. It may prove a more viable instrument, especially in combination with an erosion of the domestic debt (and its domestic currency component in particular) due to inflation.

Emerging hyper-inflation and a currency board given, the economic picture in Bulgaria has changed drastically.

First, the seignorage revenues depend on the difference between actual inflation and the inflation expected. At the very outbreak of hyper-inflation households and economic agents' expectations will be quite pessimistic, i.e. they will largely outstrip and even cause the actual course of the process.

Second, the vast amount of the dollar-denominated domestic debt and the foreign debt offset the government's profit from a runaway inflation due to concomitant rise in the nominal exchange rate. As a result, the possibility to use the inflation tax as an instrument is highly limited. Due to the unfavourable structure of liabilities the government should confine itself to some routine instruments of fiscal policy (conventional taxes and expenditure policy). Some estimates suggest that from the point of view of seignorage revenue maximisation, optimal inflation in Bulgaria should

amount to 70% on an annual basis. Hence, any measure targeted at inflation deceleration leads to an increase in the revenues from seignorage.

The decline in foreign trade will persist in the first quarter of 1997.

There will be a trade deficit which is not expected to surpass US \$50 mln. The balance between imported and exported services is expected to be positive but the surplus will be so negligible that can hardly have any effect on the current account. The negative net incomes in the first quarter, amounting to US \$180 mln, will be the key factor at work. Ultimately, there will be a current account deficit amounting to US \$170 mln in the first quarter. All this will bring about a shrinkage of BNB foreign exchange reserves to about US \$350 mln, further depreciation of the lev and higher levels of inflation. If payments on the Sodi-Devnja Deal are made according to schedule, there will be US \$120 mln worth of direct investment which will restore BNB foreign exchange reserves. These payments, however, are due in February and after the hefty amounts on the country's foreign debt the exchange rate will stabilise at much higher levels. Also, the ongoing dollarisation of the economy should be taken into account.

In the final analysis, inflation acceleration and even hyper-inflation are the only alternative to the absence of a currency board arrangement and further foreign and domestic debt servicing.

A CURRENCY BOARD ARRANGEMENT BY END-JUNE

Generally speaking, the above conclusions are to be valid in the case of a currency board arrangement by end-June. Yet, there are certain differences. Domestic debt payments will now be the key problem in debt servicing. As a result of the coupon due on bonds, May will witness a doubling of the monthly amounts of the interest due on government securities. Interest payments on foreign exchange ZUNKs, ranging between US \$20 and US \$30 mln, will add up to the regular interest payments of the budget in June. At present, it is very difficult to estimate their leval equivalent due to impossibility to forecast the foreign exchange rate without a currency board.

Again during the same period BNB will find it very hard to contain govern-

ment credit growth, for there will be an enforced budget law stipulating direct credit volumes. We can suppose that as in end-1996 credit volumes will be considerable and they will serve as budget reserves on the threshold of severe financial restrictions imposed by the currency board. In this case, domestic credit growth will generate high inflation, most probably higher than inflation in the first quarter of 1997. Galloping inflation transforming into hyper-inflation will not have an altogether healing effect on the domestic debt, for the better part of the debt was denominated in foreign currency as at end-1996. In practice, hyper-inflation will be only cleaning up its leva component but will not change its foreign exchange part.

In case BNB extends a vast direct credit to the government, then the only alternative for the budget remains the capital market, i.e. the commercial banks and their highly restricted capacity to absorb the growing amounts of government debt. Most probably, high inflation and impoverishment will compel people to turn to their slender savings as a last-ditch resort which will cause a new outbreak of turmoil in the banking sector. Ceasing the panic in the banking system means refinancing again commercial banks, despite the real effort made to withhold and reduce refinancing to about Lv 60bln at the end of 1996.

There are, too, expectations of increased revenues due to the high exchange rate and inflation. In practice, turnover is very likely to decline considerably and therefore real revenues will fall regardless of the inflation rate.

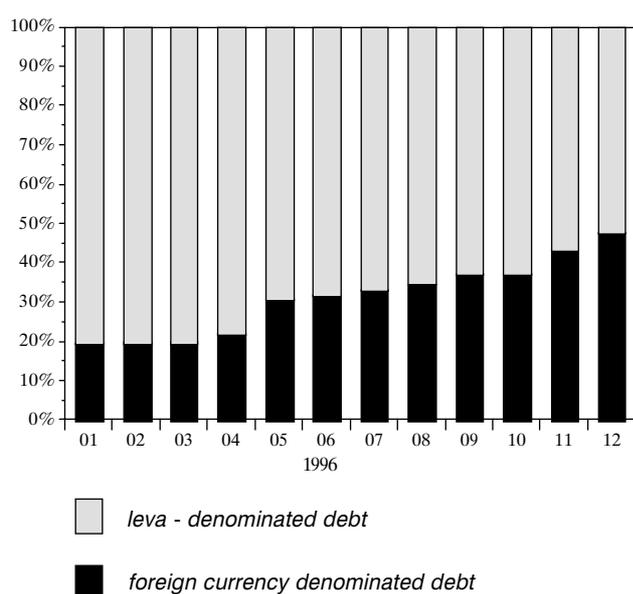
The highly limited real incomes of households, which are the major final consumer in the economy, will further contract turnover and thus erode the base of the key revenue source - VAT. At the same time, full-inflation indexation of incomes in the budget sphere is barely possible and can be in turn used to justify the lack of income adjustment in the extra-budget spheres. Thus, the possibility to increase the volume of final demand is neutralised. Hence, to increase the volume of overall turnover and output. The economy has entered a vicious circle - the impossibility for an inflation indexation of budget incomes has brought about a shrinkage (indirectly) of budget revenues, which in turn lessens the possibility for an indexation of incomes.

Due mainly to the absence of substantial foreign debt payments the current

account is expected to run a slight deficit in the second quarter of 1997.

Notwithstanding the policy choice of BNB, the lev's depreciation will continue. In the first case, easing monetary policy and increasing money supply - the exchange rate will rise proportionally to the increase of leva liquidity. Due to currency substitution in the economy there will be a growing demand for foreign currency which will multiply the effect of money supply growth on the dynamics of inflation. This is the classical mechanism of hyper-inflation. In the second case, the maintenance of restrictions will only slow down the exchange rate's rise but will not stop it. The demand for foreign currency by means of which payments on foreign transactions can be made is insufficient in itself to maintain the lev's depreciation (especially with a view to the thin forex market at present). The pressure on the lev will further increase due to the demand for foreign currency which will meet foreign debt payments in July. If the volume of BNB foreign exchange reserves does not increase as a result of finalised privatisation deals, the government will find itself unable to make any forthcoming payments on the country's foreign debt by the end of 1997 because it has run out of resources.

Domestic Debt Structure



A major conclusion, then, is that any delay in establishing a currency board in Bulgaria may only lead to a period of hyper-inflation and a possible highly inflationary stabilisation of the macroeconomic parameters. A longer delay, however, increases the possibility for financing the growing government debt payments via actual privatisation deals. Having in mind the markedly unstable economic and political environment in the country and past privatisation experience, this possi-

bility remains nothing but wishful thinking. The hyper-inflationary alternative to a

currency board delay exerts a highly negative effect on the real sector and households' incomes. In the first place, this is the sharply growing foreign exchange component of the non-government domestic credit whose actual volumes are independent of the lev's depreciation. In the second place, strong government control over the prices of major state producers will make them major loss-makers under hyper-inflation. Their loss from price controls will surpass a possible profit from a decrease in the real value of the leva credits outstanding.

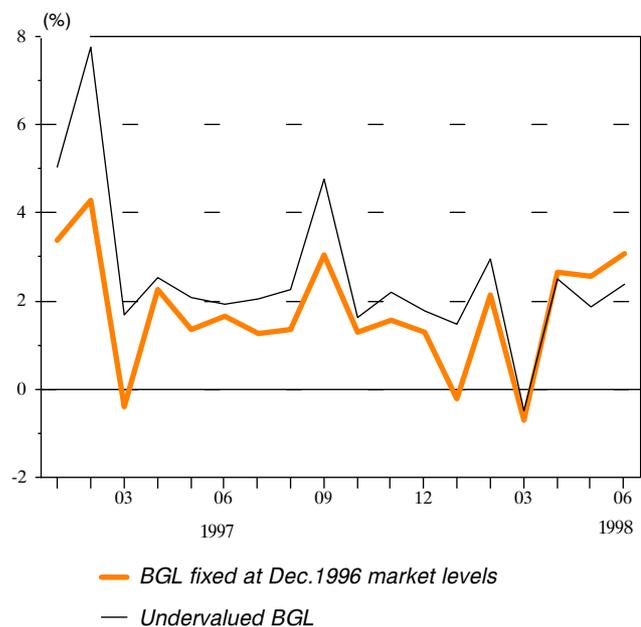
As long as the burden of the foreign exchange component of domestic credits increases in the structure of budget expenditures, the government budget will not benefit from a hyper-inflationary variant, either. Commercial banks seem to be the only winner, for the real value of bad and doubtful credits will decrease. And yet, there is one more adverse factor at work. When inflation levels increase, interest rate levels tend to increase, too. All this will increase the number of credit defaults and lead to a deterioration of commercial banks' capital and liquidity positions.

INFLATION

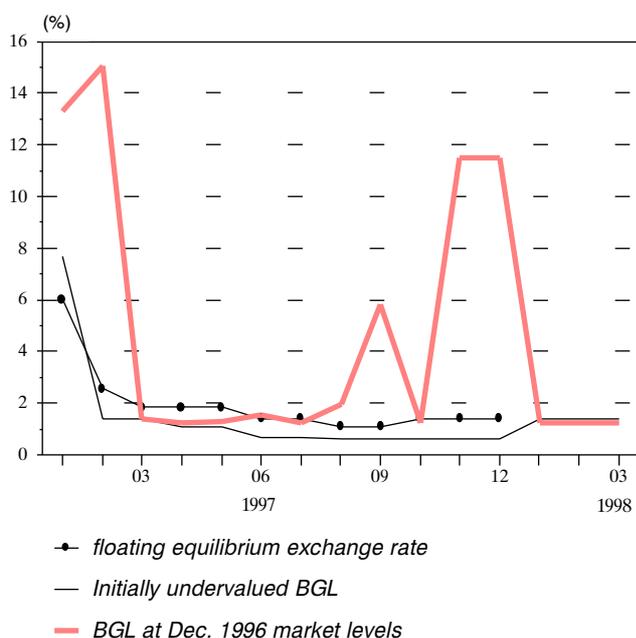
Statistical forecasts imply that inflation will decelerate after fixing the exchange rate. Provided the economy is tending to an equilibrium, inflation will begin to oscillate around and below the 2-percent level in the two to three months following the exchange rate fixing. Some of the coming months are also very likely to witness deflation.

Depending on whether the lev is undervalued or not at the initial point, there are two possible ways of relative price change and they may exert an adverse impact on price proportions.

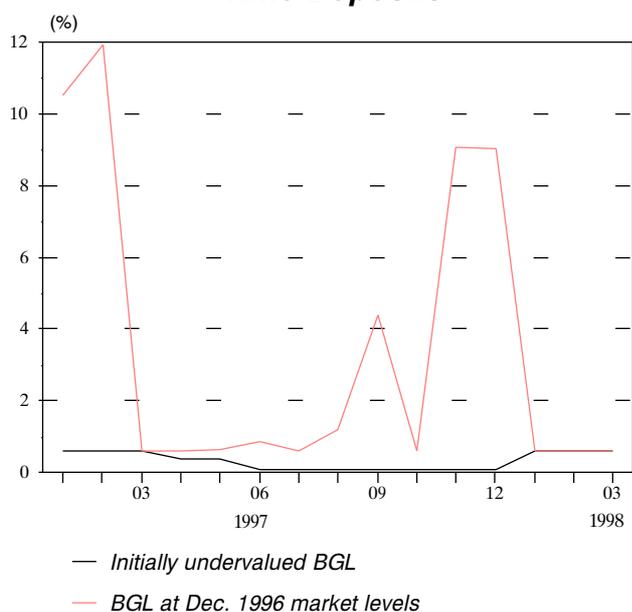
Monthly Inflation



Monthly Interest Rates on Short-term Credits



Monthly Interest Rates on Time Deposits



If the lev is fixed at its market level prior to a currency board arrangement, the relative prices of domestic goods will take up an upward trend. Forecasts unambiguously point that this will bring about growing imbalances over time. The scissors between the prices of tradables and non-tradables is coupled with a minimum imbalance only if there is an increase in production costs, e.g. an increase in nominal wages and interest on credits. In either case there is a notable contradiction with the classical description of a currency board.

Conversely, if an exchange rate at which the lev has been initially undervalued is chosen, the very start of the currency board will trigger an imbalance which will be nonetheless asymptotically convergent to zero with the passage of time. The imbalance can be eliminated within 4 to 5 months due to non-zero inflation. The system can be stabilised

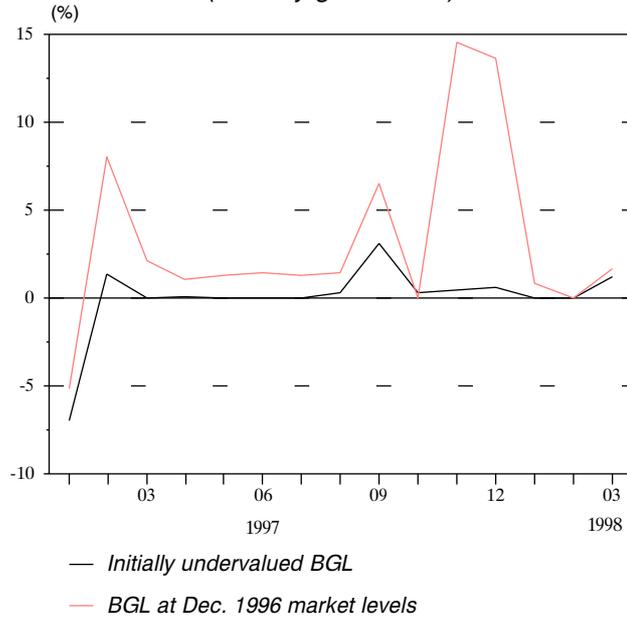
at a dollar's exchange rate of about 25% above its market level prior to a currency board arrangement.

The graph shows the simulated dynamics of the monthly inflation rate in either case and provided the economy is tending to a state of equilibrium.

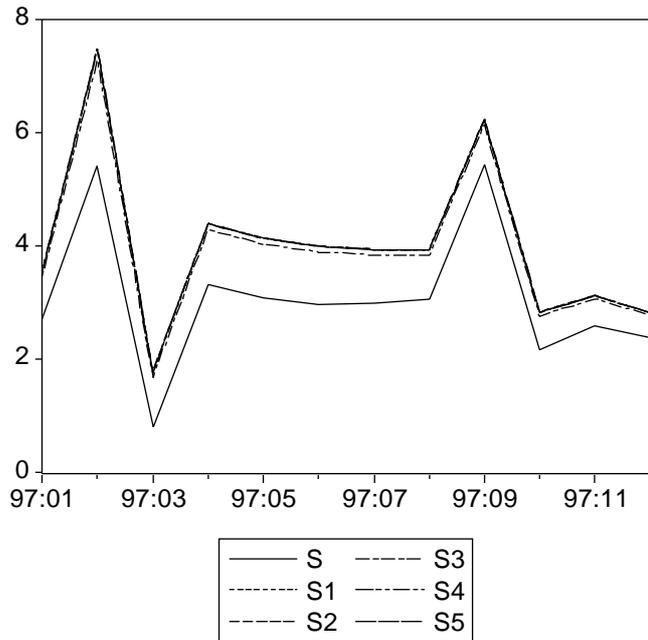
Given an initial undervaluation of the lev, the monthly inflation rate will be by

1% higher on average, as compared to an exchange rate peg at a market level. Therefore, over the March-December 1997 period accumulated inflation in the two cases will be 25% and 21% respectively. The following graphs reveal what dynamics of interest rates and wages is needed to derive minimum price disproportions. With one of the variants, peaks appear to „justify“ the already discussed scissors between international and domestic prices.

Average Wage Dynamics
(monthly growth rate)



It has been so far assumed that energy prices have been adjusted via the now-operating price adjustment mechanism. However, as computer simulations show, if energy prices are fixed, imbalances might appear and bring about higher inflation (curve S on graph 5), thus reaching some 32% in the March-December period.



The economy’s tendency towards an equilibrium is another essential condition, the violation of which may affect inflation.

Relying on the historically observed mean and variance, we can experiment with several scenarios of normal random disturbances in order to track down any equilibrium change. And the result is always higher monthly inflation rates (curves S1 to S5). Over the March-December period accumulated inflation will be by 11

percentage points higher with any of the other scenarios examined. It follows that if the current disequilibrium persists, the period may witness about 36% inflation, electricity price adjustment given, and 44% in the opposite case.

FISCAL SECTOR

Basic Assumptions

In order to avoid fluctuations in nominal leva levels, we here rely on their dollar values. Price indices are inappropriate, since PPI dynamics has differed considerably from CPI dynamics over the past two years.

Introducing a currency board means ceasing BNB direct loans, as well as no more profit remittance. At the same time, BNB will no longer be a player in the government securities market (both primary and secondary) but will most probably retain its functions as a major technical operator of issues and cash operator of the budget.

Revenues

The primary source of budget revenues - VAT is expected to step down to 150mln USD in the first quarter (against 184.8 in 1995 and 164 in 1996). An improved economic situation in the following months may bring about a revenue rise up to about 190 mln USD per quarter. Profit tax raised from non-financial enterprises and excise duties are expected to follow the similar dynamics.

A currency board will further aggravate the condition of the banking system, and of the SSB in particular. Due to this profit tax revenues from financial institutions are expected to hit lower levels than in 1995 and 1996,

The dollar levels of the revenues from income tax, customs duties and tariffs are expected to initially retain their levels of the last two year. Consequently, a slight rise is anticipated as a result of an economic pick-up.

Non-tax revenues will decrease drastically due to the lack of BNB profit remittance and cessation of receipts from Jambourgski Gas.

Expenditures

Interest and other expenditures are the two major components that make up budget expenditures.

Interest expenditures are expected to decline as a result of the decrease in average interest rates in the economy after the introduction of a currency board. At the same time, they will remain higher than their average levels due to the mechanism of interest payments on government securities - the weighted average BIR over the preceding six months (or its equivalent under a currency board arrangement) plus a premium. It is thus assumed that the average interest rate at which inter-

est payments on government securities will be made will amount to 110% in the first quarter of 1997 and 50%, 38% and 25% respectively in the following quarters. It is also assumed that the deficit will be fully covered by securities with a 3-month maturity, i.e. interest on the newly-issued government securities will be paid up in the next quarter. This is a rather cumbersome scenario, for it further burdens the budget in the initial hardest months of a currency board operation.

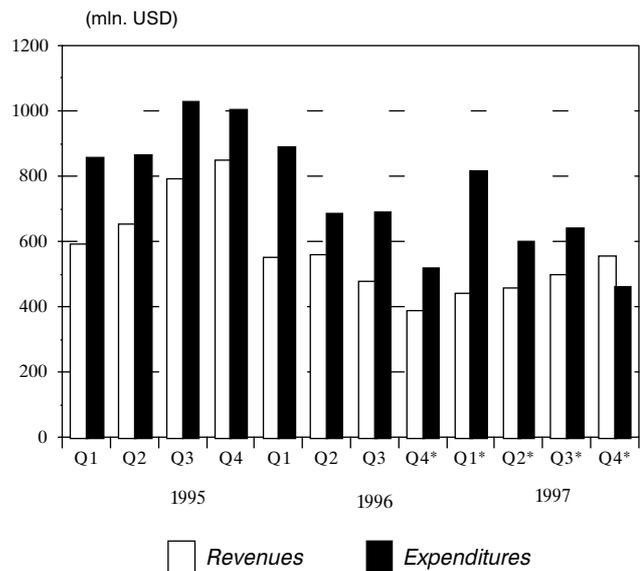
Expenditures on interest payments to foreign creditors are independent of the interest rate inside the country. The present report relies on the 1997 interest expenditures by quarters, as forecast by BNB.

Expenditures minus interest include labour costs (wages, fees and social insurance payments), capital expenditures, etc. They are expected to surpass their 1996 levels to avoid trade union unrest in such sectors as public health and education. Also, this group of expenditures is expected to further increase in end-1997 due to a relative decrease in the burden of interest payments.

Budget Balancing

As in previous years the state budget will go on maintaining a primary surplus, though smaller in absolute terms. Under a sharp interest level slump the

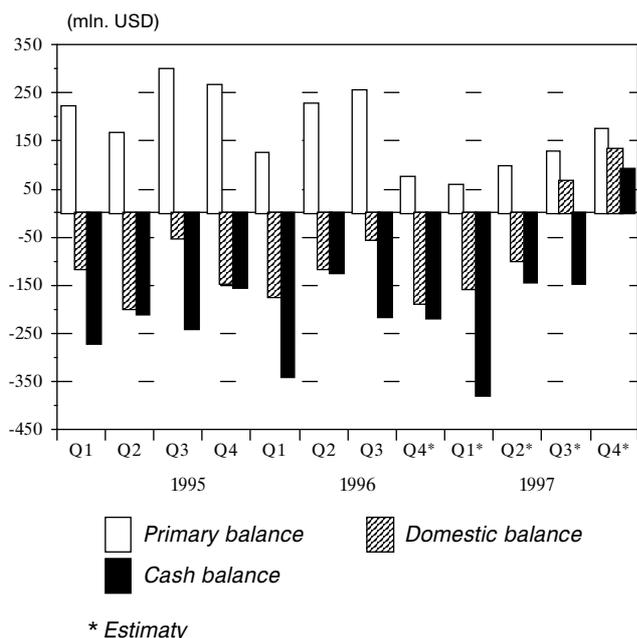
Revenues and Expenditures of the Republican Budget



* Estimaty

primary surplus is expected to lose some of its significance but its maintenance will remain mandatory in order any further government debt increase to be shunned.

Republican Budget Balances



The extremely favourable effect of the decrease in interest expenditures will probably bring about a domestic surplus of about US \$10 mln by the end of 1997.

As a whole, the trends outlined above will lead to a decrease in the cash deficit in the current year, dropping from over US \$800 mln in 1995 and 1996 to about US \$530 mln in 1997. If these trends persist, 1997 may witness primary, domestic and cash state budget surpluses in the last quarter.

BANKING SYSTEM

Like the government budget, the banking system is another great generator of deficits in the economy. Deficits should be financed and reduced prior to a currency board arrangement. In 1996 the banking system was practically broken up into banks placed under supervision and against which the Central Bank had started insolvency procedures and banks that were still scraping through as players in the financial market.

The insolvency claims on the part of BNB have not so far solved any of 13 banks' problems but have only put them off. The Law on Deposit Insurance stipulates certain government obligations to depositors. The current insurance scheme, covering 100% of natural persons' deposits and 50% of legal entities' deposits will require Lv 25 bln and US\$ 140 mln. The budget must provide resources which should become available upon depositors' withdrawal claims.

The credit portfolios of the banks against which insolvency procedures have

been instituted consist largely of non-performing credits. As at end-September 1996, non-performing credits amounted to Lv 62bln, and those classified into group B (according to BNB Ordinance #9) to Lv 27bln. The establishment of an agency for loan collection has its advantages. The concentration of resources into a single institution will allow for a proper assessment of the financial conditions of the enterprises indebted to this group of banks. Upon liquidation of the defaulter-enterprises, the procedure on creditors' indemnity can be vastly facilitated, for the single state body acting as a creditor will be the agency for loan collection. Another major advantage will be the avoidance of malfeasance on the part of sequestrators in banks against which the central bank has opened bankruptcy procedures. The disadvantages, associated with the establishment of a such an agency, are mainly institutional and bureaucratic in nature. Also, a great deal of purely technical work will have to be done. In case such an agency proves essential, it will have to be established in the shortest time possible.

Although the Central Bank has opened bankruptcy procedures against 13 banks, there are still banks in a bad financial state in the market. Although each bank's capital adequacy ratio is positive, there still remain 5 state-run and 3 private banks with negative net worth in the financial market. It is estimated on the basis of a comparison between the bank's capital plus the reserves adjusted for loss and the required reserves which banks must form (pursuant to BNB „Ordinance #9 on credit classification and required reserve formation targeted at providing for doubtful and non-performing credits“). Overall, the negative net worth of the banks which are market players totalled Lv 25 bln in end-September. The discrepancy between the provisions which have to be formed pursuant to Ordinance #9 and the actual size of banks' own capital is mainly due to the hefty share of credits in arrears in credit portfolios. As at end-September, over 60% of leva credits and 30% of foreign-currency credits were overdue. Around 15% of all credit has been classified as non-performing. To date, the situation is even worse. Due to high interest rates - a 24% monthly interest rate on short-term credits in October which makes 1246% capitalised annual interest - even otherwise regular payers would suffer tremendous difficulties in making payments. It is also possible that these figures could be underval-

ued and due to the common banking practice to extend fresh loans in order to pay off old credits, the fresh resources are classified as a performing loan.

The difficulties of commercial banks, triggered by the necessity to pay interest on all liabilities and receiving proceeds on less than half of the credits extended, are further heightened by the term incongruity between assets and liabilities. On the basis of several assumptions, we have estimated the banks' liquidity gap brought about by the term incongruity between transactions and the share of credit arrears.

It assumed that 1-month deposits are claimed after a six-month period, 6-month deposits after a one-year, and one-year deposits after a year and a half. Firms are supposed to maintain stable outstanding amounts on their current accounts over time. Thus, the average period after which a unit of deposits can be withdrawn is 8 months. At the same time, a unit of performing credit is paid back in a year and a half on average. The estimation of the duration of withdrawals and pay-backs is to a great extent approximate. Yet, if we assume that the difference between the two results in negative liquidity, its volume within a single year amounted to about US\$ 200 mln.

This sum has to be taken into consideration provided there is any pressure on the part of depositors after the establishment of a currency board. If the board's foreign currency reserves do not provide resources for the banking system which will compensate for the withdrawal of leva and foreign-currency deposits and the exchange of the leva deposits at the official exchange rate, the board can be quickly discredited. Restrictions on the lev's internal convertibility given, there may appear a parallel shadow market in which exchange rates may be multifold higher than the official exchange rate, as was the case prior to the market liberalisation in 1990. Following the Central Bank's retraction from the interbank market, banks will have to rely on their own resources or on loans from other commercial banks to deal with liquidity problems. The ongoing crisis of the confidence in the banking system has led to a notable shrinkage of the interbank market. What is more, the deposits of financial institutions with bankrupt banks are not guaranteed by the above-mentioned law. Therefore, the lack of resources in the board's foreign exchange re-

serves allotted for commercial banks' recapitalisation coupled with a hard currency board arrangement may spur new bankruptcies.

The recapitalisation of commercial banks should be underpinned by a restructuring of the banking sector. The state's share in the sector can be reduced in two ways. First, via direct sale of the Bulgarian Consolidation Company's shares in state-run banks to private (foreign included) investors. And second, a gradual reduction of BCC's share, which can be easily achieved if BCC does not acquire new shares when banks' capital is raised.

Prior to a currency board arrangement the pressing problem of BNB outstanding refinancing of banks should be settled. As at end-October BNB outstanding refinancing amounted to Lv 63 bln. Lv 47.5 bln out of them are in arrears and more than 90% of them are unguaranteed deposits. Most probably, a vast part of BNB refinancing has been directed to banks placed under insolvency procedures. BNB refinancing of other banks can be transformed into a long-term debt, for following the initial shock of a currency board arrangement output is expected to increase, and lower interest rates given, enterprises will be able to make regular payments to banks. Also, the minimum required reserves can be an additional source of liquid resources. As at present, the minimum required reserves ratio is 10% and its further decrease to 7% may free about lv 25bln worth of resources.

SAVINGS AND INVESTMENT

A possible currency board arrangement may increase the volume of savings, kept with the banking system, and thus increase the degree of predictability of the entire economic system. In our case this can lead to a certain decrease in interest level fluctuations and the inflation index as well as stop the depreciation of the national currency. This conclusion is further backed up by the estimates of the correlation between the change in the leva and foreign-currency deposits of all non-financial agents outside the Government Budget and the fluctuations of two major parameters of the financial system - the exchange rate and base interest rate.

Provided the dynamics of the base interest rate becomes more stable, there a 2.3% increase in savings on a monthly basis can be expected. Also, provided the

banking system undergoes stabilisation and confidence is restored, there can be a further increase in savings in the form of government securities by about 2% monthly. Yet, it is noteworthy that in the initial months of a currency board arrangement there can be drastic downward changes in interest levels which are expected to bring about a relative decrease in the savings available in the banking system. It can be thus said that there will be further withdrawals of deposits from the banking system and saving in the form of government securities will be avoided in the initial period when the currency board has not proved its viability yet.

What part of these savings will be transformed into investment will depend on the willingness of the banks to extend credit to the real sector. In terms of yield and security, government securities may prove to be more attractive. Thus, initially, under a currency board arrangement savings already in the banking system may be used for the purchase of government securities. What is more, if there are greater possibilities for banks to hold their assets in foreign securities, the inflow of savings is very likely to be predominantly oriented to these assets. Due to the highly limited domestic investment opportunities at present the intensification of foreign investment inflows will be crucial to the dynamics of investment activity. In this respect, the acceleration of cash privatisation is important not only for increasing budget revenues, as related to government debt servicing, but the intensification of investment activities in the country as well.

Experience in currency board arrangements in other countries shows that in most of the cases this measure is coupled with GDP growth. IMF's expectations point to 2-3% growth of GDP in the first two years of a currency board arrangement and 3-5% in the following years.

Such expectations are not groundless. AECD analysis implies that the exchange rate's dynamics is a key factor for GDP dynamics and the greater the lev's depreciation the higher the decrease in GDP. Also, we should take into consideration that the indicator's dynamics is inertia-prone and is affected by seasonal factors. AECD forecasts indicate that GDP growth can be expected as early as the second quarter of 1997 (provided a currency board had been established in the beginning of 1997 and accompanied by all the auxiliary measures needed). The GDP

increase expected may even exceed IMF's anticipations. We should, however, have in mind that GDP dynamics will depend not only on a currency board arrangement but also on the implementation of a tough structural reform in the real and banking sectors which will ensure both high and sustained growth of the economy.

CAPITAL MARKETS

The situation in end-September

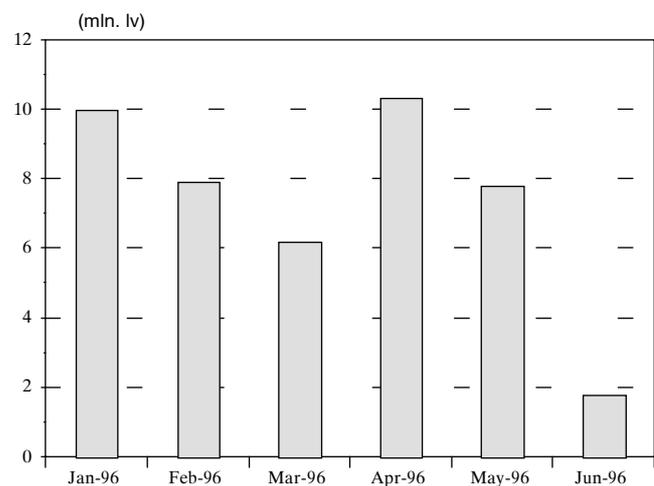
Ever since 1994 there has been a sharp decline in the volume of trade at the stock markets. 1995 witnessed a twofold decrease while in 1996 (to June) the volume of transactions with corporate securities barely hit Lv 43.9 mln (all in nominal terms).

The bulk of trade volumes at the stock exchanges consists of government securities - overall about Lv 144 mln in the first six-month period of 1996. This, however, is only a negligible part of the trade volume in the secondary market - about Lv 250 bln on average per month in the January-September 1996 period.

The major part of transactions in the secondary market of government securities passes through BNB - 93% on average in the January-September period.

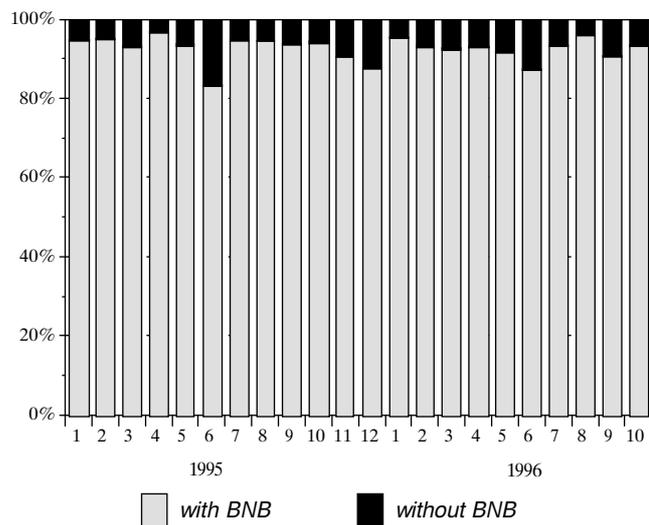
As at end-1995 BNB direct credits amounted to Lv 26051.5 mln,

Stock Exchange Turnover



Source: „Kapital“ newspaper

BNB Participation at the Secondary Market for State Securities



Source: BNB, AECD

or 7.5% of total domestic debt. As at end-September the figures are respectively Lv 41037.5 mln and 6.4%.

At the end of September 1996 BNB's credit portfolio contained Lv 88615 mln worth of government securities.

The start of mass privatisation in 1996 will exert a favourable effect on the stock markets. Unfortunately, the effect can be expected not earlier than the end of 1997.

Under a currency board arrangement, BNB will implement monetary policies no more, i.e. it will stop refinancing commercial banks, extending direct credits to the budget and bring government securities transactions to an end. As a result, the whole burden of the demand for and supply of financial resources in the economy will be placed on the commercial banks and stock exchanges (possible sources of foreign financing of agents excluded).

Short-Run Effects of a Currency Board Arrangement

In the initial months of a currency board arrangement the banking system is expected to deteriorate drastically. The simultaneous effect of the suspension of BNB refinancing and the expected withdrawals of deposits (intended for the purchase of foreign currency or merely due to the lack of confidence in banks) will trigger a sharp shortfall of liquid resources. At the same time, the government budget will be in an increased need of refinancing - both BNB direct credits and profit remittance will be simultaneously stopped, and sales of newly-issued government securities will be highly hampered due to the retraction of the major player (BNB) from the market.

All this will create the following difficulties.

Provided the Central Bank has retracted from the secondary market of government securities, the existing structures of stock markets and commercial banks will hardly be able to maintain the current trade volume of government securities. The volume of trade at the stock exchanges is rather negligible (barely Lv 114 mln out of the Lv 15524 mln overall trade volume in the January-June 1996 period, BNB excluded). At the same time, the interbank market of government securities wherein around 7% of all transactions are conducted, will suffer severely due to the lack of liquid resources to be invested in government securities.

The disappearance of BIR will create further difficulties in calculating interest payments on government securities. If the interest rate on government securities is linked to the rate in the interbank money market (instead of to the BIR), the budget will have to encounter grave financing difficulties - the shortage of liquid resources will be most probably followed by a rise in their prices in the interbank market. On the one hand, this will impede government securities sales in the primary market (banks are lacking in liquid resources). On the other, it will undoubtedly bring about an increase in expenditures on interest (due to both the higher interbank interest rate and the lag effect of the high BIR levels).

The State Savings Bank (SSB) is expected to suffer the most severe liquidity problems, for about 70% of its assets are in government securities. (SSB now has at its disposal Lv 232bln worth of assets and another Lv 161bln worth of government securities). Thus, the bank will neither be able to buy new government securities in support of the budget, nor will it be able to play the role of an alternative lender of last resort, i.e. to refinance commercial banks, as the current practice is. It is likely that SSB will not be able to counteract the pressure and declare insolvency, with all the dreary aftermath of a persistent lack of confidence in the banking system.

With a view to the problems above outlined, the now-existing stock market in Bulgaria is unlikely to be able to take the pressure. Therefore, urgent measures aimed at its stabilisation (in respect with its new role in the economy) should become a must. Also, a host of measures should be targeted at instilling confidence in the stock exchanges which at present is rather low.

Long-Run Effects of a Currency Board Arrangement

Improved economic stability will lead to a stock market expansion, which can be given further impetus by mass privatisation.

The currency board will attract foreign investors' attention to the Bulgarian markets of corporate and government securities. Most probably, investments will initially have a short-term speculative character (relying on the fixed foreign exchange rate and higher yield of Bulgarian securities) but later will acquire a long-term character.

Economic stability will largely offset the initial negative effect on the budget. Interest rates' stabilisation at low levels as well as the gradual elimination of lag effects will trigger a drop on the expenditure side. At the same time, the output pick-up expected will boost tax receipts.

Side-Effects and Stumbling Blocks

As at end-September BNB's portfolio contained Lv 88615 mln worth of government securities. There are two possible ways to dispose of it.

First, to write them off from BNB balance sheets and thus decrease the indebtedness of the government. This scenario discloses a full-hearted recognition of the loopholes in BNB Law, with regard to direct financing of the government. However, it will exert little additional effect, if any at all, on money supply.

Second, to sell them off in the capital market of government securities, which will further increase the supply of securities. This variant, however, entails two negative consequences. The first one presupposes money supply contraction provided no other concurrent measures have been taken. It follows that money supply will have contracted prior to setting the monetary base against an exchange rate peg, or at least its contraction taken into account in calculations. There, however, arises an additional difficulty in setting the price at which government securities will be sold in the market.

If the BNB continues to hold these securities, it will lead to money supply fluctuations when payments on interest and principals are made. (There is no information about the maturity structure of the securities).

Once BIR is removed a new base of setting the yield of the interest-bearing government securities should be selected. As has already been pointed out, it is inappropriate to take the interbank market yield as a base at least in the initial period. It will be much more appropriate to link government securities' yield to LIBOR plus a risk and inflation premium. Thus, the adverse effect of the difficulties the banking system is encountering will be avoided. Coupled with other changes, e.g. monthly payments on interest, sales through post offices, government securities are supposed to become more attractive to households and non-banking institutions, which will ultimately make them the major creditor of the state. Also, having

in mind that the primary market alone has a direct impact on budget financing, the network of primary dealers will have therefore to be further enlarged.

It is possible to conceive a mechanism, meeting certain conditions (e.g. if foreign exchange reserves exceed a given amount) under which a currency board will be able to buy government securities from the government. However, a fixed exchange given, it will be of little importance if they are leva- or foreign currency-denominated.

Under a currency board, the development of the capital market poses a number of problems related to its institutional background, sales techniques and debt instruments.

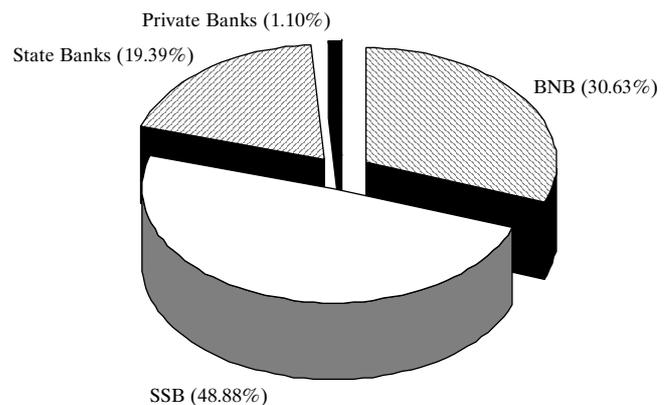
One of the possible solutions is the establishment of a Debt Management Agency. Similar institutions have been set up in Sweden, New Zealand and Hungary. Formally speaking, it can be attached to the Ministry of Finance but it has to be relatively autonomous and inherently market-oriented.

The basic functions of the agency run as follows: to exert permanent control of the government securities market, money markets and the related markets of derivatives; to ensure collaboration with primary dealers, brokers and investors; to analyse information and process data in order to work out annual and quarterly financing strategies, to project debt issue programmes, to

determine the parameters of the interest base, maturity terms, denomination and timing of new issues, to administer and regulate the market of the outstanding issues and improve their liquidity. An immediate goal of the agency is to both minimise the long-term price of the government debt and optimise its outstanding amount.

The establishment of such an institution is essential. As long as it is servicing

**State Securities by Holders
(September 1996)**



the debt BNB will not be able to carry out proper and stable monetary policies. As a result, the possibilities to create more favourable conditions for issuing new debt to the government will be lessened. A currency board makes such a contradiction impossible. Another advantage of the agency is that government debt management can be consolidated. Also, the collection of revenues for its servicing can be easily organised on a stock exchange principle.

The orientation to the capital market at present is of key importance to the existence of a market of government securities. A currency board arrangement will oust BNB from the market (as at September 30th, 1996, BNB held 31% of the government securities with the banking system).

The fact itself would be insignificant provided the debt were long-term. In practice, BNB is holding 23% of the short-term debt in the banking system. In a short-term perspective, if this share is not ousted by commercial banks, there will be real danger of a stop in the debt roll-over, which may lead to a market collapse.

Immediate measures should be taken in order to enlarge the distribution of government securities outside the banking system, which is close to its limit of absorbing securities and cannot take over BNB's share. There are several possible solutions:

- removal of BNB Ordinance on Primary Dealers (currently SSB alone out of 17 primary dealers meets the provisions of the ordinance), inclusion of the whole banking system in ensuring households and non-banking institutions an access to government securities auctions.

- sale of target issues of government securities throughout the whole banking system.

- larger distribution of government securities through brokerage houses, which under appropriate regulation will increase the demand for government securities via closer contacts with investors. It will be considered appropriate if BNB and the Stocks and Exchange Commission apply reliable criteria to investment intermediaries so that the latter may get an access to the primary and secondary markets of government securities.

The active intervention of intermediaries in the market of government secu-

rities may prove a turning point in the policy implemented so far. In order to attract a larger number of brokers, the Ministry of Finance and BNB should work out a joint strategy which will phase out the development of the government securities market as well as highlight the role and incentives of investment intermediaries. In order to be really operative, the strategy should be prepared in collaboration with both brokers and dealers.

The concentration of the secondary market of government securities is only possible in a stock exchange, for the latter has at its disposal at all the technical basis needed for the emergence of a modern and efficient secondary market (carrying out a joint project with SBF at the end of 1997).

The issue of attractive new debt instruments deserves special attention. The issue of foreign currency denominated government securities in the domestic market is a suitable option, despite the fact that there will be a foreign exchange peg under a currency board.

A fixed exchange rate will hardly restore the confidence in the lev overnight. Most probably, people will keep on holding their savings in foreign currency (more than US\$ 700 mln were withdrawn from the banking system throughout 1996). Foreign currency government securities may prove a lot more successful provided the government gives a firm guarantee of subsequent payments on interest and principal. BNB gold reserves or receipts from privatisation can be such a guarantee. A firm guarantee coupled with a higher yield and absence of a foreign exchange risk would attract short-term foreign investors. An undeveloped secondary market of government debts can be the only obstacle to foreign investment.

BALANCE OF PAYMENTS

It is taken for granted that the foreign exchange reserves of a currency board must cover fully reserve money. It is also assumed that quasi-money are constant in value, i.e. there are no withdrawals of deposits. In the Bulgarian case, however, this assumption is not very realistic. The withdrawal of deposits and their conversion in dollars may discredit a currency board due to the impossibility to satisfy all purchases of foreign currency on the part of the private sector. For that reason we

suggest a more conservative strategy, such as the foreign exchange reserves to cover in full 2/3 of broad money. Covering the bulk of money supply means cushioning the shrinkage of the money supply, as triggered by the foreign debt payments in the first quarter of 1997. The table below gives an account of the estimates of broad money in end-1996, foreign exchange reserves and the sources of financing reserves.

Table 1**Foreign Exchange Reserves Needed and Sources of Financing**

<i>Broad money in end 1996</i>	<i>1162 bln. lv</i>
<i>2/3 of broad money</i>	<i>775 bln. lv</i>
<i>Foreign exchange reserves</i>	<i>1.5 bln. USD</i>
<i>Own reserves</i>	<i>740 mln. USD</i>
<i>IMF</i>	<i>700 mln. USD</i>
<i>Other sources</i>	<i>50 mln. USD</i>
<i>Foreign exchange rate</i>	<i>517 lv/USD</i>

It is reasonable to use part of the foreign exchange reserves for the recapitalisation of the banking system. The sum employed for recapitalisation should not exceed US\$ 100 mln. When the currency board extends some amount of resources intended for recapitalisation, money supply should be decreased by the amount of dollars taken out of the reserves.

The budget deficit will be financed via government securities, and the major buyers will most probably be non-banking institutions. According to AECD estimates, the combination between a foreign exchange peg and a base interest rate of about 20% will bring in about US\$ 300-500 mln. However, these amounts are excluded from the estimates of the initial operation of a currency board. The overall balance of payments will correspond to changes in foreign exchange reserves, and therefore to changes in money supply. The balance of payments, however, does not bear upon the initial terms of a currency board.

One of the disadvantages of a currency board is its inability to cope with

crisis generated by external or internal shocks. A typical example of this is the effect of the Mexican crisis on Argentina. The currency board's foible evolves from the necessity to maintain a foreign exchange peg, even with a deteriorating balance of payments. A notable difference is here made between a closed and open economy. With an open economy, a fixed exchange rate leads to a price fixing close to the system of international prices. As an axiom, the system of international prices is more efficient and ensures a more efficient allocation of resources. With a highly open economy, such as the Bulgarian economy, a stable foreign exchange rate is preferable to uncertainty, as triggered by the instability of the foreign exchange rate tomorrow. Things are a lot different with a closed economy where price changes in correspondence with international prices are more complicated. It is for that same reason that currency board arrangements are not recommended to closed economies. The markedly open character of the Bulgarian economy is definitely a favourable condition for the establishment of a currency board in Bulgaria. □

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