AGENCY FOR ECONOMIC COORDINATION & DEVELOPMENT

ECONOMIC STABILIZATION IN BULGARIA IN 1992

A Survey of the Key Policy Issues in the Bulgarian Stabilization Programme

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I. THE FRAMEWORK OF MACROECONOMIC POLICIES

The attempts at stabilizing the East European economies have reached a critical stage. Following the relatively fast success of financial restriction, the stabilization effort was trapped into seeking the delicate balance between fiscal and monetary tightness under conditions of painfully advancing structural reforms.

The implementation of macroeconomic policies has come under pressure from two sides. On the one hand, the intrinsic logic of the "classical approach" applied at the first stage of the stabilization program (the "Polish paradigm") is in the limelight of much controversy and reevaluation. Faded discussions concerning the advantages of "shock therapy" versus "gradualism" have reemerged. On the other, it is the different configuration of the political forces nowadays that has already undermined the foundations of the then-existing social consensus. The dominant mood is one of "reform fatigue".

These pressures challenge not only the approach and outcomes of the stabilization program, but also the fundamental guidelines of macroeconomic policy. To abandon them would mean to undermine the stabilization process while leaving the integrity and consistency of macroeconomic policies at the mercy of populist sentiments. The current developments in the social and political realities in Eastern Europe cannot be thought of as exogenous to the policy of stabilization. Like them or not, they form an indispensable part of the economic policy trade-offs in the transition period.

It is now a year since the AECD presented its first progress report on the pace of the stabilization program. The macroeconomic issues we then tackled focused on two closely related points, viz. the effectiveness of the program anchors and the prospects for economic recovery.

Not surprisingly the same key issues seem still to be the pressing items on the agenda today and will probably remain of substantial concern for economic policy-makers for some time to come. Against the current economic background we have to carefully consider whether there is an overshooting effect of restrictive policies or else fiscal and monetary restrictions are being systematically (and successfully) evaded.

If we stick to the overshooting hypothesis, we thereby admit that the initial disequilibria have not been so persistent as to warrant the recorded shrinking of the real economy. Hence the potential for at least some moderate economic growth. Conversely, if there were no overshooting, the economy has reacted adequately to the initial imbalances but the latter have not yet been

eliminated entirely. This second hypothesis implies a different emphasis, viz. the degree of microeconomic adjustment to operation under hard budget constraints.

The plain issue we face after one year of stabilization is whether hard budget constraints are really operative in the Bulgarian economy. Notwithstanding the fact that much of the public debate focuses primarily on the severity of the economic distress and the potential for quick recovery, we still feel that this second problem is far more relevant in judging the success of the stabilization effort. As experience clearly indicates the outcome of a stabilization program is ultimately decided by the strength and effectiveness of the budget constraints facing both the state and the enterprises.

The position of the AECD is that to provide an overall assessment of current macroeconomic developments and of the short-term prospects one needs a clear-cut answer to the following issues:

First, what is the degree of effectiveness of the stabilization nominal anchors? The answer to this question implies an assessment of the actual impact of fiscal and monetary restriction.

Second, what is the underlying inflationary potential in the Bulgarian economy? Different estimates of the inflationary potential have very different implications for the major economic policy decisions. At present there is no visible consensus as to the extent of the inflationary potential.

Third, what are the feasible options to stimulate individual final demand components without risking the triggering off of inflationary pressures? We can resolve this issue only within the context of the available foreign financing.

Previous publications of the AECD have extensively commented on the general structure of the stabilization program. Suffice it to say here that, it is a heterodox program involving two nominal anchors and which substantially relies on official foreign financing. With the free floating of the exchange rate the burden of fighting inflation falls upon the proper mix of fiscal, monetary and incomes policies.

Critical parameters of the program are the volume and the timing of foreign financing which is expected to fill the balance of payments gap. The strategy of filling balance-of-payments gaps has been widely adopted by the West as an emergency solution. With the disintegration of the USSR the general opinion is shifting towards a clear realization that this is no longer a viable medium-term strategy. Sooner or later, it will have to give way to voluntary capital inflows.

An important overall restriction imposed on the stabilization program was the degree of credibility that it could generate and rely upon in the course of its implementation. As in all such cases, credibility decays with time until a threshold level where the efficiency of macroeconomic policies practically vanishes.

In the Bulgarian case the external credibility of the program was preconditioned by the extent of official financial support and the pace of negotiations with commercial and official bank creditors. As for its domestic credibility, it depended heavily on exchange rate and inflation performance, the availability of loopholes in monetary and fiscal restrictions, as well as on the progress of structural reforms and the overall living standards. Stabilization credibility on all these counts visibly diminished in the second half of 1991. The problem with stabilization credibility is that it apparently displays strong nonlinear, hysteretic effects. The alleged irreversibility in the conduct of economic policy implies that by reversing the path of economic policy decisions one ends up with outcomes very different from the ones he would have produced by just keeping the original policy stance. Inconsistencies of this kind can ultimately generate a sustained hysteric mood with the corresponding reactions on the part of economic agents.

A global restriction on the stabilization program is the fuzzy social and economic structure of the present Bulgarian society. Typical of all post-communist societies is the appearance of a peculiar economic vacuum eventually filled by "money laundering" agents, trade union and corporate structures and Mafia-like outfits. But these are basically transient social agents with no firm grounding in any particular stratum and loosely defined, often switching economic interest. The authentic market agents are still a minority.

All this creates an environment of fundamental uncertainty about the reactions of economic agents to prescribed economic policies. Typical entrepreneurial behaviour motivates a relatively small but quickly expanding number of agents such as real estate owners, established private businesses or people whose property has been recently restituted. Neither large enterprise managers (subject to various pressures), nor workers at large have market-based incentives. All this erodes the social support for any stabilization policy thereby laying the groundwork for a strong and popular "anti-stabilization" coalition.

II. THE EFFECTIVENESS OF NOMINAL ANCHORS

The outcome of the stabilization effort and the constellation of macroeconomic policy tools depend by and large on the effectiveness of the credit and incomes nominal anchors. The introduction of a third anchor (e.g. using a crawling peg of the exchange rate) is but a theoretical option. While it is an extremely powerful instrument in stabilizing the volatility of inflationary expectations, a fixed exchange rate may prove an excessively rigid and inefficient instrument. Both the absence of a stabilization fund and the fairly good track record of the foreign exchange market in Bulgaria, as well as the pending agreement with commercial bank creditors on the terms of reducing the debt overhang do not warrant the introduction of a fixed exchange rate.

1. The Credit Anchor

The primary objectives of the stabilization macropolicy amounted to: (i) containing the inflationary pressures, triggered off by the price liberalization, the subsequent price shocks and the active inflationary expectations of both producers and consumers;

(ii) the elimination of the pre-stabilization monetary overhang. Stabilization of the exchange rate and the smoothing out the seasonal swings in output were secondary macroeconomic goals. But secondary goals were soon abandoned as they stood in sharp contrast with the basic guidelines of macroeconomic policy. The overall control of credit expansion in the economy rather than the growth of a particular money aggregate was the major preoccupation of the monetary authorities.

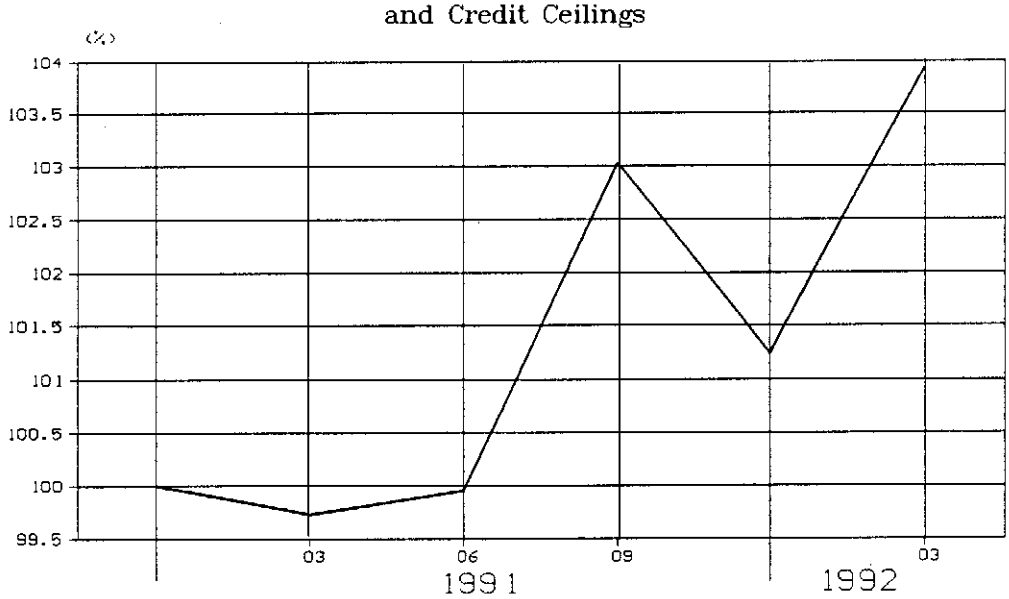
The mechanism used is that of **direct control over credit expansion to the non-government sector.** Its prime instruments for regulating are the credit ceilings, which are individually established for each commercial bank. They were first determined on a quarterly basis, and since April 1992 - on a monthly basis. The volume of money demand expected evolves from the inflation anticipated (concurrent with the government's macroeconomic framework), changes in GDP and money velocity. The change in net foreign assets (as resulting from the balance of payments) and the government's necessity for bank credits (as consequent upon the budget deficits and ways of financing projected in the Budget Law) are also taken into account. In order to set up an equilibrium between money supply and money demand, credits extended to the non-financial sector and consumers are taken as residual

amounts. On the basis of these calculations a general credit ceiling is established for both the economy as a whole and the government in particular.

Credit allocation to commercial banks is based on their relative share in overall credit at the end of the preceding year. Since June 1992 individual credit ceilings have reflected the changes effected in the relative share of resources attracted to commercial banks' liabilities by the non-government sector. Thus on the basis of their relative share in the preceding three months and the corresponding coefficient, each commercial bank's credit ceiling ranged within the limits of 2 percentage points, and since the fourth quarter of 1991 - there have been no limits whatsoever.

As market-oriented monetary instruments have begun to be largely and progressively used, the mechanism discussed is becoming less and less important. They have to do with necessity for creating a vast variety of extra-banking prerequisites for their implementation.

Ratios between Actual Credit and Credit Ceilings

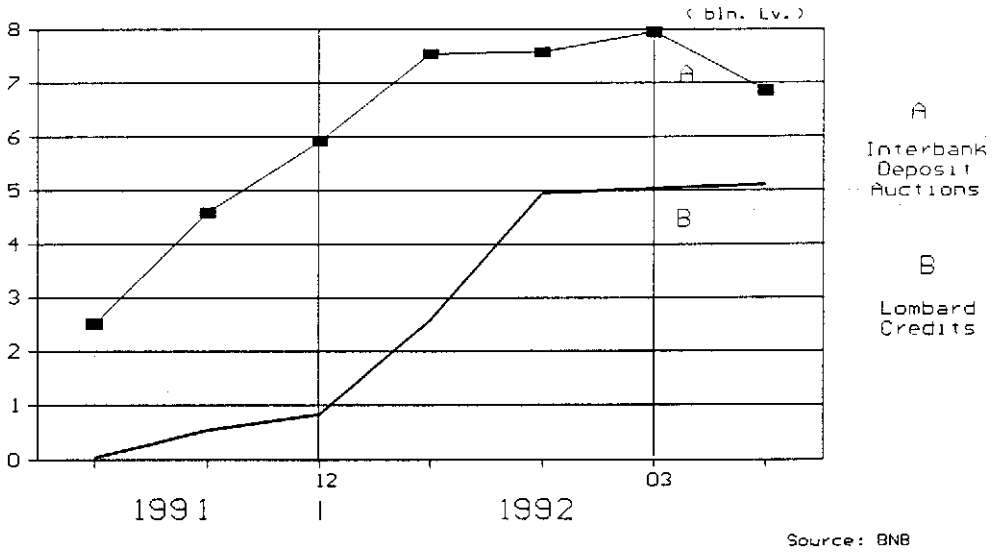


Source: BNB

Credit ceilings were generally observed in the first half of 1991 while in the second half they were exceeded by 2 - 4 %. Generally speaking, they functioned as constraints on money supply and contributed to the reduction of aggregate demand. Nevertheless, they had their ill effects on credit allocation. Retaining the 1990 structure of credit meant influencing interbank competition unfavourably. Stimuli to gain a larger deposit volume are exhausted as banks' assets approximate the credit ceilings established. Most influential commercial banks run out quickly of their credit ceilings while vast

sums of unemployed resources remain with smaller banks. As a result of this, credit resources have been inefficiently and inadequately allocated and competition among banks put under constraint. We can thus say that the rising interest rates on credits granted by quickly-consuming-credit-ceiling banks and the reallocation of their free resources to foreign currency transactions are consequent upon the above-mentioned processes. All this doubles the risk of commercial banks' portfolios and leads to cases of instability and abrupt exchange rate fluctuations of the lev.

Balances of Interbank Deposits
and Lombard Credits



Source: BNB

The possibility of banks to handle transactions covering two-third of the unused part of credit ceilings is now being discussed. This measure will do away with the disadvantages of the mechanism now operative and improve credit allocation. The efficiency of the credit anchor depends largely not only on the control over banks' credit expansion but on tough control of and rigid restriction on "money creation" by the Central Bank as well. Uncontrolled refinancing may inject overliquidity in commercial banks, resulting in credit ceiling exceeding or rechanelling of their resources to foreign currency transactions. Net refinancing of commercial banks through credit expansion to the amount of 4202.7 million leva accounted for the injection of additional liquid assets into assets with a higher return. Banks preferred to grant the non-financial sector part of their free resources. This resulted in an initial credit ceiling exceeding (despite the sanctions imposed) by 2.35 billion leva in the first quarter. Therefore, we can say that credit ceilings (7% against December

1991 or 64.5% against December 1990) failed to produce the constraining effect required in early 1992. This in turn only fuelled inflation.

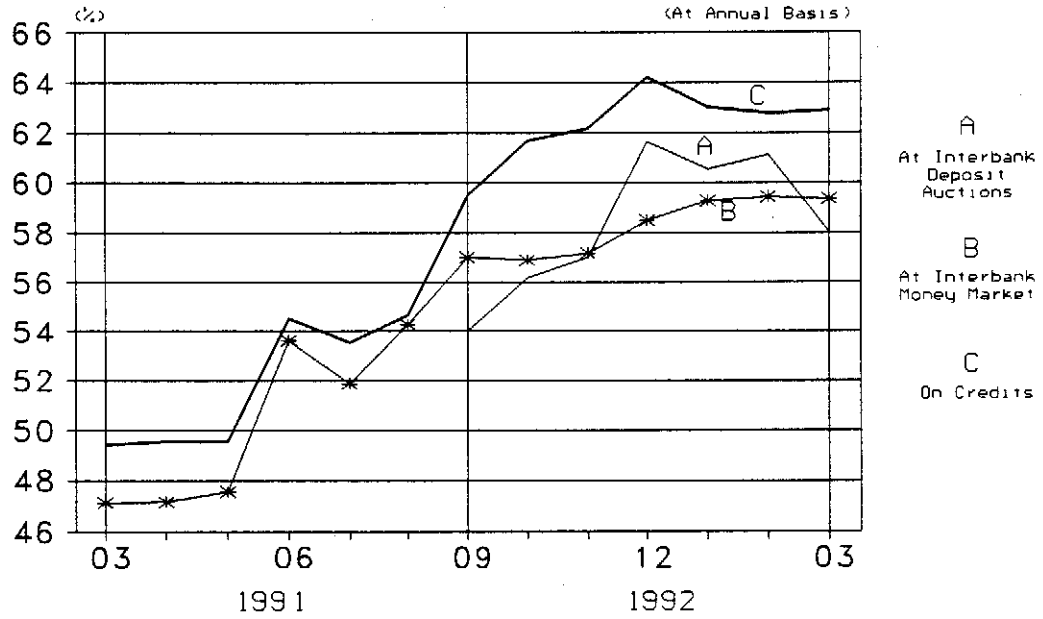
The major factor accounting for banks' increased liquidity in the period considered was the Lombard credit extended against government bonds on their bad loans, which had been transformed into a government debt. As no subsequent issues of bonds are to be launched by the end of the year, the impact of inflation is expected to be muffled.

In the majority of cases credit ceiling exceeding in the first quarter of 1992 pointed out to the risks of uncontrolled credit expansion. According to AECD **credit ceilings can function as an efficient instrument of control on condition that some quantitative limits on BNB refinancing of commercial banks are introduced and closely followed.**

In order to reduce domestic demand, credits granted to the government sector were placed under strict control. In principle, this hinders the unfolding of **the crowding-out effect** of the non-government sector into domestic credit. In the first three or four months of the stabilization programme the effect produced was rather restricted ranging within the narrow bounds of 2-2.5 percentage points. It meant exceeding the performance criteria for government net credit. Consequently the fluctuation registered was offset.

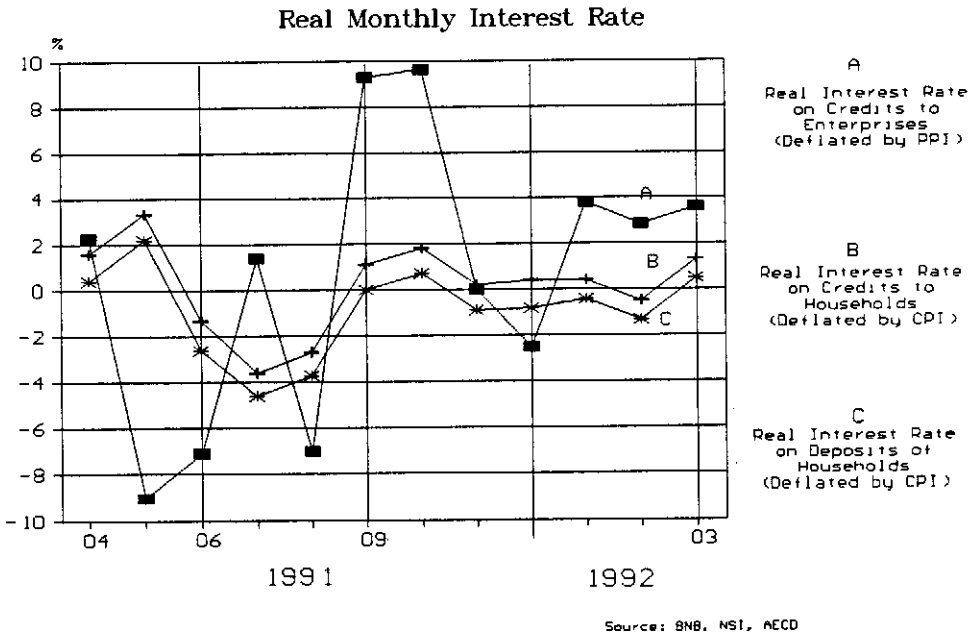
Inflationary expectations may decline and inflation rates decrease as long as the growth of money demand is restricted via **high nominal interest rates.** Thus in February 1991 BNB's base interest rate rose to 45% and after a period of fluctuations in early summer it settled at 54% in August.

Dynamics of Market Interest Rates



Interest rates on new credits and deposits demonstrated a higher degree of dynamicity and flexibility. In March 1992 they spiralled up to 62.88% and 62.22% respectively from 42.77% and 39% in February 1991. By September 1991 the interest rates on credit in the interbank money market had run parallel to credit interest rates. Ever since then credit interests have been following the dynamics of the interest rates at the interbank deposit auctions. All this speaks of the close interdependency between the cost of refinancing commercial banks and the cost of credit, which they have extended to the non-financial sector.

The high nominal interest rates aimed at weakening inflation impact via redirection of the monetary overhang to time deposits. As well as forcing the loss-making businesses to restructure or declare bankruptcy when unable to do so. Although the task was partially fulfilled, consumers were practically transformed into net creditors. The real interest rates on deposits manifested a steady negative trend of decreasing. They steadied at the negative percentage point of -8.9% in the period April-December, though a set of corrective anti-inflationary mechanisms were well into effect as early as February and March. This fact alone accounted for the depreciation of consumers' savings and the large scale transfusion of resources from savings accounts into the accounts of enterprises took on the form of a specific kind of subsidies. All this resulted in a certain shrinkage of the demand for national currency as well as a transfer of assets into foreign currency, which perpetuated further devaluation of the lev.



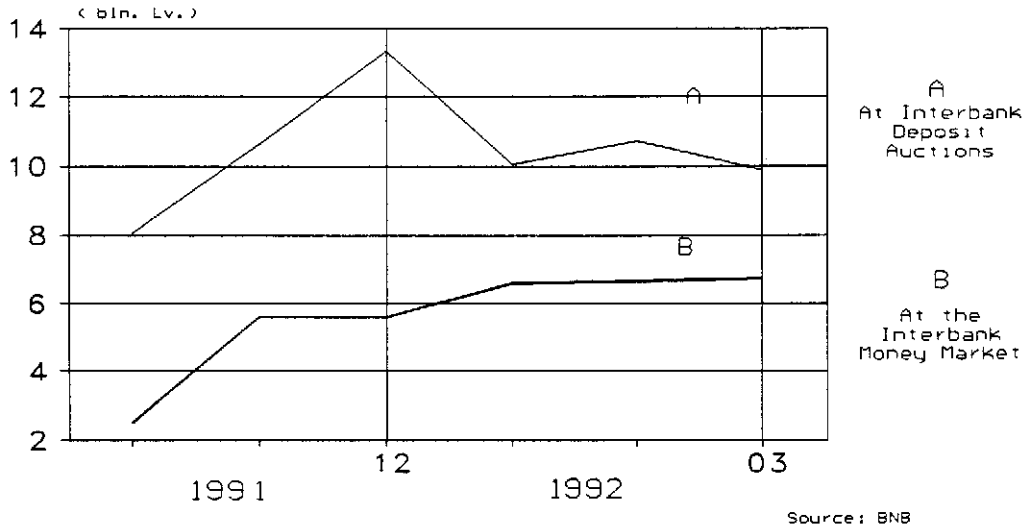
As compared to nominal interest rates, the faster growth of consumer prices accounted not only for the depreciation of consumers' savings

but for the reductions in the government domestic debt and firms' liabilities (in particular trade companies and firms producing goods for final demand) to the banking sector as well. Nevertheless, a great number of enterprises which put up their production for sale at producer prices (the latter being much slower in their growth than consumer prices in 1991) had to confront considerably high real interest rates during certain spans of time throughout the year. Thus, for example, the real interest rate on credit extended to enterprises reached 10.2 percentage points from April to December.

The conditions on credit affecting state firms were further complicated by the fact that only 50% of their interest payments had been recognized as actual expenditures before taxing profit. Relying on AECD calculations we can say that the increase in the sums transferred to the budget by credit-drawing enterprises corresponded to a 22-24% increase in the effective interest rate. Along with a host of other factors among which the lack of any alternative for privatization and continuous crediting by commercial banks, the above tough and rigid conditions of credit prompted the accumulation of vast amounts of non-performing and bad debts and practically made the enterprises non-viable. What is more, vast interest payments were calculated within the prices of production and thus grew into a powerful factor letting loose latent inflationary pressures. As for the viable firms, we can say that had adjusted to the new levels of interests by the end of 1991.

In the interbank money market the average interest rate in 1991 was a steady 53.52% and rose to 58.49% in December. It amounted to 61.62% at the interbank deposit auction held in the same month.

Amounts Traded at Interbank Deposit Auctions and at the Interbank Money Market



Source: BNB

The volume of credit allocated via the interbank money market was too large as compared to the volume of interbank deposit auctions held. BNB exercised stronger control over the interbank deposit market, which in turn preconditioned the advantages of the interbank money market over interbank deposit auctions. Furthermore, the flexibility of the former allows the two parties to enter into direct negotiations as to the conditions of credit (term and interest rate).

The close interdependency among commercial banks and lack of reliable information as to their financial status among interbank money market players may have proved a real danger to the stability of the financial system. This in turn led to cases (Jambol and Bobovdol commercial banks) when BNB's control was often evaded and basic banking regulations left out of consideration. Following the assumption of a basic necessity for a reliable banking system as well as for the gradual restriction and subsequent disappearance of unguaranteed deposits granted by the Central Bank, we think that **the fusion of the two mechanisms of refinancing and formation of a contemporary interbank market into a single whole is an appropriate measure strengthening BNB's control over the existing banking norms and regulations.**

Central to the efficiency of the restrictive monetary policy adopted was the control over the convertible currency flows into the money stock ant its "sterilization" via the lev component of M1. The period following March 1991 witnessed a wide range of fluctuations of the former offsetting the fluctuations of the latter. Their offsetting was most clearly pronounced in December but it was insufficient in power to produce any sizeable effects. The dynamics of M1 had been following very closely the dynamics of its convertible currency component. That is why it is difficult to say if these were conscious efforts to effect "sterilization", or rather a matter of "intuitive" response to convertible currency flows.

As a whole, credit controls through the agency of financial instruments have reemerged as an efficient **direct** stabilization tool. The money stock and credit underwent a drastic shrinkage in real terms by 62 and 59% respectively. The period also laid the beginning of a step-by-step transition to more flexible mechanisms of credit market organisation. Rather, the unfavourable consequences of monetary policy implementation were to be sought in credit allocation.

At the same time, in considering the effects of the credit anchors we have to bear in mind that the shrinkage of the demand for credit could not go

beyond a certain limit, commensurable with the decline of economic activity. With the absence of investment, the demand for credit brought essentially to bear on the settlement of current payments and wages. This component was not expected to record a further shrinkage as long as state firms did not have to face the impending danger of declaring bankruptcy. They continued to draw credits despite the soaring level of real interests. This could only happen under the conditions of general collusion between the banking sector and firms that at least part of the interest payments is not paid up. What is more, under such conditions high interest rates as a rule oust solvent agents from the market. Yet, they induce a further demand for credit for the purposes of paying up at least part of the interest due

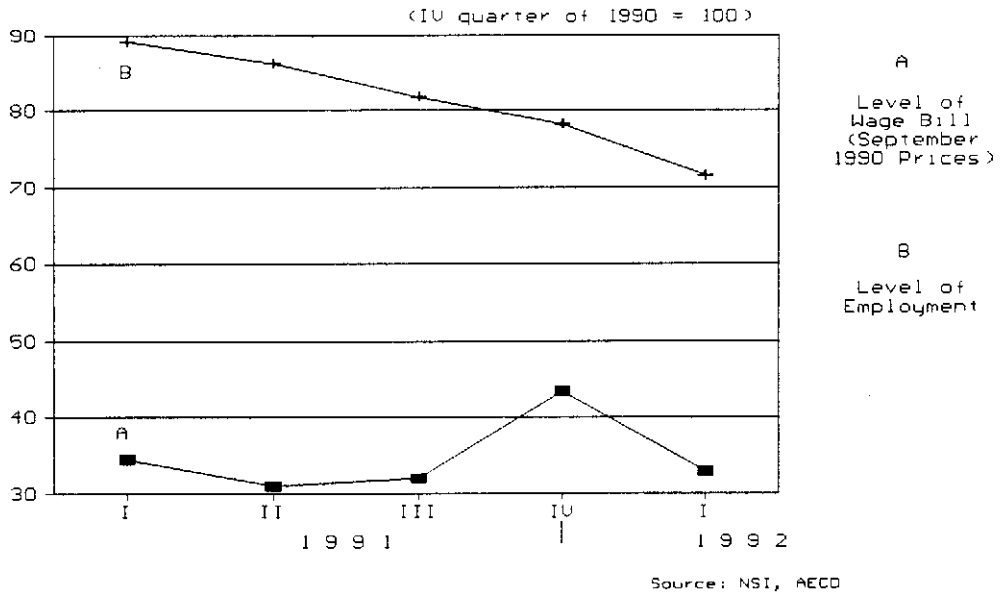
It follows that **the efficiency of credit restrictions should be carefully considered.** Economic agents found their own ways to evade restrictions through credit ceiling exceeding. The basic mechanism at work amounted to the outburst of interim credit (see III.5). It further reinforced the interdependency among enterprises obliterating the distinctions into "good" and "bad" firms. The lack of a reliable information system by means of which risk and solvency can be properly assessed hinders the implementation of an efficient credit policy and credit management.

2. The Incomes Anchor

The restrictive incomes policy effected amounts exclusively to control over the dynamics of the primary source of consumers' incomes - wage. Wage bill ceilings and profit taxation whenever the former are exceeded are the prime instruments of incomes policy implementation.

The impact of wage decreases varied over the previous stabilization period. The sharp decline of the real wage in the first quarter of 1991 (by 68% as compared to December 1990) was a necessary step towards overcoming the disequilibrium between supply and demand under the conditions of a continuous and painful fall of output. It was a measure towards doing away with the monetary overhang and taking terms of trade shock. The real wage recovered only partially in the months to follow. It was a process that was most clearly pronounced after the period of transition to free wage negotiating.

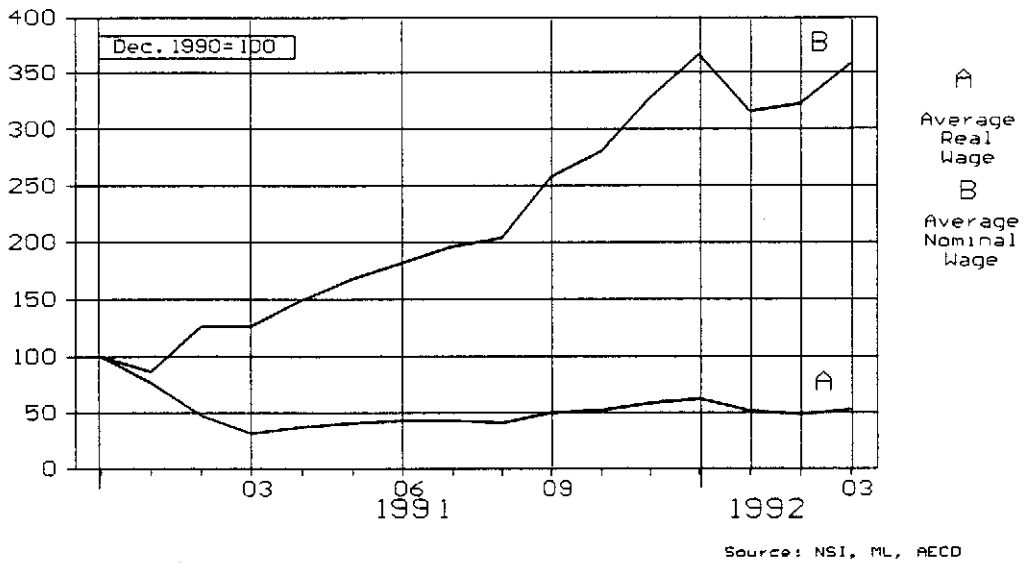
Level of Employment and Real Wage Bill



Source: NSI, AECD

Thus, we can say that as compared to the statistically accounted wage bill in state enterprises, in its strictly statistical sense the incomes anchor remained relatively stable. In comparison with the fourth quarter of 1990, the first quarter of 1991 witnessed a wage bill decline by 65.6% at constant prices. In the period from April to December 1991, it grew by 40.9%. Overall, in the first quarter of 1992, the wage bill in real terms was 67.1% lower than that in the last quarter of 1990. Growing unemployment accounted for the low level of the wage bill in the year.

Average & Minimum Wage Indices



Source: NSI, ML, AECD

The possibilities for the wage bill to remain a relevant regulating stabilization device in 1992 are rather hypothetical. The mechanism (on which no agreement with the trade unions has been achieved yet) for regulating wages in 1992 aims at halting the outstripping wage bill rise as referred to inflation rates. Thus, we can retain the average real wage reached in 1992, and in some cases even its increase.

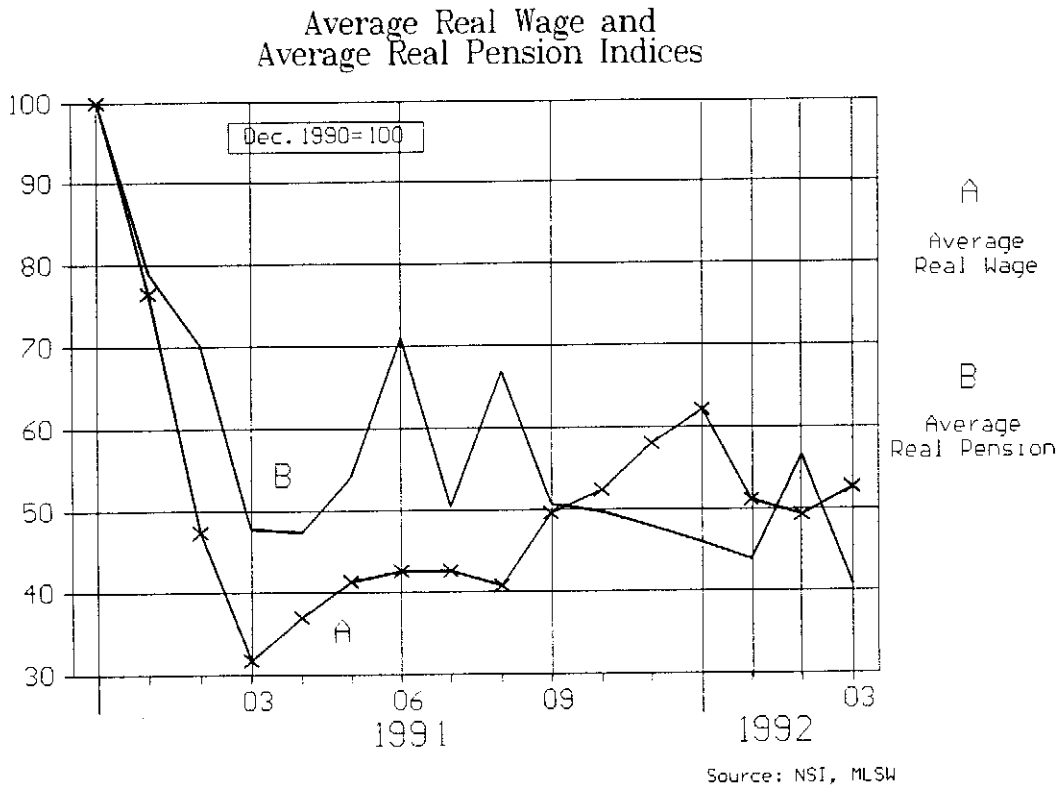
Inflation index forecasts in projecting the state budget becomes the basis of assessing maximum wage increase. If the forecast index is exceeded by 10% (as compared to the last quarter of 1991) a mechanism of negotiations and corrections is put into effect. Changes in individual wages are carried out only within the limits of the wage bill. Exceeding forecasts means profit taxation by a steep tax scale.

Wage bill ceilings are calculated on the basis of a 64.7% average annual inflation for 1992, which is far from being realistic. Surpassing the rate of inflation forecast will result in:

- a substantial drop in the number of employed workers, which in turn will prompt a further rise in unemployment benefits;
- an inflationary effect that has to ensure wage increases aiming at paying up the corresponding tax once wage bill ceilings have been exceeded.

Wage negotiating is at the core of the incomes anchor mechanism. The mechanism is a test of the government's ability of hold back wage growth. The lag of three months, after which the revised inflation coefficients and wage indexation will be put into effect, is an issue of both controversy and immediate concern on the part of trade unions. What is more, at each successive round of negotiations new trade union claims are expected.

Retaining the real level of wages, 1992 is expected to record an average wage growth in real terms. AECD has suggested its own variant of a higher, but more realistic annual inflation rate of 81%. Forecast inflation exceeding is indexed by the overall differential to the actual inflation rates. Under these conditions the same mechanism of setting the maximum non-taxed wage amount will prompt a 2% drop in the real wage in 1992. The average real wage in 1992 will start decreasing at an annual rate of inflation surpassing 72%. Higher inflation rates presuppose higher wage bill ceilings but rule out any possibilities for wage correction negotiating throughout the year.



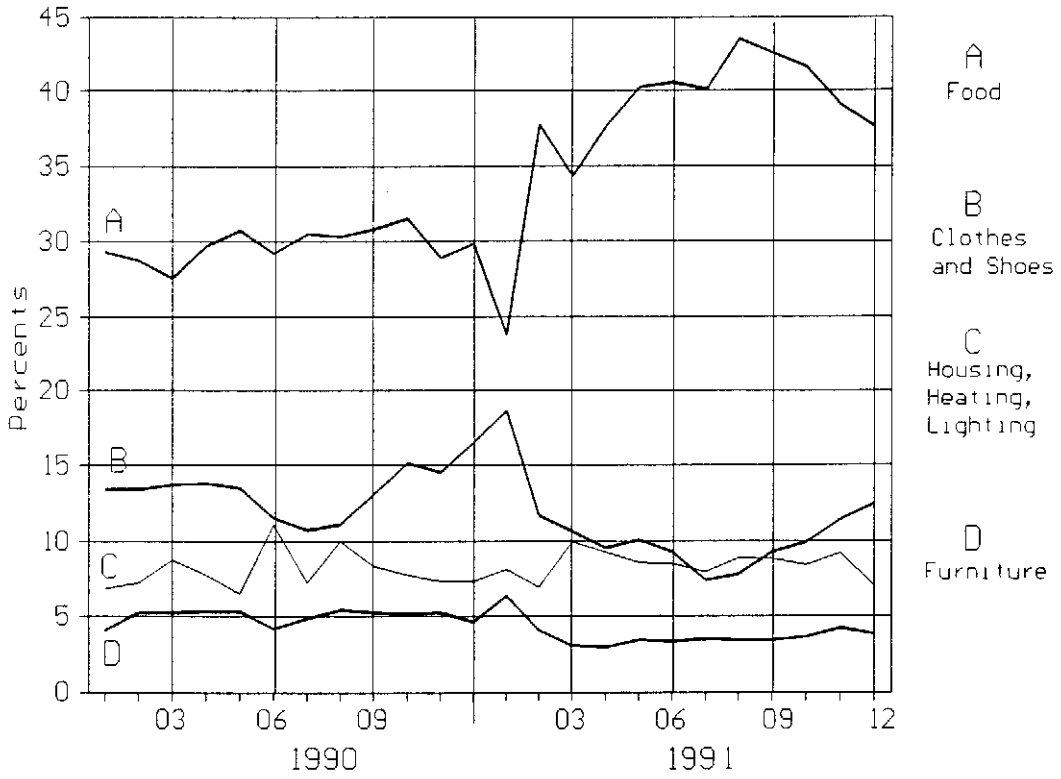
The incomes of pensioners and unemployed workers pose a serious problem. By September 1991 the loss of the purchasing power of pensions was smaller than that of wages. In the eight months to follow the average nominal pension remained unchanged (the only exception being the 200-lev markup paid off in February 1992. Thus, in the last few months the real pension decreased substantially and in March 1992 it hardly covered 34% of the real wage. Over **the last few months there have been substantial cuts in the ratio between the average wage and the average pension (the latter being only 34% of the real wage).**

The period following September 1991 deepened the gap between the real wage and the real average allowance of the unemployed. As compared to the general cuts in the average real pension, the average real allowance of a single unemployed showed a sharper decline. As referred to the growing number of retired and unemployed workers, their continuously declining real incomes are expected to function as a factor offsetting wage growth. At the same time it will generate further political and social tensions.

Wage restrictions have been successfully implemented. They, however, can not be referred to **household incomes as a whole** for two reasons: the appearance of new sources of incomes and unreported incomes.

In the period following the price shock, disposable income dropped by 6% which corresponded to the wage bill decrease registered in the same period.

Relative Shares of Money Household Expenditures

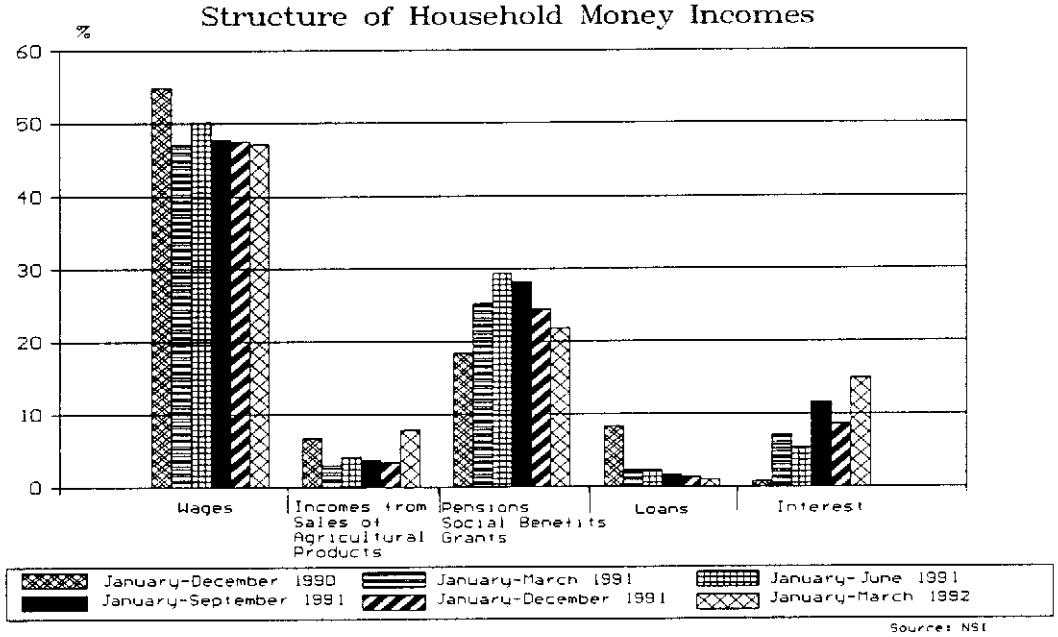


Source: NSI, Household Budget Data

Consumption tended to restore its "normal" structure. This pointed indirectly to the weaker impact of the restrictions on **aggregate incomes.** As the above data on incomes budgets reveal, at the end of 1991 there was a gradual obliteration of the "abnormal" structures of consumption characteristic of the initial stage of stabilization. Such a restoration of previous structures could be only related to the rise of aggregate incomes.

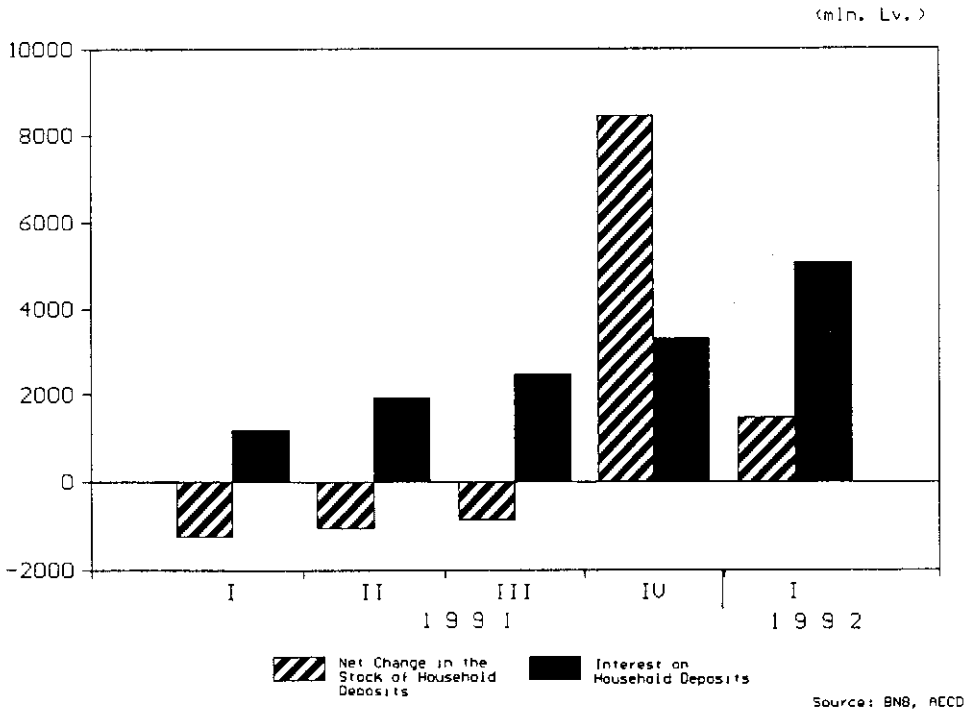
The appearance of **new sources** of incomes gave rise to a drastic change in their structure in 1991. A major change amounted to the fact that pensions and interests rather than loans and wages made up consumers' incomes.

Structure of Household Money Incomes



The high nominal interest rate on deposits last year led to a substantial rise of the interests due. In absolute terms, the income from interest approximated the income from pensions. Interest rates were as high as to offset not only the sums withdrawn from household deposits but also to effect a slightly discernible rise of household leva savings when the basic income sources signalled a downward trend.

Leva Savings of Households



There has been a change discernible in the dynamics of deposits since the end of 1991. Having followed a steady downward tendency of dynamics in the last quarter of 1991 and the first quarter of 1992, leva deposits registered a rise in their volume. It reflected the growth of incomes, as received from wages and was indicative of a positive marginal saving rate.

Interest rates in the previous stabilization period were not as high as to make up for the headlong rate of inflation and retain the real level of household savings. 1991 as a whole and as divided into sub-periods can be characterized as a period of negative interest rates on household deposits. Even in the sub-periods following September 1991, with the rise of the nominal interest rate, the real interest rates steadied at the negative level. The first two months of 1992 witnessed the continued depreciation of household savings. All along in the period February 1991 - March 1992 the impetuous rates of inflation lowered not only the interest due in real terms on deposits (64.81%) but also 71.7% of the very deposits.

This tendency, though not clearly marked, came to the fore even in the months of the first price shock. Inflation had a disruptive effect on 10% of the nominal deposits from April 1991 to March 1992. The real level of savings has decreased by 1.2% since early 1992. March 1992 is one of the few months in which deposits grew up by 0.5% in real terms and inflation did not destroy the interest due completely.

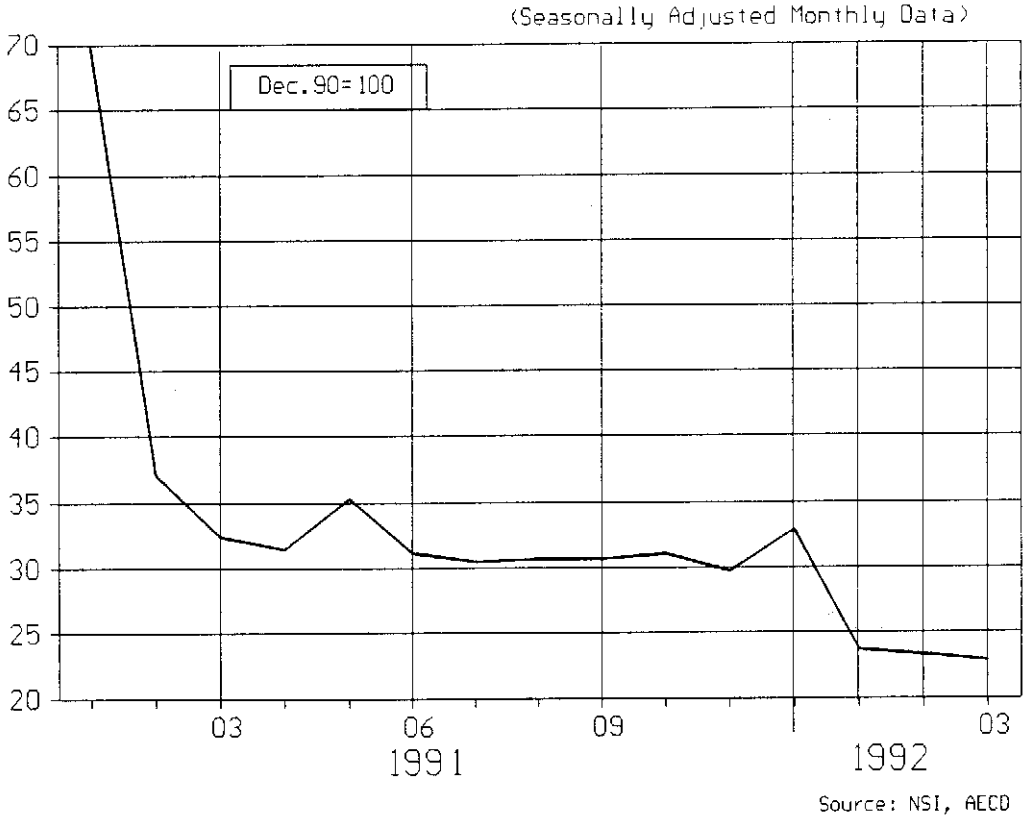
The clearly distinct negative interest rate on demand deposits made households restructure their deposits. The share of time deposits increased, for they earned higher interest and caused lower depreciation of household savings. In addition, the lower degree of time deposit liquidity weakened the impact of inflation in the domestic market. As long as inflationary anticipations would persist and the real interest rate would be markedly negative households are expected to recede from this type of deposits. They would respond to the lowering real values of deposits, "outpouring" their savings on the market of durables.

As for **unreported incomes,** the larger part of which consists of incomes in the private sector, we can only rely on indirect data. Unreported incomes (i.e. incomes from private farms and the roughly estimated value added in the private sector) represent 25% of disposable incomes. If we eliminate incomes stemming from individual farms and take personal incomes to be about 60% of the value added in the private sector, personal incomes in this sector can be roughly estimated at about 10% of households' money incomes.

Retail Sales

(base indices, at May 1990 prices)

(Seasonally Adjusted Monthly Data)



Source: NSI, AECD

An indirect indicator of the growing importance of the private sector in the real economy is the stagnation-ridden turnover index in the state sector. It steadied at a practically invariable and low absolute level in the second half of 1991. The fact that turnover did not respond to the rising real incomes in the period following the second half of 1991, as well as its unusually low "statistical" level point out that the private sector accounts for a growing part of personal consumption.

Incomes from entrepreneurial activity and capitalization of tangible assets have undoubtedly become an essential part of total incomes. With the adoption of the Restitution Law in 1992 their volume hit even higher percentage points. **The incomes anchor proved to be not as efficient an instrument** as it had been originally thought to be in that the growing importance of these incomes as well as the lack of control over their growth neutralize the effects of wage restrictions.

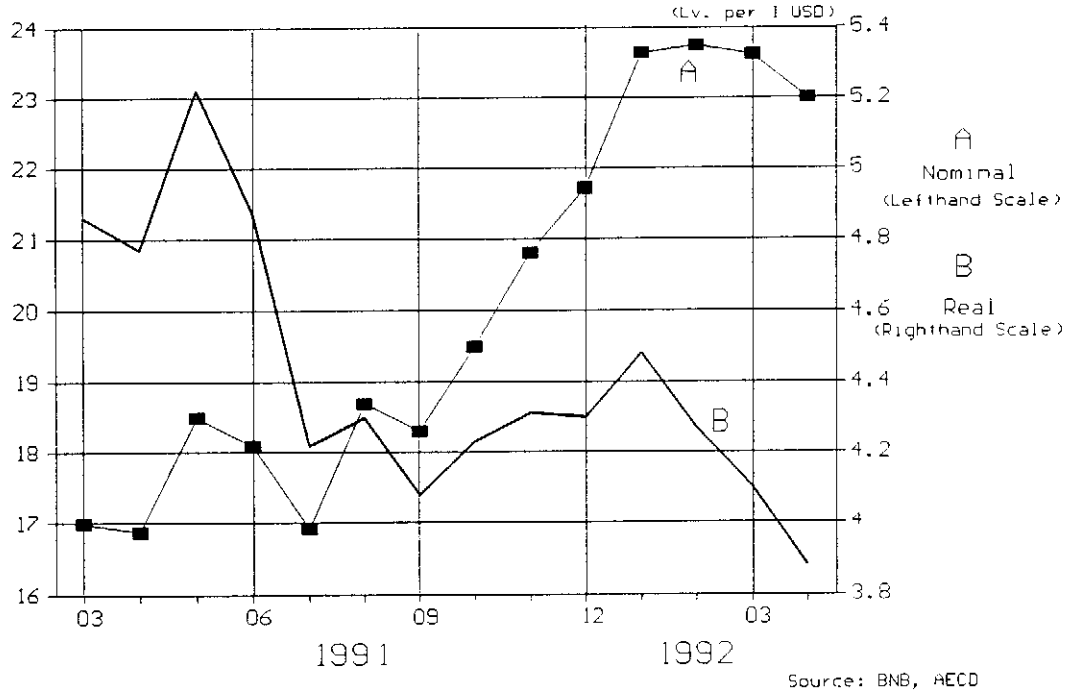
3.Exchange Rate

The high degree of uncertainty of inflation predictability in the first year of the stabilization programme as well as the lack of sufficient foreign exchange reserves did not allow us to use the exchange rate as an anchor of prices and expectations. The Government abolished the system of multiple exchange rates in February 1991. Instead, it introduced a unified exchange rate of the lev, thus intending to intervene in the interbank market. A parallel foreign exchange market came into being due to certain restrictions imposed on households (eased in 1992) and capital control. It served consumers' needs and its quotes followed closely the official market exchange rates.

Households and economic agents are still holding vast amounts of foreign exchange resources. Which is why we cannot rush to conclusions as to the end of foreign exchange substitution and lasting restoration of people's confidence in the lev. Large scale transfer of foreign currencies into leva could be discerned only in periods when firms suffered the aftereffects of liquidity problems (paying off taxes and wages).

Persistent inflationary expectations and the lack of confidence in the lev gave rise to a substantial depreciation of the lev's exchange rate against the dollar in early 1991, which became a powerful inflationary factor. It became clear that both the Central Bank and the Government could not remain indifferent to the level of exchange rates and aimed at maintaining such a real depreciation of the lev which corresponded to an improved balance of trade without endangering its price stability. The volume of foreign currency traded was considerably small (about $2.1 billion at the end of 1991), which gave the impression that the foreign exchange market was easy to get a good handle on. But BNB's attempts to supervise and stabilize the market through interventions proved less efficient than expected. Although the foreign exchange market has been created for the purposes of serving import and export transactions, it was determined not by the volume of transactions but the expectations of the market players who tried to make capital gains of exchange rate movements. It was these expectations of theirs that accounted for the intensive dynamics of the exchange rate in 1991. They were believed to stand closest to people and economic agents' faith in the economic program and the course of the fiscal policy in particular.

Nominal and Real Exchange Rate



After the initial strong devaluation of the lev and the subsequent adjustment to its equilibrium level, the lev has been following a steady tendency towards nominal depreciation since mid 1991. The latter was due mainly to persistent inflationary expectations of price rises, hazy economic prospects of development and decrease in the nominal interest rate in the summer.

A linear representation of the exchange rate helps us use a number of techniques of exchange rate forecasting. Although they do not give an exact account of the turning points of the exchange rate's short-term trend, they set the general outlines of its long-term movements. We were justified in concluding that fluctuations in the nominal exchange rate were governed by **the inflationary differential of the lev to the dollar rather than the nominal interest differential between the two currencies. The exchange rate was expected to at least follow the rate of inflation anticipated.**

However, the dynamics of the exchange rate in early 1992 indicated that a change in market players' reaction had occurred. Anticipations that the vulnerability of the lev (as generated by the high inflation rates in January and February; the miners' strike as well as the price jump following the price liberalization in April) would give full scope to the depreciation of the lev were not justified.

Presumably, the information available had been left out of consideration long before a new clear-cut trend came to the fore with the overcoming of a given critical stage. This non-linear way of reaction, accounting for the growing importance of the established market stereotypes, makes us extremely cautious in providing exchange rate forecasts by means of classical methods.

The unpredictability and susceptibility of the exchange rate to speculative effects partially neutralized the positive impact of floating exchange rates.

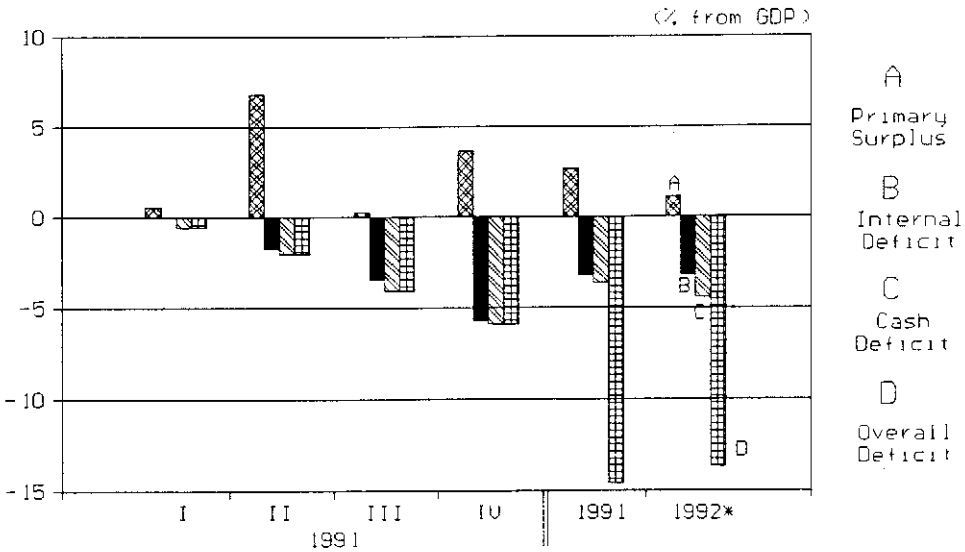
Ever since the beginning of 1992 the lev has been losing much of its stability, signalling a medium-term trend of depreciation. If, at a 65% rate of inflation expected at the end of 1992, the lev's **real** exchange rate remains steady at its early 1992 level, its **nominal exchange rate** is expected to reach a level of 35-36 lv/USD. Given the same conditions, at a 85% rate of inflation, the nominal exchange rate is expected to amount to 40 - 41lv/USD. With a view to the 5%-rise of the real exchange rate (projected by the government, i.e. a higher rise of prices due to the devaluation of the lev) these levels are to amount to 31 and 35 lv/USD.

In the period following March 1991 the real exchange rate of the lev against the dollar (as resulting from a change in domestic and dollar inflation) was relatively stable. Against the background of occasional and speculative fluctuations, several periods of depreciation were set off. They improved the competitive position of Bulgarian exports. The accounted dynamics of the lev's real exchange rate was mainly due to the so-called effect of currency substitution. The reevaluation of the Bulgarian currency was consequent upon the low activity of foreign exchange market players and the lev's relative stability at the beginning of the year. But the considerable devaluation of the lev in early 1991 did not cease to be a substantial incentive to exporters.

4. Fiscal Restrictions

Without formally functioning as a stabilization anchor, fiscal policy was at the core of the stabilization program. Its functions were as follows: contribute to the shrinkage of aggregate demand and bring to life the Government's intentions not to command the economy. The influence of tax policy in forming specific incentives to both consumers and producers were, however, shelved for the time being.

Government Budget Deficit
(Quarterly and Annual Data)



* The Government Budget Law

Source: MF, AECD

As in other East European countries, fiscal restrictions proved one of the most successful steps in the initial stages of financial stabilization. With the close of the fiscal year (1991) the cash deficit was reported to have slightly exceeded 5 billion levs (against 3.953 billion levs projected in the Revised Budget Law). Nevertheless, the basic goal of the fiscal policy (retaining the cash deficit within the range of 3.5 - 3.6% of GDP) was achieved.

As compared to 1990, in 1991 the primary budget balance proved positive, despite the cash deficit registered. The primary deficit remained close to the budget projections. As for the internal and overall budget deficits, they were surpassed by 2.4 and 1.6 billion levs respectively.

As compared to the other East European countries, fiscal restrictions in Bulgaria assumed greater proportions and can be said to be an undoubted success of the stabilization policy. But as practice shows, fiscal results are best in the initial stages of the stabilization programme, while in the stages to follow budget parameters deteriorate as a rule.

The impact exercised on the fiscal system was best expressed along the following lines:

- price liberalization led to a drop in subsidies but also undermined the revenue part of the budget. The system of tax incidence and collection failed to function properly under the new economic conditions;

- with the transition to a unified foreign exchange rate, substantial non-tax revenues dropped out but so did expenditures on export subsidies. Under the specific economic conditions of 1991, payments bearing upon clearing trade and trade bilaterism with East European countries came to the fore;

- rising interest rates influenced the structure of budget revenues considerably. At the same time the growth of profit tax revenues raised from financial institutions covered completely interest payments to the banking system;

- there were the first signs of uncertainty in budget projecting, which in turn necessitated the establishment of a genuine tax administration.

Pursuant to the Budget Law for 1992 is the decrease in the relative weight of the primary surplus by a 1.2 percentage point. Due to a cut in the share of interest due on the domestic debt to GDP, the domestic deficit is to experience a slightly discernible drop. The rise in the law-projected interest due on the external debt will result in a rise of the relative weight of the cash deficit. The share of interest in arrears on the external debt falls by a 1.5 percentage point. Hence, the fall of overall deficit.

As compared to 1991, the 1992 Budget makes projections for a twofold rise of NDCG, brought about by an increase of the cash deficit (by 2.3 times against the 1991 Budget Law and by 3 times against the 1991 Budget Report) as well as by repayments on short-term government securities accumulated in 1991 and early 1992. Also, (as referred to the favourable budget result in 1991) a threefold rise of the sum of negative foreign financing is projected.

In judging the efficiency of fiscal restrictions under the present conditions, we have to consider the following basic points:

- in its relation to the rest of the world, the state has experienced soft budget restraints. The overall deficit in 1991 and 1992 was mostly financed from abroad because of the rescheduling of the foreign debt;

- any data on the actual burden of the budget in the national economy are imprecise because of the hazy assessments of GDP that are deliberately biased in a favourable for the budget direction;

- inflation obliterated the outlines of the domestic debt to the banks. It fell to 16% in 1991 from 35.4% to GDP at the end of 1990.

As related to GDP, the domestic debt and the interest on it paid represented 21.3% at the end of 1991. The ratio of the domestic debt to budget revenues stepped down to 37.8% in 1991 from 67.4% in 1990. (With a view

to the amount of interest paid on the domestic debt, it amounted to 49.1% of budget revenues). In spite of their enormous increase, nominal interest payments could not offset the depreciation of the domestic debt due to the effects of inflation;

- the share of direct bank financing remains high and is expected to rise even higher in 1992. The transformation of short-term credits extended by BNB into long-term ones points to crucial decisions as to the future liabilities of the state;

- the timing of budget implementation is extremely uneven, signalling a clear-cut tendency towards a concentration of expenditures and revenues at the end of the year. This in turn generates economic pressures;

- the transfer of profit tax revenues raised from non-financial enterprises to financial institutions could offset budget deficits in 1991, but not in 1992.

1991 set the beginning of government securities issues, which aimed at non-inflationary budget deficit financing. Since there are no alternative sources of deficit financing (excluding direct BNB loans), the issue of short-term Treasury bills has become a rolling snowball of ever-growing payments to be made. On the other hand, as long as commercial banks are the sole purchasers of Treasury bills, the budget has to take into account interest rates on new credits but not on deposits alone. True, commercial banks find Treasury bills very attractive because of the low risk of loss rooted in them. In contrast with the interest rates on credit extended to enterprises, interest payments on Treasury bills are guaranteed. They can also be used as a collateral against lombard credits. The increased servicing cost of Treasury bills, however, is not to the advantage of the budget, which is credited by BNB at the base interest rate. Hence, the constant pressure on the part of the Ministry of Finance for its decreasing.

We should also bear in mind that certain forms of Treasury bill purchase by commercial banks only (and not by other institutional sectors outside the banking system) are forms of indirect budget financing on the part of the Central Bank. It results in an increased money supply, which in turn perpetuates further inflation. The mechanism of transforming the purchase of government securities into forms of inflationary budget financing is rooted in lombard credit extension. The Central Bank refinances commercial banks against a collateral of Treasury bills and government bonds at the base interest rate. BNB does not set a limit on the overall lombard credit volume. Commercial banks can pledge as a collateral the whole volume of government

securities purchased and draw credits amounting to 80% and 90% respectively of the nominal value of three-month Treasury bills or bonds for bad loans, that have been transformed into a government debt. 3846.5 million-leva Treasury bills were sold in the first quarter of 1992, part of them being pledged as a collateral against lombard credit amounting to 1381.8 million leva. The money stock can be said to have thus increased by 536.7 million leva after the above amount had been netted out by repayments of 845.1 million-leva lombard credit in the same period.

The transformation of the 4128 million-leva bad loans of state enterprises to banks into a government debt, at the end of the year, amounted to the same result. Commercial banks were offered long-term government bonds against the liabilities of the above enterprises. The government thus lightened the debt burdens of these enterprises and pledged a guarantee on their debts to the banks. However, because of the opportunity given to banks to draw lombard credits against a collateral of government bonds, this procedure injected liquidity at the cost of a 3666 million-leva increase of the money stock, which equalled the amount of lombard credit extended against a collateral of government bonds by 31 March 1992. Inflation was thus further fuelled.

From a macroeconomic point of view this way of budget financing has the same consequences as those of direct crediting by BNB. It generates an inflationary potential by a growth of the money stock, which at the end of March 1992 amounted to 4202.7 million leva.

It is here appropriate to answer the question what the advantages and disadvantages this type of financing has for the three parties (commercial banks, the Central Bank and the budget).

First, depending on the different ratio between interest rates on credit, Treasury bill yield and the base interest rate, commercial banks earn 4.5 to 5 percentage points on this operation annually. In order commercial banks to earn such a profit (at a 65% interest rate on credit), the acquisition price of Treasury bills should not surpass 87.91 levs. At a 70% rate of interest on credit, it should not exceed 87.83 leva. **Second**, the budget increases its expenditures on deficit financing by 1 to 5 percentage points but thus evade the limit on direct financing on the part of BNB, projected in the Budget Law. **Third**, BNB makes no financial gains out of this. Nevertheless, government bonds are a reliable guarantee on the government domestic debt to BNB. Also, the Treasury bills issued allow the Central Bank to exercise indirect control over the money stock by handling open-market operations. Pledging

them as a collateral against lombard credits means both keeping them out of the market for a period corresponding to the term of credit extended and reducing the volume of government securities by means of which the above operations are to be handled.

All this points out that **the accomplishment of the budget restrictions and the government's intention to withdraw from the national economy should be carefully considered. Budget equilibrium is extremely precarious and it will remain so unless the structure of budget revenues undergoes a fundamental change.** Although a number of laws bearing upon almost all kinds of taxes have been passed, the structure of the tax system did not break down. The 1992 Budget keeps the structure intact. Meanwhile basic market principles for raising additional funds have been violated. Thus, the introduction of the excess wage bill growth tax, the recognition of only 50% of the interest paid for tax purposes, the 50% transfer of after-tax profit, the limited reevaluation of durable assets and accelerated amortization can be identified as palliative measures.

For the time being, owing to soft external constraints and palliatives for raising funds, the government keeps up with its own budget restriction. The introduction of a new revenue structure is unrealistic at present. For only the introduction of VAT will take about three years with a revenue shortfall in the first year envisaged.

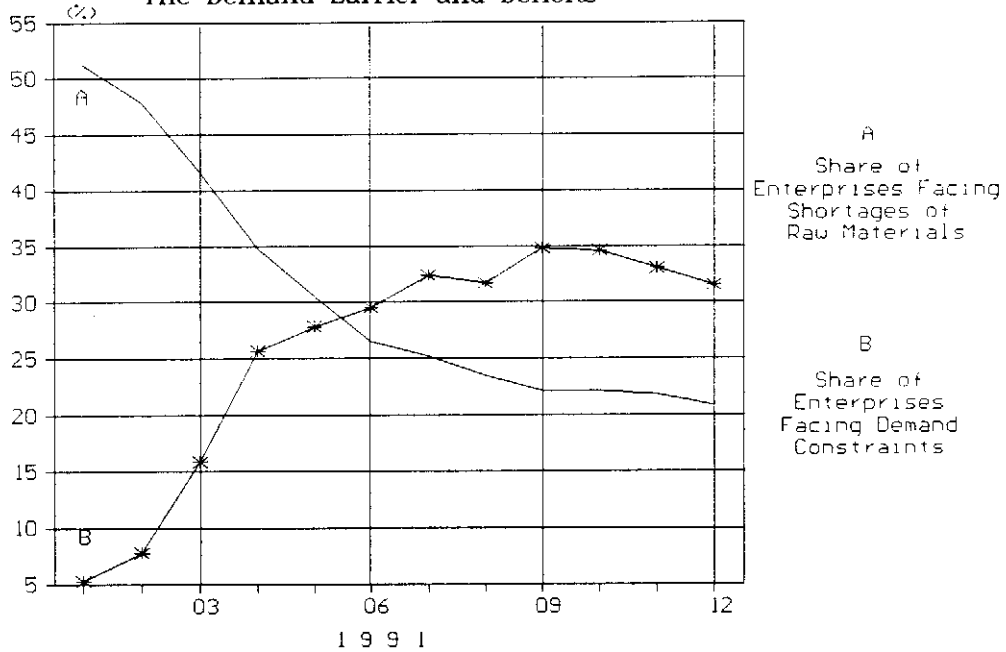
Maintaining this course of nominal fiscal restrictions means subjecting fiscal policy to lasting and acute attacks. The accumulation of a large cash surplus in early 1992 (by April) was consequent upon payments in arrears and profit revenues raised by financial institutions. At the same time tax receipts are disastrously falling behind, and they are the ones immediately related to the current economic situation. Although expenditures seemingly kept up with an even schedule, the latter was only caused by regular interest payments. It follows that the overt budget equilibrium can be easily destroyed in the course of the current year.

5. Restrictions at the Microeconomic Level

Hard budget constraints on enterprises and households are the ultimate goal of the transition to a market economy. The stabilization program is only an episode in this stepwise transition. But it is at this stage that the critical mass of prerequisites that will irreversibly confront agents with the principles of the market has to emerge. Carrying on stabilization programs without having the critical mass needed yields little effects, if any.

The Bulgarian economy underwent fundamental changes in 1991. The scope of typically market incentives was obviously enlarged. The reaction of economic agents was anticipated. Both households and economic agents were involved in an intensive process of acquiring a learning-by-doing market behaviour. Enterprises had to confront and cope with the demand barrier for the first time.

The Demand Barrier and Deficits*



* Relative Share of Enterprises Reporting as a Reason of Decline in Output:
a) Shortages of Raw Materials
b) Demand Constraints

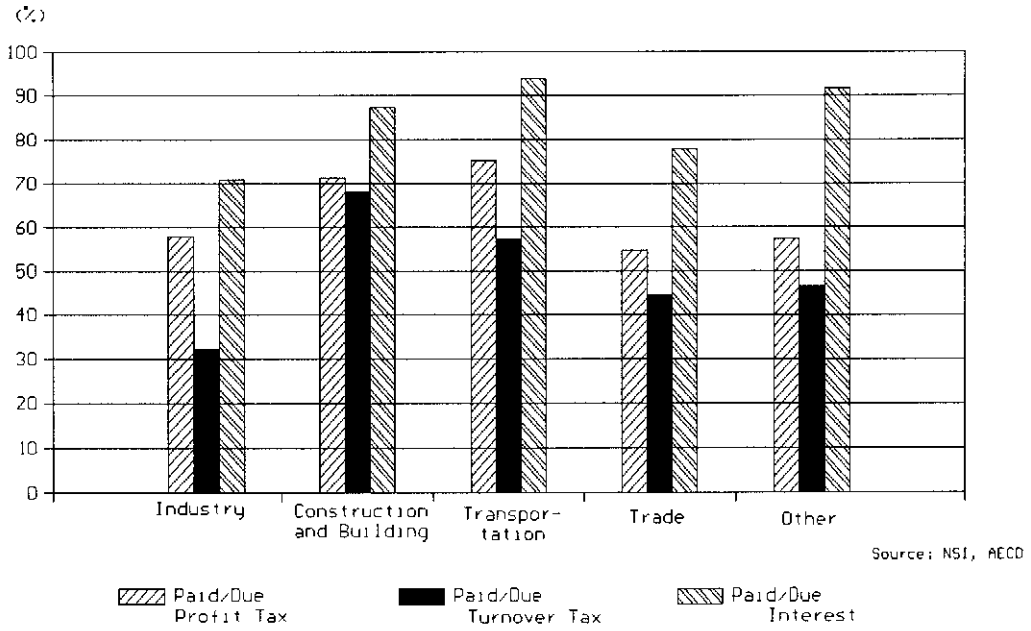
Source: NSI

Despite the changes effected, the ambiguity associated with state ownership has persisted. The national economy is at present experiencing macroeconomic instability, engendered by a **simulation** of market behaviour. There are solid mutual relations among a part of the private enterprises, state firms, the banking system and the budget, which allow them to function under conditions of soft budget constraints. Their relations rest on generalized insolvency; the possibility granted to loss-making enterprises to draw credits for operation expenses; the growing bad debts to the non-banking sector. This process can be essentially characterized as rechanelling consumers' savings to problem or plainly insolvent debtors.

For fear of a **generalized** bankruptcy, politicians are reluctant to provide even formal recognition of **individual** bankruptcies. This in turn underpins largely fictitious transactions in the economy. Thus the share of enterprises facing up to their clients' insolvency, increased sharply.

Real Financial Pressures on Firms – I

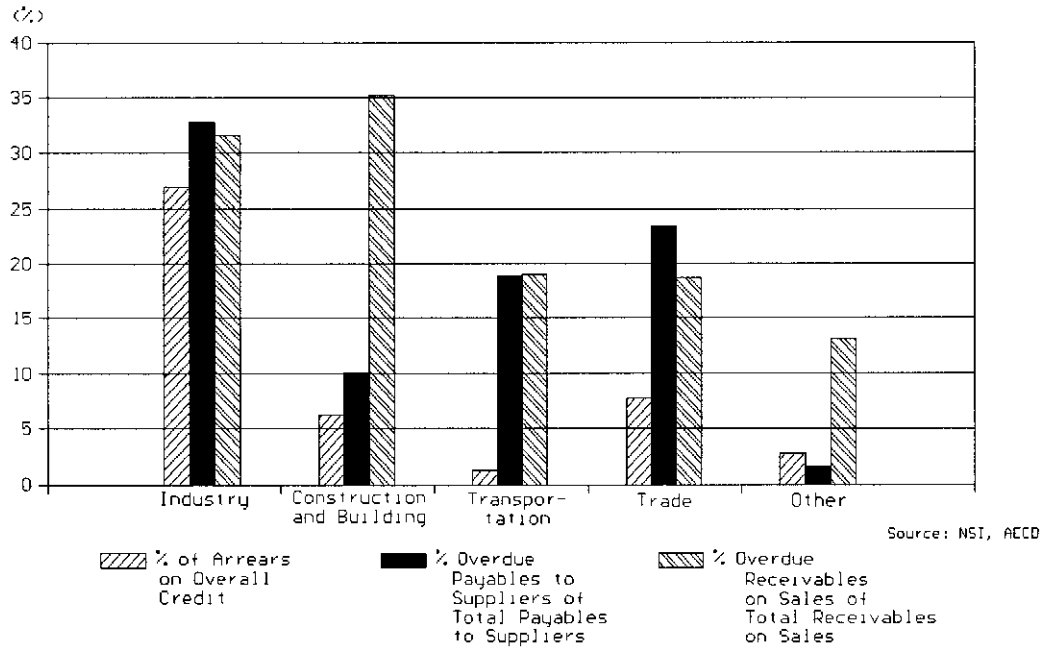
(I Quarter of 1992г.)



We will not dwell into this problem but highlight the stylised facts of living under "soft" budget constraints by drawing on official data on enterprise financial accounts. Unfortunately, first quarter data are not suitable for extrapolation since they are usually not typical.

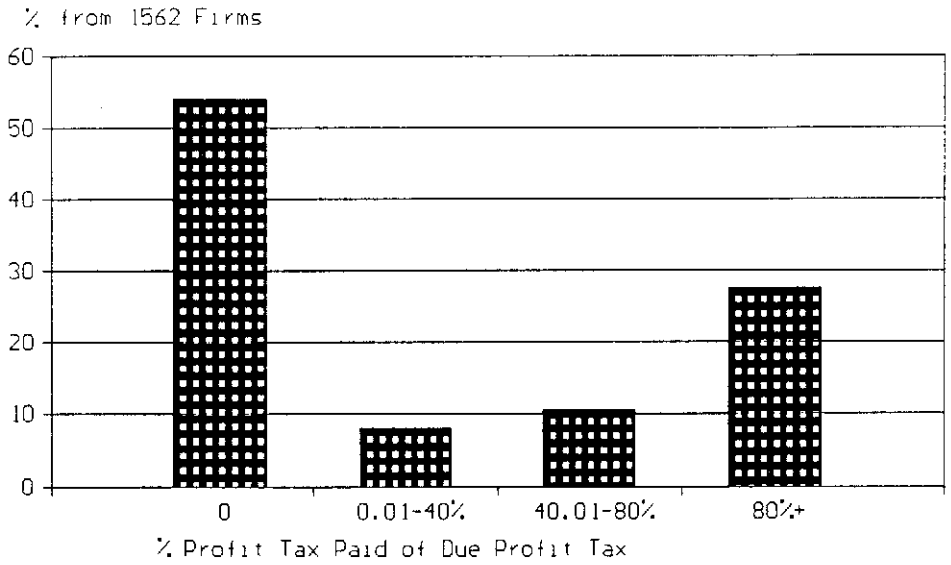
Real Financial Pressure on Firms – II

(I Quarter of 1992)



1° The degree of tax collectibility is sharply falling. This concerns both private and state firms. The degree of tax collectibility ranged between 30 and 83% in 1991. In agriculture it amounted to 45.8%. The ratio of taxes paid to taxes due (by branches) fluctuated between 53% and 75%; this in turn gave rise to a genuine "tax hole" in the first quarter of 1992. 719 firms paid out their profit tax, 843 did not pay it at all; and the remaining part did not report on taxes due to the statistical authorities. It is noteworthy that budget statistics registered a substantial rise in the absolute amount of profit tax revenues. Even thus, the amounts collected are falling behind those due.

Distribution of Firms According to Profit Tax Paid
(I Quarter of 1992)



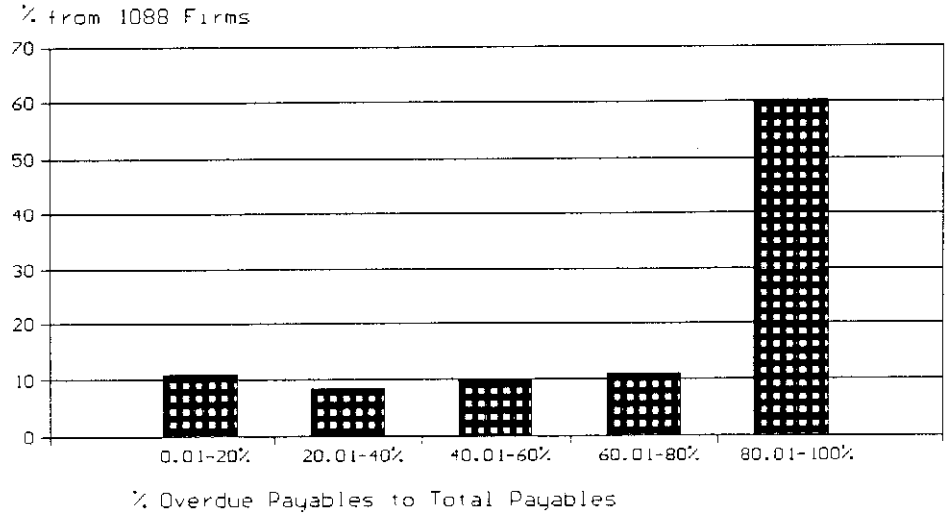
Source: NSI, AECD

2° In the first quarter of 1992 arrears in industry represented 27% of overall credit. In the remaining branches this share was considerably lower;

3° In the first quarter of 1992 overdue payments to suppliers amounted to 32.7% of total arrears in industry and 23.4% in trade. With 654 firms (60.1% out of the 1088 firms with overdue payments) overdue payments represented 80-100% of their total amount. At the same time overdue receivables on sales were 31.6% and 18.7% respectively of total receivables in industry and trade. With 797 firms (50.3% out of the 1583 firms with overdue receivables) overdue receivables range between 80-100% of total receivables. This is one of the quantitative parameters of interfirm indebtedness. Because of the "rough" character of the statistical data available, part of it has been included in the cost of inventories.

Distribution of Firms according to Overdue Payables to Suppliers

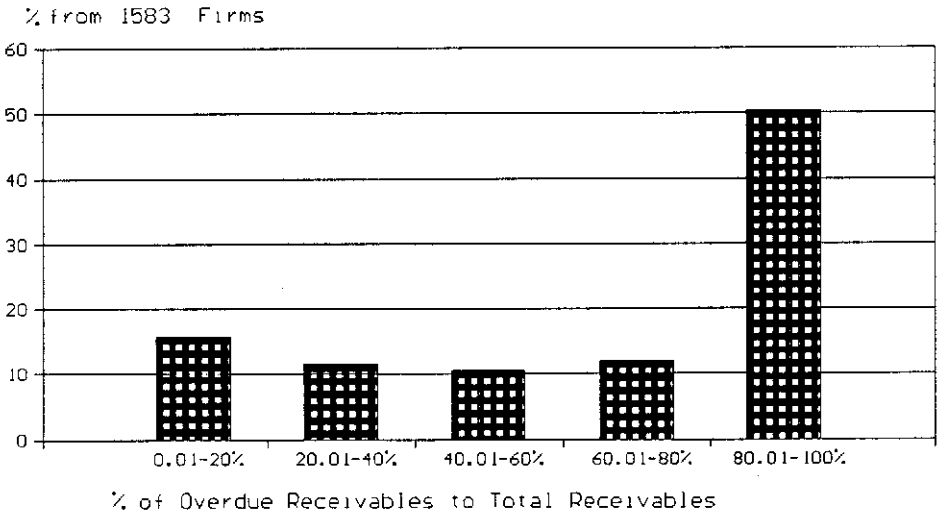
(I Quarter of 1992)



Source: NSI, AECD

Distribution of Firms according to Overdue Receivables on Sales

(I Quarter of 1992e.)

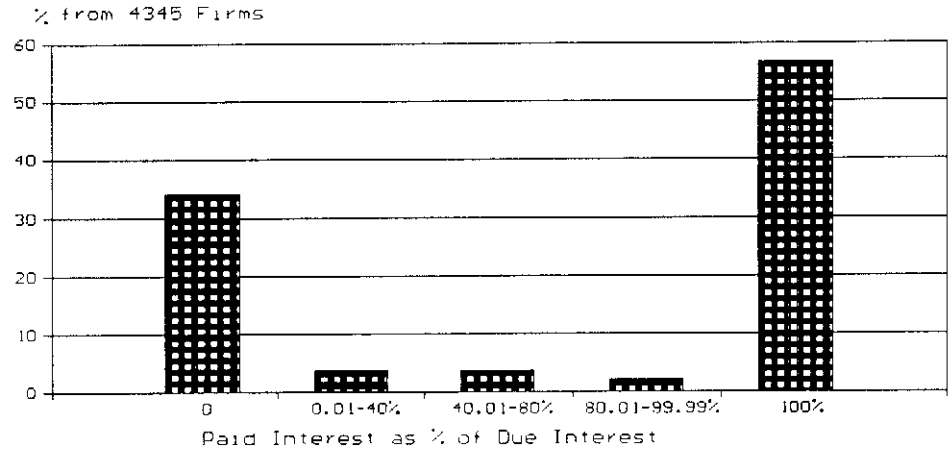


Source: NSI, AECD

4º In the first quarter of 1992, interest paid in industry amounted to 70.8% of interest due. As for the rest of the branches, their share was much higher. 1481 (34% out of 4356 firms) did not pay their interest, and 2460 (56.4%) paid the full amount of due interest, while the remaining 9.6% paid less than their interest due.

Distribution of Firms according to Interest Paid

(I Quarter of 1992)



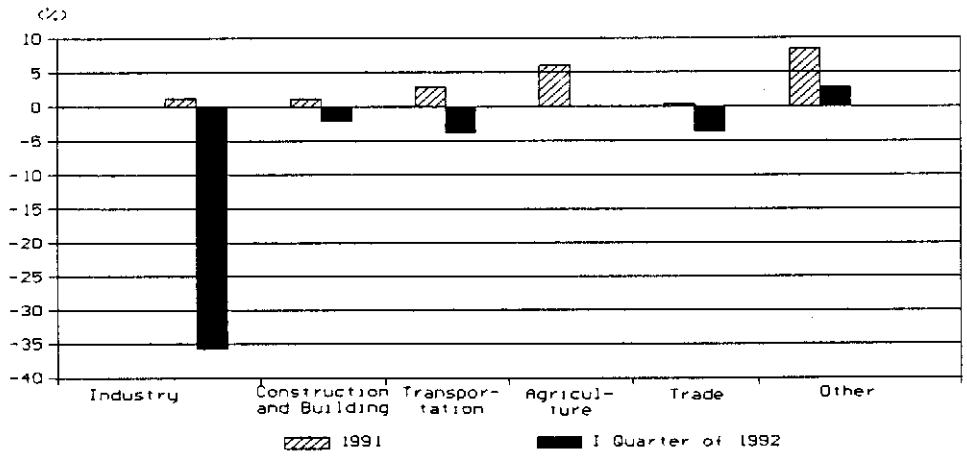
Source: NSI, AECD

A major reason for the above trends is the wretched financial status of enterprises. The net profitability of all branches (after tax profit minus losses) still remains at an extremely low level. It was a bare 1.16% in 1991 for the industrial sector. The beginning of 1992 recorded a real slump in net industrial profitability which plunged down to minus 35.7%.

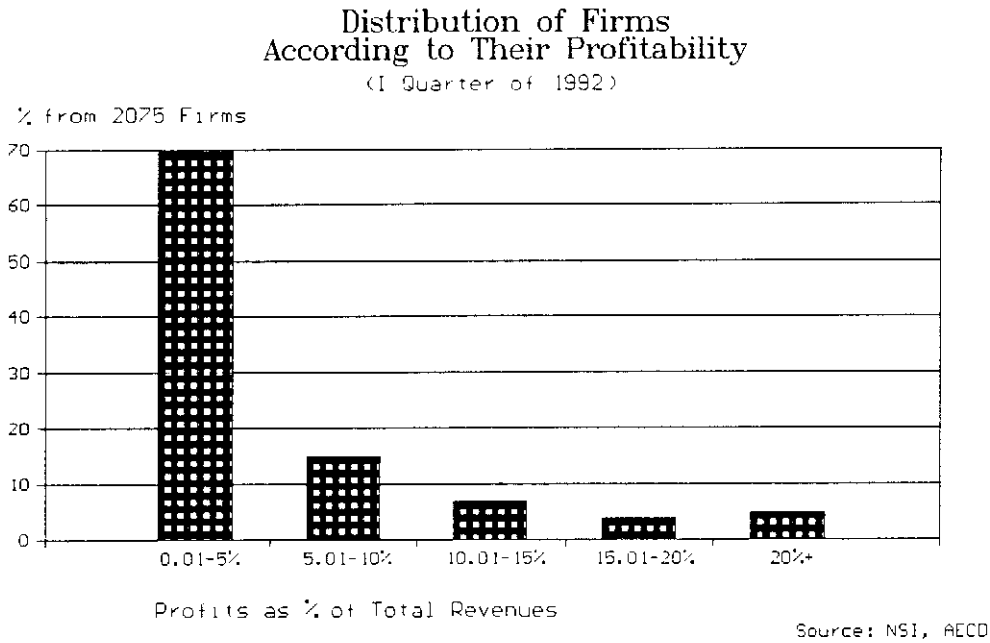
Out of 5476 firms, 2675 (37.4%) ended up the first quarter of 1992 with some profit and 3092 (56.5%) were loss-making. 309 firms reported neither loss nor profit. With a clear-cut bunching in the range of 0.01-5% profitability, the average rate for all profit-making firms hardly reached 5.28%. At the same time with 14.6% of the firms, the accounted losses exceeded 50% of total revenues. It is possible that the visible slump in accounted profitability is partially due to seasonal and accounting factors.

Net Profitability Rate by Branches

(Profit-Losses)/Total Revenues



Source: NSI, AECD



All this made economic agents evade the nominal credit anchor. Obviously, efficient monetary restrictions require that the appropriate legislation on bankruptcy should be consistently applied. This will allow banks to pursue Chapter 11 solutions with their bad debtors and thus cease the credit expansion that is currently being forced on them.

III. INFLATIONARY POTENTIAL

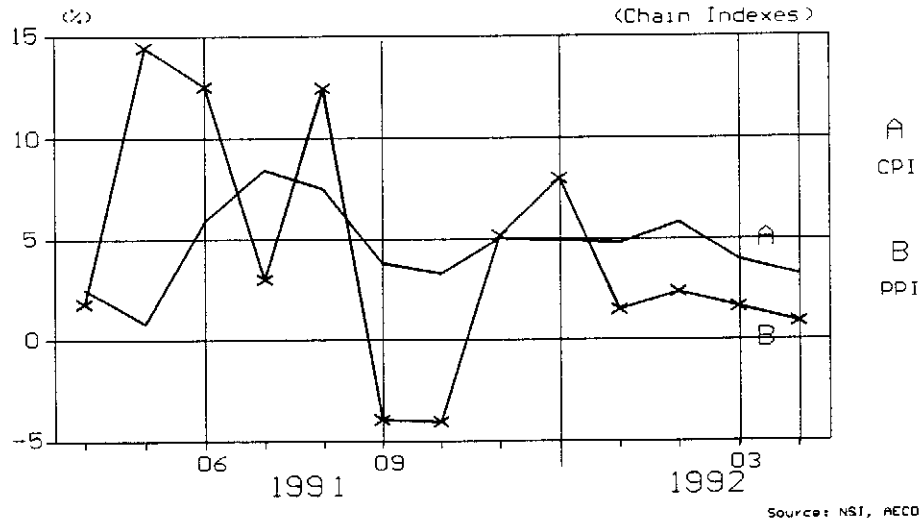
The structure of macroeconomic stabilization policies depends largely on a precise judgement as to the character of inflation. A hypothesis has been recently advanced that the overshooting effect of restrictions in East European stabilization programs has been brought about by the fact that inflation sources have not been correctly identified. By their very design the programs were targeted at demand-pull inflation, while in the course of stabilization inflation proved to be of the cost-push variety.

Under current economic conditions a common opinion as to the character of inflation and the underlying inflationary potential is a must. Also, it is central to the proper timing of any changes in monetary policy, e.g. playing with the base rate.

1. The Character of Inflation

At its initial points the stabilization program aimed at influencing all components of aggregate demand thus overcoming monetary overhang and suppressing inflationary expectations. A delicate question arose over the change of the stabilization program as early as mid-1991. The contention that economic recovery was then possible relied on the view that the economy had been working after the Keynesian model and non-inflationary stimulation of aggregate demand was admissible. AECD formulated a view of its own that there were no conditions for recovery and untimely stimulation will only heighten the negative effects on economy.

Producer Price Index (PPI)* of Industrial Output and Consumer Price Index (CPI)



* PPI is Calculated by AECD upon Original Data Provided by NSI

As in the other East European countries the problem deserving clarification was the "residual inflation" sustained after the initial price shock. In Bulgaria it ranges between 3 and 5% monthly and exceeds program expectations. The continuous maintenance of inflation at a low absolute level has to do with the structural parameters of the economy and can hardly lower it drastically in near-future.

At present inflation dynamics contains the following basic components:

Elements of cost-push inflation. Quantitative assessments for the nine months of 1991 show that the bulk (79.8%) of producer price growth in industry was brought about by the price increase of raw materials, fuels and energy. The share of labour costs diminished while the share of unit labour costs began to increase after the prominent initial restriction in the first half of 1991.

The considerable real wage growth in the last quarter of 1991, without resulting in a distinctly rising labour productivity, fitted the picture of cost-push inflation.

Finally, the still intact regional (and in a number of cases national) monopoly power of many producers allows them to put almost all of the burden of increased costs onto consumers.

Sharp change in terms of trade. This factor adds up to the remaining cost-push inflation factors. Ever since the negative shock of 1990, brought about mainly by the disintegration of the CMEA price system and the Persian Gulf crisis, the terms-of-trade index has been slowly going on the increase. Although the price of oil set back at its mid-1990 level, it is difficult to say that the index has fully recovered. The general decrease in the prices of Bulgarian exports, triggered off by both the onrush of a large number of beginners in the business (often with undeveloped market skills and unreliable information) and the sharp devaluation of the lev in 1991, accounted for the above index status. The government could not exert a substantial influence on this process on account of the fact that it monitored, and still does, the minimum prices of a quite a limited group of goods (meat and animals, dairy products, wood, etc.). And yet, the index has continued to maintain a slow upward trend due to the rising lev's exchange rate against the dollar since the beginning of the year. This in turn will make exporters set even higher prices of their exports, thus avoiding losses.

Elements of demand-pull inflation. Among the final demand components, export alone manifested a markedly rising trend in the second

half of 1991. Although the period recorded a substantial wage rise, the latter did not reflect on a statistically reported growth of personal consumption. As has already been pointed out, some of the growth was attributed to private sector consumption (unreported).

True, the increase of personal incomes had a largely offsetting function in attention to the fall in the first half of 1991. But considering the effect produced, we can say that the **speed** of change took on even greater importance in the last quarter of 1991. Although the first two months of 1992 saw a slightly discernible drop in the average real wage, March recorded a sharp increase again.

Credit restrictions were one of the prime tools reducing demand in 1991. The "freeze" on liquid assets into time deposits as well as the increasing amount of savings came to the same effect. The avoidance of credit restrictions via interfirm credit and credit ceiling exceeding partially neutralized the effects on demand. Furthermore, the lower liquidity of time deposits was rather conditional: with a relatively inconsiderable change in interest rates or inflation, these deposits could turn into liquidity-generating assets.

This dynamics justifies us in concluding that demand-pull inflation elements could come to the fore, though their quantitative influence on overall inflation deserves further clarification. A possible sharp increase of incomes (independent of its origin) may produce a certain inflationary effect. It will be further reinforced provided the incomes anchor is "freed" by an untimely lowering of the base interest rate.

Inflationary expectations. "Inertial" components do exist in inflation under the current economic conditions in Bulgaria. AECD has always held the view that economic agents' inflationary expectations are vigorous. Regular entrepreneurial surveys among firm managers provide ample and positive evidence that inflationary expectations are active. The presence of such an element is further hightened by the floating exchange rate.

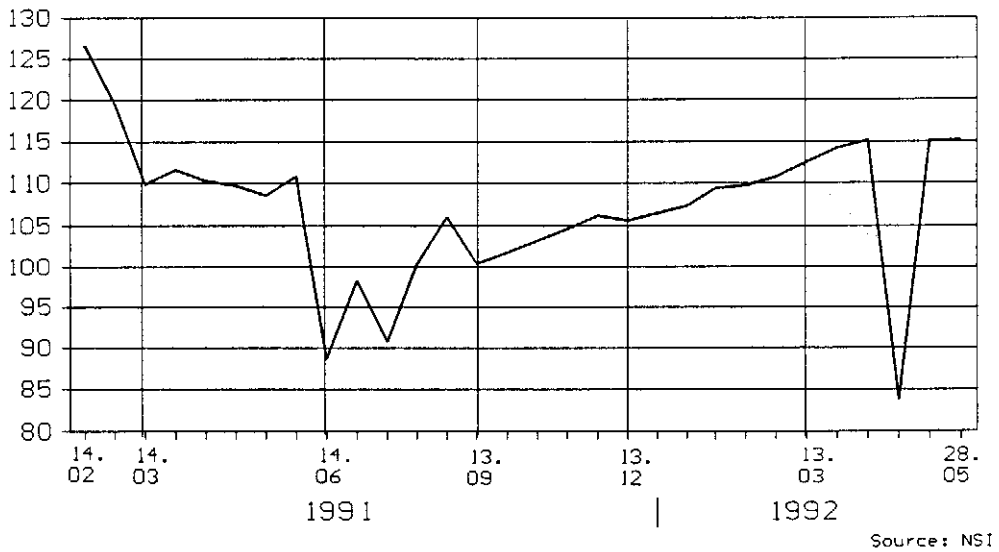
The initial sharp price jump can also be recognized as a factor fuelling inflation. Inflation may assume an inertial character on condition that other nominal variables (money, credit, wage) tend to catch up with/ gain on the sky-rocketing jump of prices.

2. Sources of Discrete Inflationary Impulses

The approach to price liberalization, adopted by the government in 1991, can be characterised by a stepwise easing of price controls. The stages were clearly set off by the removal of price controls over food and energy products, most substantially subsidized in the past. They also differed in scope. The greater part of price liberalization was carried out in February 1991. Only energy products (electricity, heating, gas, coals and oil product) and public utilities, comprising less than 10% of retail and wholesale sales remained under direct price control. Energy products registered two price adjustments in 1991 (February and June). The domestic prices of oil products levelled up with the world prices, while the prices of electricity and heating approximated them but remained well below both their level and domestic costs. With the rapid rise of energy prices in June, the government put an end to electricity and oil product subsidies. However, heating and domestic transportation continued to be subsidized. Food prices rose substantially in February and only partially in August.

As each stage of the step-by-step price liberalization is carried out, a certain amount of inflationary potential is accumulated in the goods monitored which at some point may discretely break free engendering price shocks of different dimensions. At present the goods monitored contain in some form the major sources of "discrete" inflation. The potential foci of inflation are to be sought in:

Ratio of Actual to Forecasted Prices of the Goods Monitored
(Forecasted prices = 100)



Source: NSI

The prices of goods and services of prime necessity, monitored by the government. Initially they included 14 groups of goods: food and fares. Their amount totalled 18% of retail sales. The government set "forecast" prices, whose original level was on average 5 times higher than the previously administered price levels. In practice, they provided the threshold at which authorities started to exert control and regulate the profitability of goods and services, whose actual prices surpassed forecast.

Pursuant to Resolution 64 of the Council of Ministers, dated 17 April 1992, was the rise of energy prices. The number of the goods monitored was reduced to 7. Their forecast prices were exceeded by 20 to 44%. The price rise of the seven goods, monitored by the government, amounted to 20% in the first fifteen days of May. The second half of May recorded no change, which could be interpreted as an instance of inflationary potential exhaustion of this group of goods. Because of the low effective demand registered, only 20-30 firms have announced a price rise of their production since the beginning of the year. Pursuant to same resolution were the minimum procurement prices of agricultural products which exceeded their previous forecast level by 30% on average. It implied that they remained a source of latent inflationary potential in the economy.

Limit prices of fuels and gas, which ever since mid-1991 have been set on every 15 days by the National Commission on Prices on the basis of the average world prices and the lev's exchange rate. In the period from February to June limit prices were exceeded respectively by 369 to 792% in industry and 125 to 343% in households. (Only in June the prices of energy, coals and oil products rose by 70%). Properly speaking, the prices of this group of goods have already been brought into line with world prices but with the enforcement of the new Customs Tariff they are expected to become a source of inflationary impulses.

Fixed prices of electricity and heating, coals and gas. The prices of electricity and heating for producer's needs stepped up by 786 and 1459% and 646 and 750% in households in the period from February to June. The wholesale prices of coals went up by 2322% while their retail prices by 1175% in the same period.

Pursuant to the resolution above cited, the prices of electricity and heating registered a further rise by 35%. This can be said to be the prime source of inflationary impulses whose influence is to fully unfold in the following two or three months.

The New Customs Tariff. The enforcement of a new customs tariff may exert some influence on the inflation of several groups of goods in the second half of 1992. As a whole, the rates of the tariff items are higher than the previously used ones. (According to AECD estimations the **unweighted** average tariff is by 9 percentage points higher). The abolition of the 15%-import tax will, however, offset this rise.

Activated inflationary expectations in the short-run are due to:

- price rise of the goods left out of government control as well as a substantial increase of procurement prices;
- price rise of fuels and energy, with universal application, which in turn will result in a price rise of the remaining goods;
- total removal of energy power subsidies, which will subsequently lead to another price correction of energy production.

3. Inflation Forecasts and Implications for Interest Rate Lowering

As long as the basic argument favouring interest rate lowering maintains that inflationary potentials are exhausted, anticipated inflation will be an issue of central economic concern.

AECD expects the GDP deflator to amount to 85 - 90% (including the "carry-over" effect) in 1992. By the end of the year the growth of consumer prices is expected to range between 80 and 90%. These estimations rely heavily on the budget-projected actual decline of GDP by 3.8% as well as on the supposition that the government will manage to stick closely to a restrictive incomes policy.

The current macroeconomic situation allows of abrupt changes in the above forecasts. Under the existing external constraints on the national economy, inflation has become extremely sensitive to changes in its cost and demand components. In carefully considering the influence of interest rates on both components, we should bear in mind the following basic points.

- the sharp interest rate lowering will lead to a withdrawal of deposits and immediate impact on demand;
- interest rate lowering will not provide a solution to the pressing problems of firm indebtedness. The solvent firms have already adjusted to the levels of interest, and to the definitely insolvent ones such a circumstance will hardly change matters;
- the currently active and the immediately impending discrete inflationary impulses make interest rate lowering inappropriate in the short-run;

- activated demand components of inflation may be quickly prompted up by the existing economic and political situation. In the near-term this may generate a rise in the nominal pension as well as a possible wage growth acceleration.

The arguments cited do not imply that interest rate lowering is not a desired goal. The inflationary effect of high interest rates is obvious. It may also affect firms which are on the borderline of solvency and under less restrictive conditions may prove to be viable.

Interest rate lowering may prove appropriate in case of failed attempts to influence cost-push inflation by imposing restrictions on aggregate demand. Tightened monetary restrictions (credit ceiling lowering) contribute to output decline. Increasing energy prices and enforcing the new Customs Tariff means engendering a new shock on aggregate supply. The above conditions given, prices will rise despite demand suppression, which in turn will halt the increase of supply.

In similar situations interest rate lowering may reduce the amount of interest payments within total costs and give the firms, trapped by low demand, another chance to revive output with lower interest rates. Consequently, producing simultaneous positive effects on output, supply may increase hobbling demand-propelled inflation down the track.

A negative side effect may result in the maintenance of loss-making firms. But as long as a properly functioning mechanism of bankruptcy of state firms is not adopted, economic pressure may prove futile.

In any case, interest rate lowering should be carried out provided all necessary conditions are ensured. An untimely easing of the "official" restrictive monetary policy means disrupting the most stable element of the stabilization program. Interest rate lowering, coupled with the government's declarations of abandoning high rates may signal the abandon of restrictive stabilization policies.

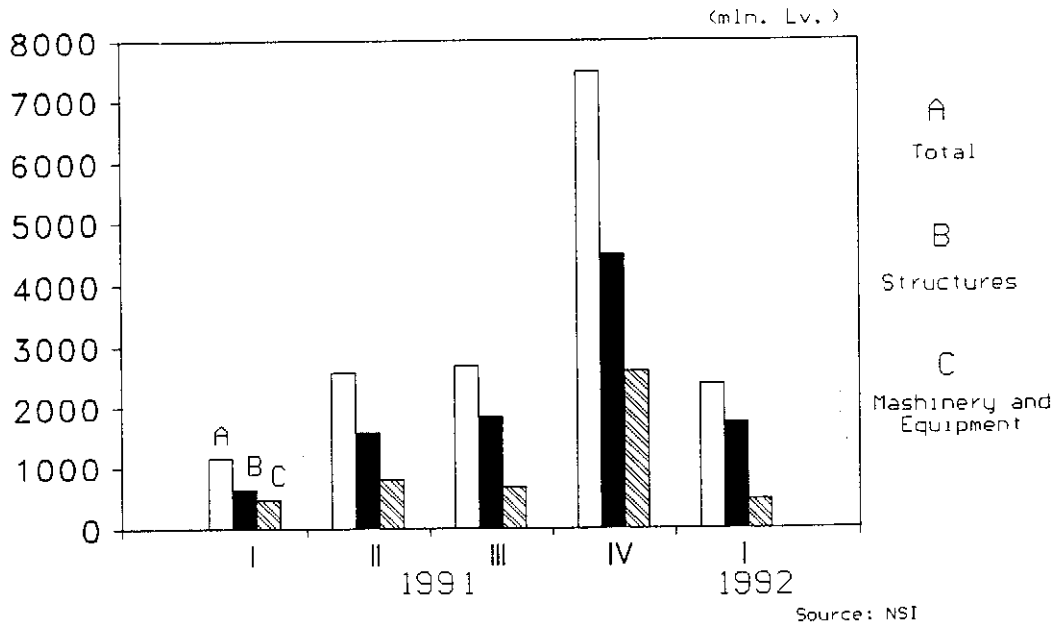
IV. PROSPECTS OF RECOVERY

1. General Framework of Economic Growth

From a macroeconomic point of view the problem of economic recovery amounts to the consideration of: the potential for non-inflationary growth of the different aggregate demand components; and the strength of restrictions on supply and foreign financing.

All factors acted upon the shrinkage of economic growth in 1991. They were further intensified by foreign shocks, the effect of which will persist in 1992. The configuration of the active factors in the national economy has not undergone a substantial change in the current year but has been highlighted by the following conditions.

Volume of Investments
(Quarterly Data)



Source: NSI

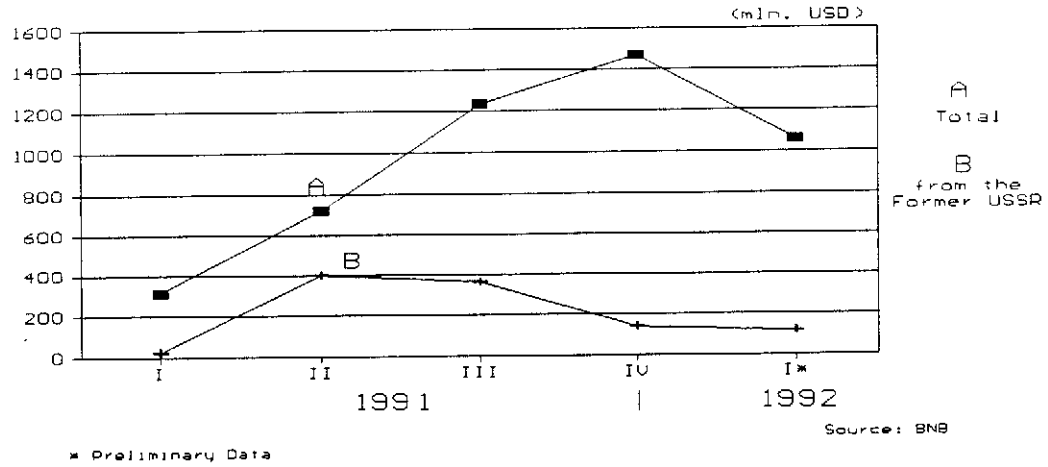
Although a certain revival in this area is possible, a substantial **investment impulse** is not anticipated. The basic depressive factors are the budget restraints on government investment and the wretched financial status of state firms. Credit restrictions generally exert a negative influence. In respect to this, a certain pick- up in investment may be caused by the reallocation of credit flows and to non-financial enterprises from the State Fund for Reconstruction and Development. The flow of direct foreign

investment anticipated can be said to be inconsiderable. Without being able to gauge the private sector, we can say that it is expected to make key contributions.

The general trend discernible in **the change of inventories** is towards decreasing. It follows that this component will add up little, if at all, to GDP growth.

Personal consumption is expected to change within the framework of changes in real incomes and savings. Within the context of wage and pension growth and interest rate policies implemented hitherto, consumption is not expected to increase substantially. New sources of unreported incomes will account for its growth.

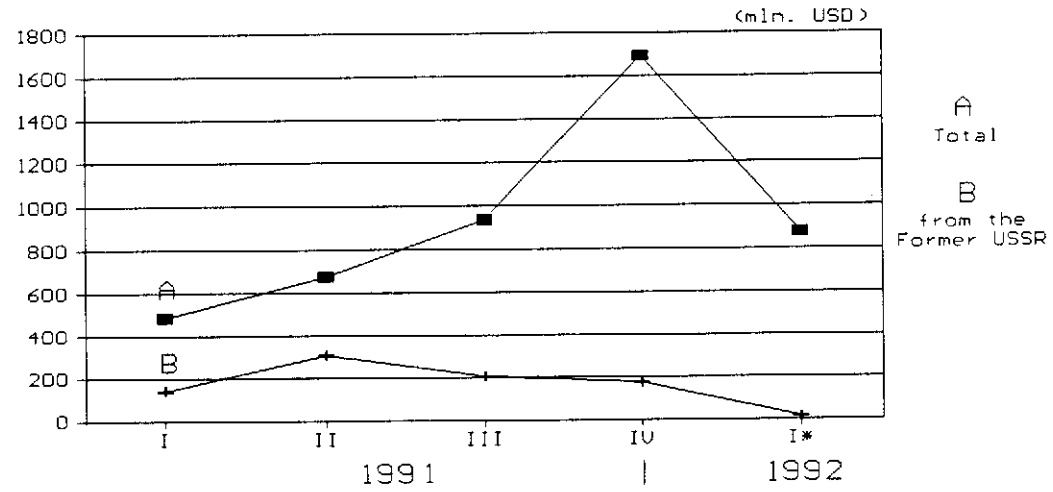
Export in Convertible Currency
(Quarterly Data)



Source: BNB

* Preliminary Data

Import in Convertible Currency
(Quarterly Data)



Source : BNB

* Preliminary Data

The current situation in agriculture may bring about an increase in **import** requirements in 1992. Certain investment import requirements may also arise over expenditures of the State Fund for Reconstruction and Development resources.

As in 1991 limited foreign financing possibilities will be the main constraints. As long as there is no change effected in macroeconomic policies, they will place import within the framework of foreign financing. An untimely acceleration of its growth may undermine foreign exchange reserves, depreciate the exchange rate (i.e. generate an inflationary impulse) or eventually impose administrative controls.

Within the context of the stabilization policy, "the degree of freedom" in the economy results from its ability to carry out export expansion. But this is only a relative freedom, for Bulgarian exports are import-intensive.

The conditions suggested, set out the medium-term potential of growth. They do not rule out the restructuring of the active factors, neither their stimulation or even revival, reinforced by the impact of short-term factors.

2. Foreign Financing

Bulgaria has been filling in the "financial gap" in its balance of payments through the financing of official financial institutions for two years. As previous experience suggests, foreign financing has come in in very small amounts on a flexible schedule. This in turn has put a constraint on short-term prospects for growth.

Total financing requirements in 1991 amounted to $ 3.1 billion , $ 2.4 billion of which were rescheduled or deferred foreign debt repayments. The "financial gap " of $ 0.7 billion has been filled in by international financial institutions.

Total financial requirements in 1992 are estimated at $2.6 billion, $1.5 billion of which are rescheduled foreign debt repayments. The widest, as compared to the other East European countries in need of official financing, the "financial gap" in Bulgaria is estimated at about $1 billion.

If the financing of the balance of payments ensures short-term prospects for economic growth, the foreign debt imposes the main constraint on medium-term potential. The inability of the country to service its foreign debt, as embodied in the moratorium on foreign debt repayments in 1991, put an end to almost all financial flows from unofficial foreign sources to Bulgaria.

Even the regular commercial financing of turnover via letters of credit and overnight commercial credits has become highly restricted and complicated. This fact alone has a markedly negative influence on foreign trade turnover, for it requires a 100%-import payment in advance and defers proceeds on export. Credit from international financial institutions serve mainly to maintain the foreign exchange reserves of the Central Bank at a comparatively satisfactory level, provide raw materials and stabilize partially the lev's exchange rate. Foreign investment financing is reduced to 70% of the official credits to the State Fund for Reconstruction and Development and paltry amounts of direct foreign investment (55 million $). Though not the sole reason for its small amount, unsettled foreign debt problems put the brakes on foreign investment. Since domestic investment is limited because of the undeveloped and rather backward private sector and structural budget deficit problems, the small amount and share of foreign capital flows practically thwart the country's hopes of quick recovery and economic growth.

The difficulties Bulgaria has to face are inevitable, for the country cannot start to serve its foreign debt without its radical restructuring and reduction. The negotiations with the Commercial Bank's Advisory Committee have entered a stage of intensive talks on possible solutions to the problem. Bulgaria has submitted a financial package consistent with the financial support of IMF and the World Bank. The package relies on a comprehensive one-step agreement based on a reduction of the better half of the country's indebtedness.

3. Prospects for Export-led Recovery

The second half of 1991 marked a substantial acceleration of export growth (excluding foreign trade with the former S.U. republics). It was carried out at a very low absolute level and the possibilities for its transformation into a general economic export-led recovery, are intimately related to the prospects of development of our basic markets.

The CIS. The share of this newly formed group of states in Bulgarian export has been declining since 1989 but it still ranks among the highest. Being at the initial points of stabilization, the European CIS republics are facing identical supply-side problems. The raw materials needed for the Bulgarian economy are included in indicative lists of trade exchange with Russia and Ukraine. The low clearing dollar's exchange rate and the aggravating economic and administrative constraints are an impediment to trade exchange outside the indicative lists.

Eastern Europe. With the disintegration of CMEA Bulgarian exports plummeted to the possible minimum of 200 - 250 million $. The former CMEA member-countries have formed no new region of economic exchange in Europe yet. A main determinant of Bulgarian export will be the settlement of trade deficits with the above countries. In this sense, the exchange rate of 3.50 lv/transferable rouble will be an insufficient incentive to exporters. The budget should, in addition, make provisions (maybe the 20% of the State Fund for Reconstruction and Development, envisaged for export-promotion) to bolster up trade deficit settlement.

Trade exchange with Third World countries. There are two groups of reasons for the markedly negative trend of trade exchange with the developing countries. The political reasons concern Iraq, Libya and partly Syria (mainly along the line of armament export shrinkage). The economic ones amount to the above countries' insolvency. The latter is undermined by the very impossibility to carry on exports on credit due to the outrageous need for cash or equivalent import as well as the high degree of indebtedness of some of these countries to Bulgaria. No export "boom" is expected in the short-run.

Trade exchange with the OECD. The only bright prospects of Bulgarian export are linked with the OECD and Western Europe in particular. The relative share of OECD member-countries in Bulgarian export have grown by more than two times against 1989. This was partly brought about by exchange rate movements. The association of Bulgaria to EC (which is to take place by 1993) is expected to give a further impetus to the trade exchange with the developed countries. It is also expected to bring about an increase of export quotas for Bulgaria's less competitive commodities, a reduction of customs duties and abolish non-tariff restrictions. The asymmetry of reduction and subsequent removal of customs barriers between Bulgaria and EC will improve the trade balance with EC member-countries.

In conclusion we can say that the expectations of export development in the near-term are comparatively favourable. As compared to 1991 a certain growth of export is expected in 1992. A moderate growth of 2 - 4% annually is also expected in the period from 1993 to 1995.

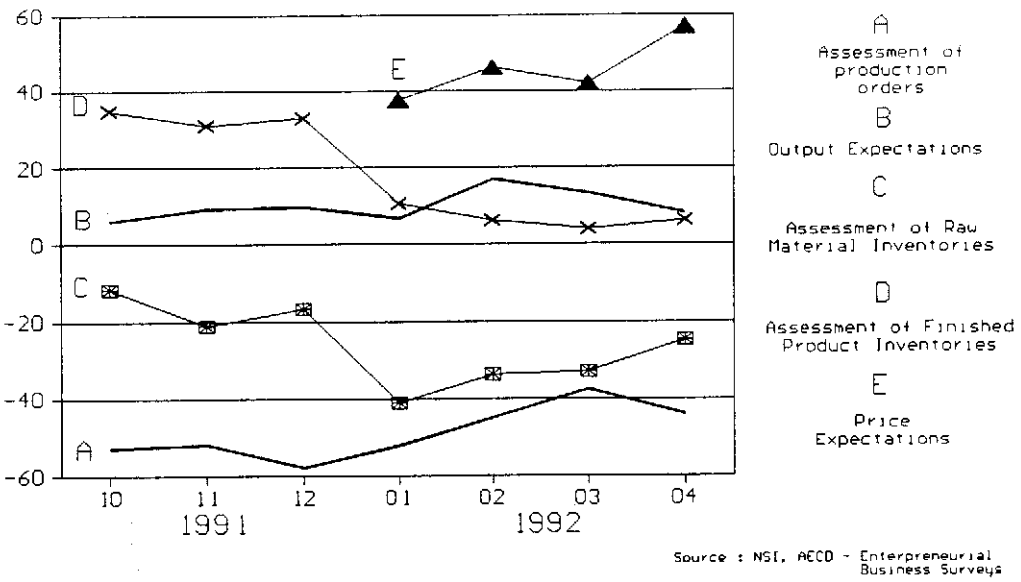
4. Microeconomic Assessment of the Prospects of Recovery

The prospects for economic recovery can also be viewed from the specific standpoint of the firm manager. It should not be overrated. But

neither should it be left out of consideration. It provides valuable sample information based on the entrepreneurial surveys carried out among the managers of several state industrial enterprises. Following a methodology, conceived in close collaboration with AECD, NSI has been conducting monthly entrepreneurial surveys for seven months.

There are three grades of assessment: normal, below and above normal (referring to stock level), and with no change, fall or increase registered (referring to the remaining answers). What is important with this scale of assessment is the difference between the shares of the negative and positive answers. It is noteworthy that answers reflecting no changes are not taken into account.

Entrepreneurial Business Surveys
in Industry*



Source : NSI, AECD - Enterpreneurial Business Surveys

* (% of Firms With Positive Opinion (Expectations) - % of Firms With Negative Opinion (Expectations))

The answers should be carefully tackled because the information contained has not been fully examined yet. We will here highlight only the key points underlying firm managers' expectations in the last few months. They are an essential part of the assessment of the basic business conditions and possible **short-run** prospects for output recovery;

- ever since the beginning of 1992 finished product overstocks have manifested a downward trend, which is further evidenced by NSI data. It affects both domestic and foreign market production. From the point of view of business cycle patterns this fact indicates producers' adjustment to the real

market volume as well as a higher degree of responsiveness to the demand barrier. In principle, a decrease of finished product overstocks allows producers to react more aptly to a possible revival of supply;

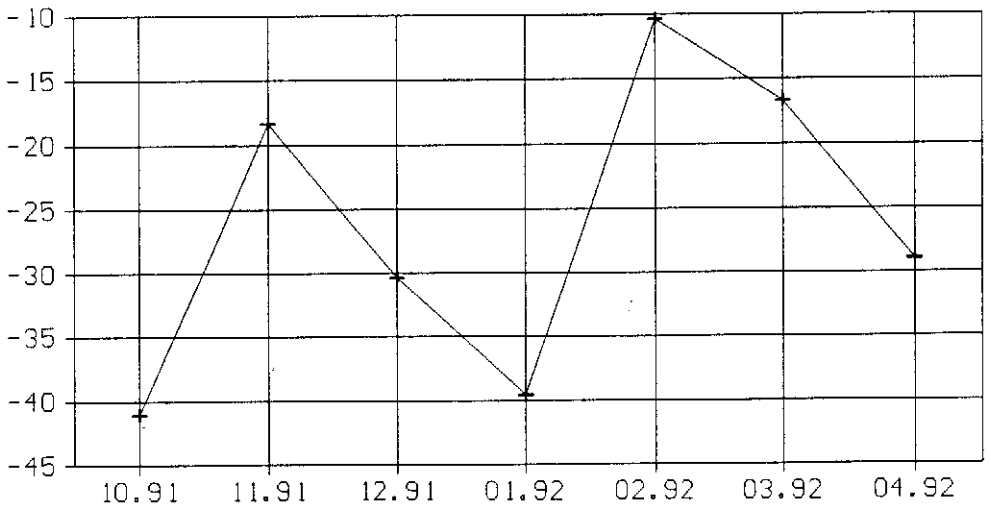
- as the prevailing number of negative answers to the question of raw material supplies suggest the bottlenecks of supply have not been fully overcome;

- entrepreneurial surveys hint at no expectations of output recovery. The answers to this question border on total neutrality and reflect dominant depressive moods. The assessments of orders, indicative of a certain "improvement" within the general framework of pessimism, manifested a distinct tendency towards change;

- anticipations of price rises, reflecting a stable adjustment to inflation, are markedly positive;

- there is a trace of optimism underscoring the answers to export prospects.

Agency for Economic Coordination & Development
The Economic Expectations Barometer (EEB)



Source: AECD

Relying on entrepreneurial surveys, AECD has constructed a synthetic barometer of economic expectations (EEB). EEB gauges the direction of change in firm managers' expectations to optimism or pessimism (see AECD Business Surveys, March 1992). The limits of EEB change range from +60 to -60. The upper limit corresponds to "total pessimism" while the lower one to "unanimous optimism".

EEB dynamics suggests no fundamental change in the general status of economic activity over the last few months. The barometer has typically oscillated about -20/-30, which corresponds to lasting depressive effects. Nevertheless, if we are to define any EEB trend of development, we should point to a slightly discernible positive deviation of the barometer in the past three months.

The lack of uniformity in answers prevents us from making any generalizations as to clearly cut tendencies of "deterioration" or "improvement" of firm managers' expectations. Most of them have geared up for a slightly positive trend of development. This assessment stands in sharp contrast with the reported data on the financial status of firms. Entrepreneurial surveys, we think, highlight assessments of the "physical" and market potential of firms, while statistical data disclose underlying generalized problems of insolvency in the national economy.