
Agency for Economic Coordination and Development

**THE BULGARIAN
ECONOMY IN 1994**

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The macroeconomic situation in Bulgaria after four years of stabilization efforts, is characterized by accelerating inflation, low confidence in the national currency and frequent forex market upheavals. The currency substitution and the „dollarization“ of the economy have rendered powerless the control over the money supply and the inflationary processes.

The diagnosis for the economic situation was moulded into the abstract slogan for changing the „model of transition“ without any definite macroeconomic parameters and clear outlines of a new economic policy.

The present 1994 Annual Report of the AECD¹ draws on previous analyses and statements on the Bulgarian transition to a market economy and highlights the **opportunities** immediately open to the economic policy.

■ **The 1991 programme.** An IMF-supported stabilization programme based on control of the money supply² and nominal wages was launched in February 1991. It was designed to eliminate the main macroeconomic imbalances and secure a steady macroeconomic equilibrium as a basis for long-term non-inflationary growth. The liberalization of prices, of the foreign trade regime, and of the forex market were intended to eliminate the monetary overhang, while raging inflation had to be stemmed by restrictive monetary and fiscal policies supported by an adequate incomes policy.

■ **The implementation of the 1991 programme.** The restrictive monetary policy was sustained till the third quarter of 1991. Afterwards the Central Bank began adjusting the money supply to the actual inflation rate with a lag of some 3 months. The incomes policy was undermined by the wage bargaining system introduced in November 1991, and in particular, by the wage indexation in 1993. Fiscal policy developed an expansionary stance since mid-1992, raising the cash deficit to 12% of GDP in 1993. The inconsistent and contradicting measures blocked the macroeconomic re-

¹ *The Agency for Economic Coordination and Development.*

² *More precisely, controlling the leva credit expansion by credit ceilings for commercial banks.*

form in 1993 which was considered „lost“ for the reform³. 1993 rounded off with a grave crisis on the domestic forex market which conditioned the financial instability in 1994.

■ **Why did the 1991 programme fail?** The reasons should not be sought in the programme itself, but in the reluctance to undertake any changes of the institutional and legislative structures inherited from the planned economy. Vested interests obstructed the formation of independent institutions of the economic reform, which in turn frustrated any consistent economic policy. Not being supported by clear and tough „rules of the market game“ and a genuine political will for ownership restructuring, the stabilization quickly degenerated into an exercise in solving current and recurrent problems.

■ **What happened in 1994?** There was a futile attempt to apply again the initial stabilization programme. The restrictive stance of the monetary and fiscal policies was restored, and the BNB changed its instrument of control on the money supply⁴, trying to introduce tough restrictions. However, the exchange rate and inflation remained beyond control and followed the trend of mutual adjustment.

■ **How to curb inflation?** There is an **absolute need** for a new macroeconomic stabilization effort. It should be made **only in the presence of political will** for its launching and consistent implementation, and of a precise coordination of all macroeconomic policy measures. Unfortunately, a new stabilization effort has minimum chances of success under the present state of institutions and legislation.

The present AECD 1994 Annual Report examines the impact of high inflation and the nominal depreciation of the leva on the main macroeconomic parameters and the behaviour of economic agents. **On this basis it outlines the short-term prospects for the economy and the possible macroeconomic policy options for 1995. □**

³ *The Bulgarian Economy in 1993: Annual Report, AECD, Dec. 1993.*

⁴ *The credit ceilings were abolished in July 1994 after their inefficiency was acknowledged.*

THE MACROECONOMIC VARIABLES

The sequence of forex market crises starting in late 1993 were an outcome of mounting errors and inconsistencies in the macroeconomic policy.

- BNB's extremely liberal licensing policy did not allow strict control on the activity of many financial institutions and frustrated banking supervision.

- The lack of coordination between the BNB and the Ministry of Finance led to the concentration of large government debt payments to commercial banks in certain periods, and created liquidity the banking system could not absorb.

- Wage indexation created excess liquidity in the household sector.

- Frequent and economically unjustified changes in interest rate, especially in 1993, were an additional factor of macroeconomic instability and undermined the leva deposit base.

The signing of the external debt deal with the London Club creditors was presented as a channel for excessive reduction of BNB's foreign exchange reserves. The US dollar became the favourite option for secure investment of free money. The pressure on the US dollar increased, triggering off a series of forex market crises in late 1993 and throughout 1994.

Financial Destabilization

It is rather doubtful that the Central Bank deliberately sustained an artificially high BGL rate as a nominal anchor in 1992 and 1993. BNB's net purchases of foreign exchange exceeded 180 million USD for the period January 1992 - November 1993. This indicates that the bank sustained a lower, and not higher, BGL exchange rate (Fig. 1).

The lack of substantial BGL depreciation till mid-1993 was not due to any deliberate BNB policy. One of the reasons for it was the high initial real depreciation of the BGL in 1991 which adjusted it to an equilibrium level in 1992 and 1993. Another reason is the large slump in real incomes in 1991 which tended to restore

their 1990 level. Thus, in our view, the **inconsistent macroeconomic policy which brought the economy back to its pre-stabilization level** was the only reason for the sharp BGL depreciation in late 1993 and early 1994 (Fig. 2).

BNB's monetary policy strategy was not consistent with the money demand and the anticipated behaviour of economic agents. The inadequate Central Bank management of reserve money, which allowed for excess commercial bank reserves, raised the money supply (Fig. 3).

In 1994 the BNB continued to „help“ troubled financial institutions and inject leva liquidity into them. This raised doubts in the neutral and tough stance of the monetary policy the Bank tried to follow since mid-1994. The troubled banks were placed under soft budget constraints and they turned to BNB as a lender of first resort, instead of closing their dollar positions, sell their real assets and cut expenditures.

The forex market crises and the lack of a nominal anchor changed the behaviour of the major economic agents. Market psychology and investors' attitudes took the upper hand on the forex and money market and weakened the significance of the fundamentals: the balance of payments, the state of the real economy and the interest spread. The forex market systematically extrapolated the trend and past leva depreciations were transferred into the present. Thus inflation almost exploded in March, April and September 1994.

Since February till mid-year price changes were catching up with the exchange rate with a lag of 1-2 months. Since June economic agents have been responding almost instantly, closing the time gap between both curves (Fig. 4).

The AECD econometric estimates reveal that for the period January 1993 - September 1994 83% of the inflation variance is explained by three variables: previous month inflation, exchange rate change in the current period, exchange rate change in the previous month. Each percentage point of depreciation is fully transferred onto the price index in no more than a month.

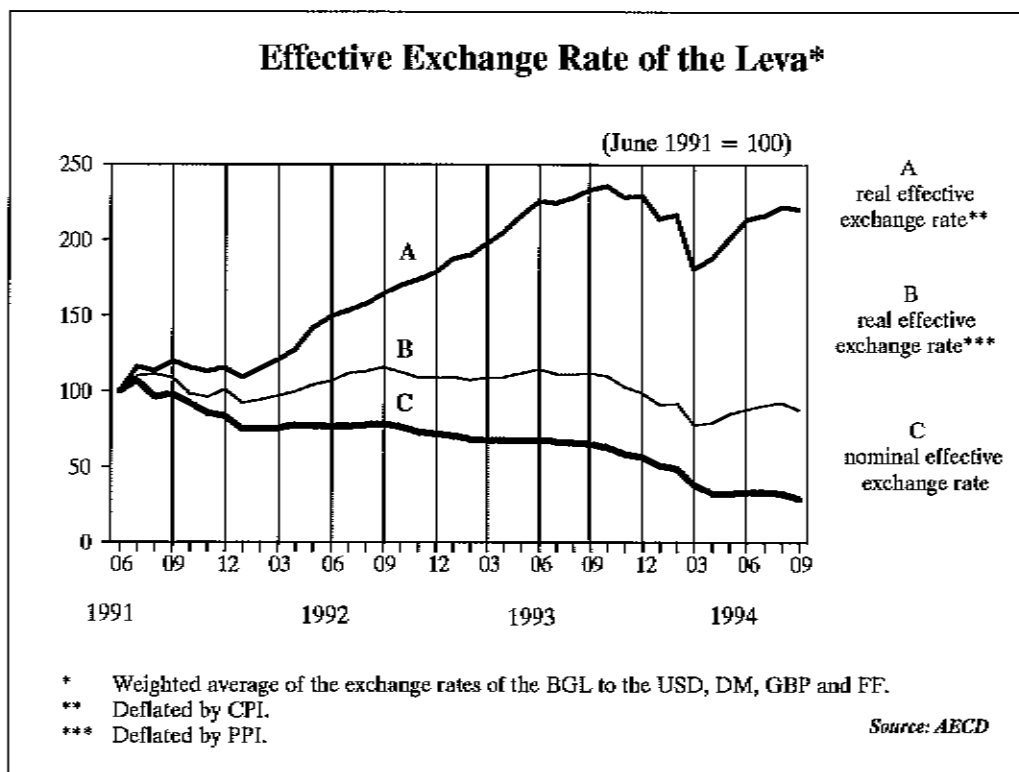


fig. 1

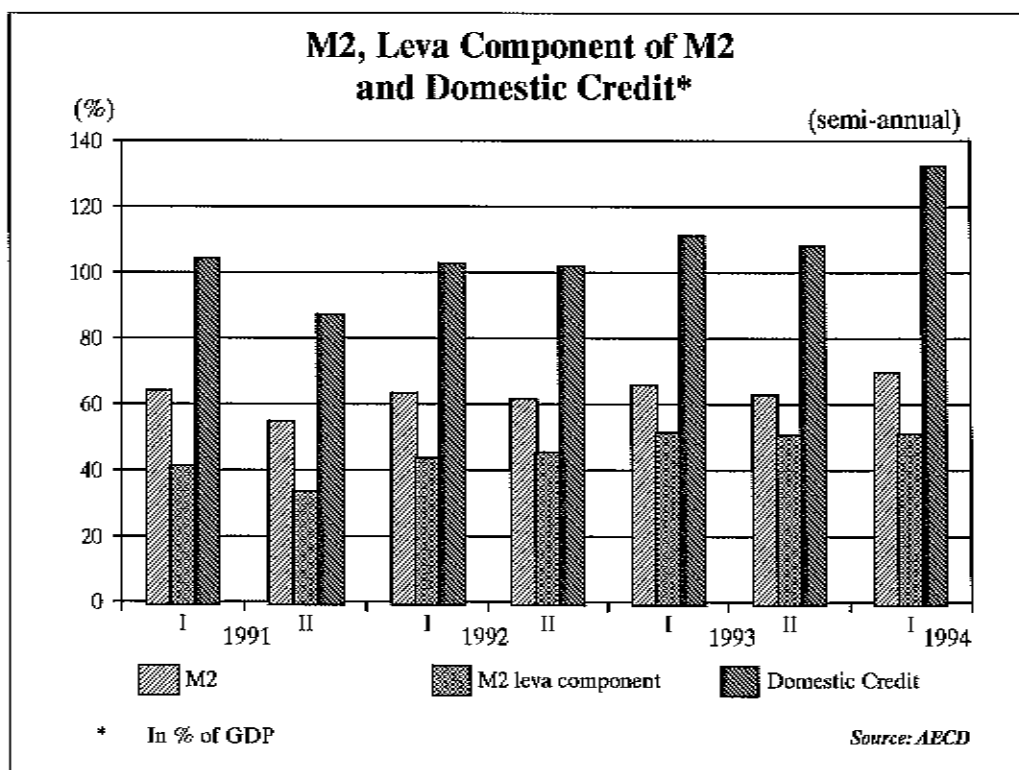


fig. 2

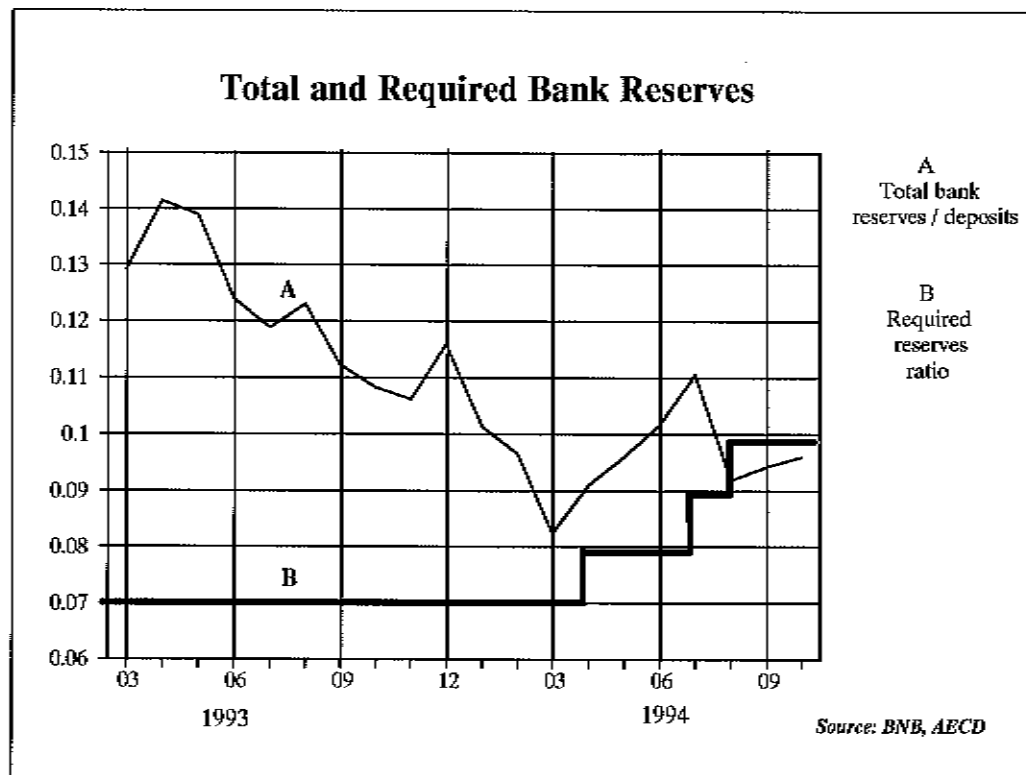


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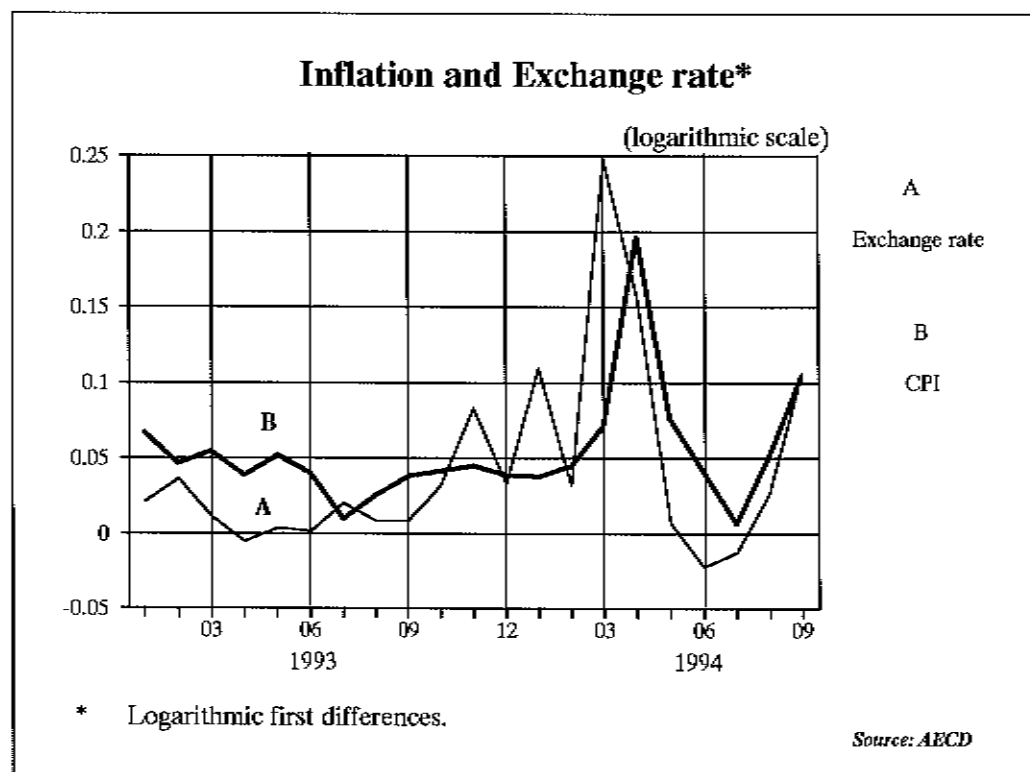


fig. 4

High inflation usually raises volatility of individual prices causing changes in relative ratios. Economic agents who can push prices above the average inflation level increase their real revenues. If they are strong enough, they can consolidate the new structural ratios by stabilizing and curbing inflation. If they are not strong enough, **we may expect a new cycle of inflation acceleration** in which the losers in the preceding cycle would try to regain their position.

Relative Prices

Inflationary processes in 1994 changed one of the basic proportions in the economy: the relative prices of tradables and non-tradables.

This ratio is of special macroeconomic importance to economies like the Bulgarian one - small open economies burdened with external debt. The ratio between the volume of tradables and non-tradables produced determines and is in turn determined by the trade balance. A restructuring of the economy is needed for the beginning of foreign debt payments since a positive trade balance presupposes a larger output of tradables than of non-tradables. The exchange rate depreciation stimulates such a restructuring of the economy.

While the price ratio of tradables to non-tradables closed on 1:1 in 1992, in 1993 it changed drastically to 0.7:1, and in 1994 it jumped sharply to 1.14:1⁵.

The same process underlies the different price dynamics of goods and services included in the overall CPI - the official inflation measure. Commodities accounted for 85%, and services to 15% of household money expenditures which serve as CPI weights. In 1992 and 1993 the growth rate of goods prices stayed below the average inflation rate, while service prices increased

⁵ The estimate is based on the weight of services in the GDP, the services price index and the GDP deflator.

faster than the average inflation. Goods price dynamics conditioned the acceleration of inflation in 1994. In November 1993-October 1994 their average growth amounted to 125.3%, fully reflecting the 124.9% BGL depreciation. In 1994 services prices grew on a twice lower rate than goods prices.

The service sector is predominantly private-owned. In 1995 it may well push prices up to make up for their lower growth rate in 1994.

Trade Balance

After the 1993 setback in the Bulgarian foreign trade which recorded a large deficit, data for the nine-month period of 1994 show certain improvement. The reversal began in the second quarter of the year when exports exceeded imports for the first time since late 1992. Preliminary data for June-September indicate a sustained positive trend in spite of the cumulative deficit since the turn of the year⁶ (Fig. 5).

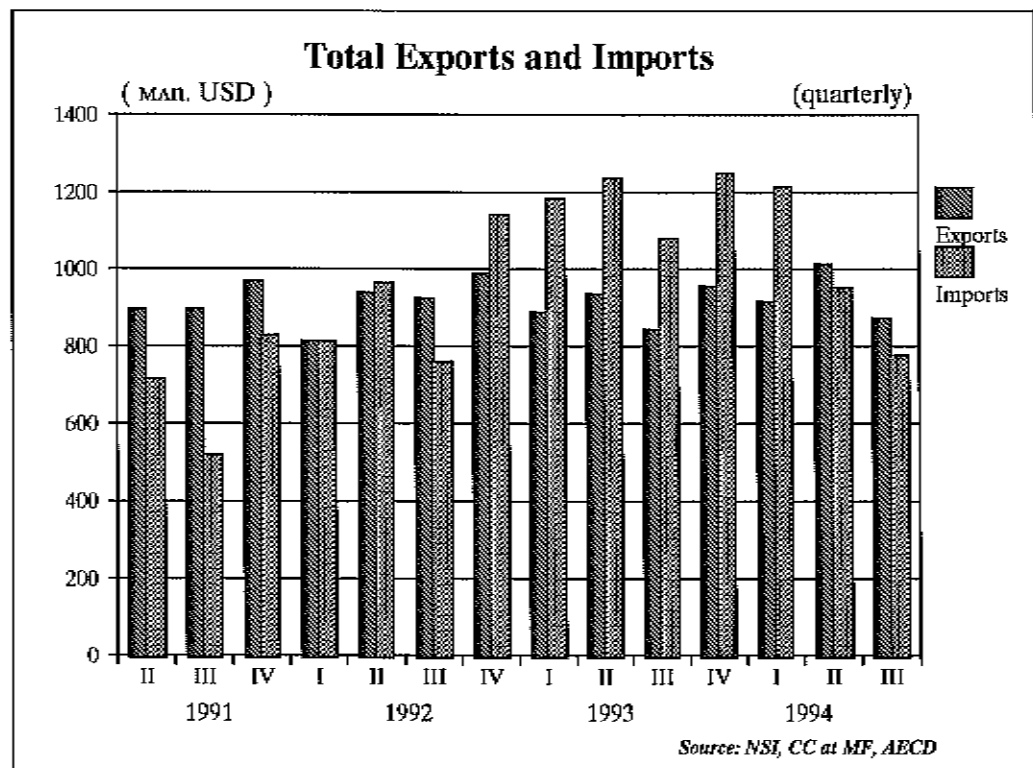


fig. 5

⁶ Banking data show a turnover increase of over twofold in the first nine months of 1994 relative to the same period in 1993, while the trade balance ran a surplus of 500 million USD.

The BGL depreciation influenced the volume of imports as well. In 1992-1993 imports grew steadily, reaching peak level at the end of 1993 which coincided with the absolute low of the real USD exchange rate. **The forex market upheavals since November 1993 and the crisis of March 1994 pushed the imports volume down to its 1991 level.** The fastest adjustment was observed in non-durable consumer goods whose import plunged sharply at the end of 1993 and was falling throughout the nine-month period of 1994. The import of non-perishable and intermediate goods responded with a 3-month lag: in the second quarter its fall was 20% stronger than in the first quarter.

No empirical relation is observed between exchange rate changes and exports. The real BGL overvaluation did not suppress exports, and the BGL depreciation did not spur their rise. The weak upward trend in exports since the third quarter of 1993 was mainly due to increased re-exports. The overall slump in Bulgarian goods exports amounted to some 4% in 1994. Clearly, **the higher price competitiveness of Bulgarian exports due to BGL depreciation is not sufficient for the expansion of Bulgarian export markets.**

Industrial Output and Expectations for Overall Economic Growth

Relative price changes became the driving force behind the recovery in the manufacturing industries. NSI data indicate real-term industrial output in the nine-month period of 1994 was 4% up on the same period in 1993 (Fig. 6).

Industrial output has been steadily rising since October 1993 due to higher labour productivity and falling finished product inventories. In 1992 and 1993 the level of inventories was very high, and this was one of the reasons for the slower rise in producer prices compared to relative prices. The quicker inventories turnover in 1994 indicates falling overstocks and a better market orientation of production.

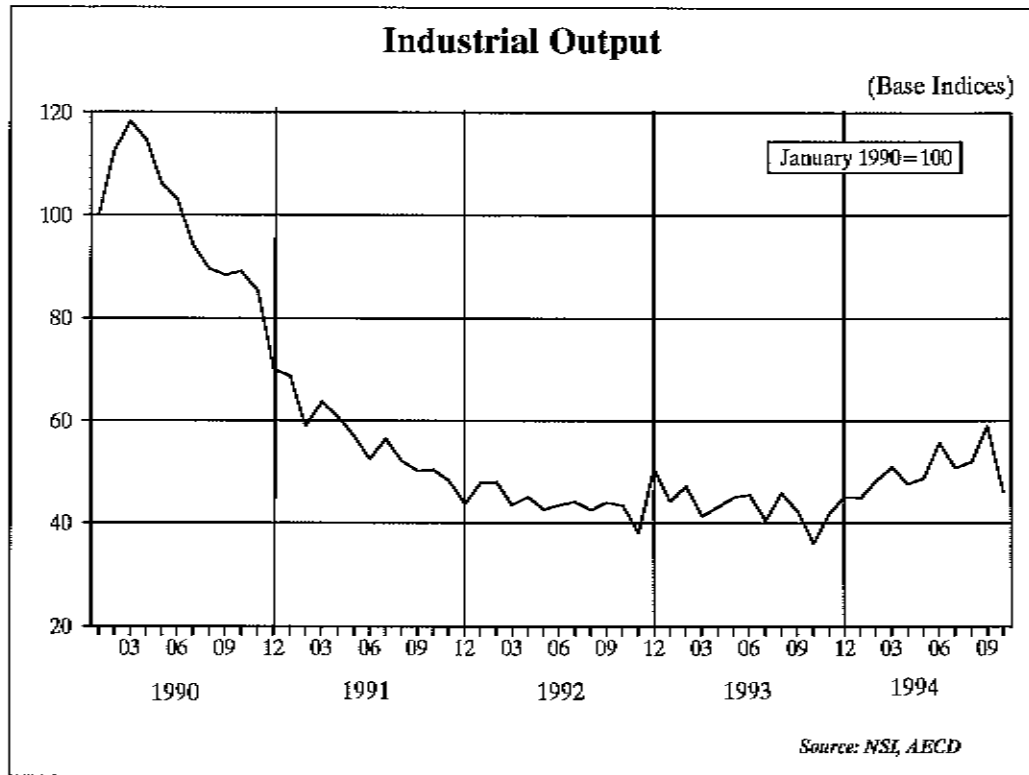


fig. 6

The scope of output revival in industry can be gauged by the diffusion index of output and sales. In early 1994 the index went beyond the provisional 50 % benchmark between depression and recovery (Fig. 7).

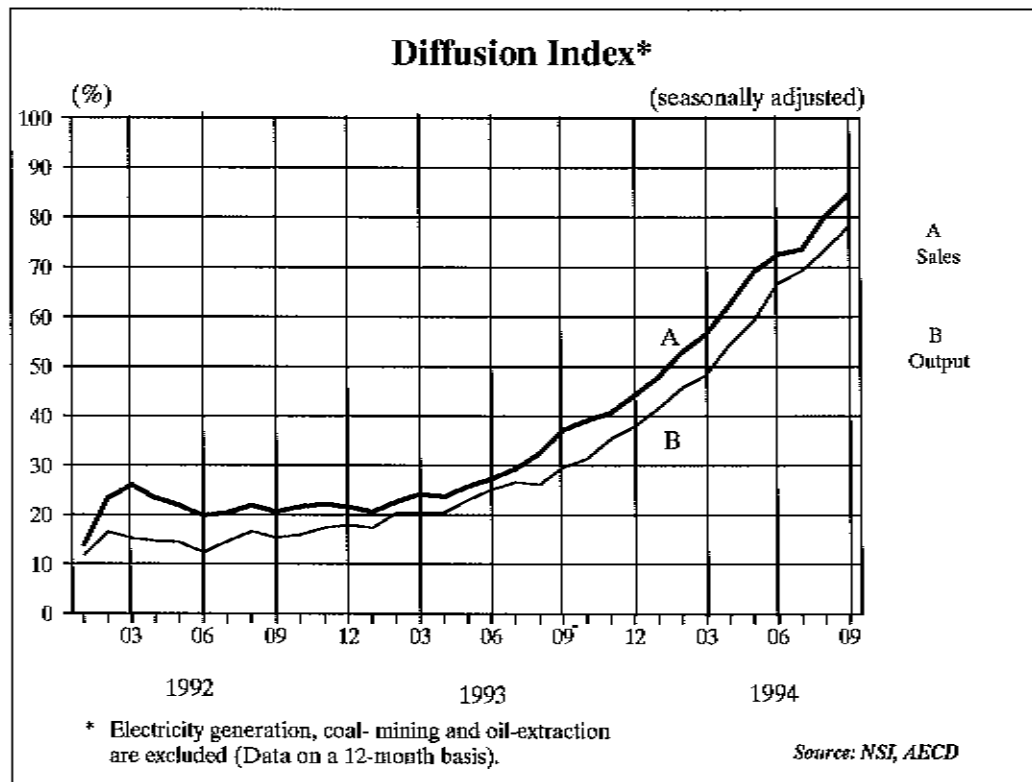


fig. 7

The standard business situation analysis interprets real growth (decline) during five consecutive periods as strong evidence of the stability of the processes under way. In 1992 only ferrous and non-ferrous metallurgy registered relatively steady growth rates. In 1993 these branches were joined by the chemical and printing industries. Over the nine-month period of 1994 steady growth rates were observed in 11 branches, the exceptions being electrical and electronic engineering, food and textile industries.

Industrial pick-up may reverse the trend to induce growth in the other sectors of the economy. In the first half of 1994 GDP fell by 0.8% on an annual basis. The 11.2% drop in agriculture and forestry was the main factor behind the overall GDP decline, while the industrial sector registered 2.3% growth. AECD anticipates 4%⁷ growth in agricultural production by the year-end which would raise real GDP.

The changes in GDP influence the **employment dynamics**. Public sector **employment** continued to fall throughout 1994 as well, but its rates slowed down. The average monthly decline amounted to 1.5% in 1991 and to 1% in the next two years, whereas over the nine-month period of 1994 it fell to 0.3%.

Industrial employment accounts for 57.9% of overall employment in the real sector and determines the dynamics of employment in both the real and the public sector as a whole. There is an increasing number of industrial branches **with steady or growing employment**. There already belong two of the branches with high relative share in industrial employment: the food and chemical industries.

NSI Labour Force Surveys show that the **number of employed in the private sector** rose by some 95 000, and the number of unemployed fell by 90 000 from October 1993 till June 1994. **Presumably, this is the first evidence of the growth in private sector employment offsetting the fall in public sector employment.**

⁷ The AECD forecast is based on the expected 1994 yield and the reported live-stock production for the nine-month period of 1994.

The slowdown in employment fall in 1994 was due to the low real wage. Increased labour productivity as well as the recovery in some industrial sub-sectors may indicate a future employment stabilization in the sector, and hence, throughout the economy. In 1994 the number of unemployed followed a stable downward trend.

1994 was the first year since the transition onset in which the Bulgarian economy displayed symptoms of market behaviour. They were evident in the classic trade-off between lower incomes and growth and falling unemployment.

The Agricultural Sector

In 1994 (the nine-month period relative to the same period in 1993) purchasing prices in agriculture lagged behind the average growth rate of both consumer and producer prices in industry. The ratio of farm-gate to input prices decreased. Over the stated period (relative to the same period in 1993) input costs increased by 58.2% on average while purchasing prices grew by 47.4%.

After the suspension of direct government subsidies for agriculture in 1991, subsidized working capital credits to agricultural producers became the basic government policy in the sector. However, preferential credits could not offset the effect of falling real prices of agricultural products. Even subsidized interest rates burden agricultural producers.

Commercial banks also suffer losses from these high-risk credits. Agriculture is the sector with the relatively largest share of bad credits. According to BNB data, at the end of 1993 the share of bad credits for agriculture accounted for 27.1% of total credits for the sector, while in the real sector the share amounted to 18.3%. The banks accumulate credit arrears which „actively“ wait to be transformed into government debt.

The export policy for agricultural and food products in 1994 was again geared to solve current problems. Quantitative non-tariff restrictions such quotas for duty-free or low-duty import, lower ex-

port taxes and absolute export bans were intensively used.

The Interim Trade Agreement with the EU went into effect in 1994, but nine-month data indicate declining trade turnover of agricultural and food products with the EU area. The failure to fill the preferential quotas may be due to exogenous factors, but the similar agricultural and food export mix of Bulgaria and the EU is still the main reason for the thin trade.

The process of land restitution continued in 1994 as well. As at the end of October 1994 the final restitution decisions of municipal land commissions accounted for 31.1% of land specified for restitution, and land for temporary tenure - to 36.8%.

The private sector in agriculture expanded in 1994, accounting for 44% of arable land (against 28.9% in 1993). Its share in agricultural production is larger, and expectations for 1994 close on 62%.

The development of agriculture may be accelerated only with the conclusion of the land reform and the clear defining of the methods for government intervention.

Registered Household Incomes

The incomes policy since early 1994 is based on the quarterly indexation of budget-related wages, the minimum wage and the base minimum income with forecast inflation coefficients. In case of substantial rise of actual over forecast inflation, compensations should have covered 70% of the difference. Thus the initially announced incomes policy did not allow for a big slump in real household incomes.

Although actual inflation was thrice above the forecast level, **wages were not compensated according to the initially announced scheme.** Instead, indexation continued to use the forecast coefficients.

Incomes policy in 1994 had a severely restrictive stance. This led to a sharp fall in real wage incomes in the state-owned sector. After the average wage in real terms rose strongly in 1992 (and

practically stagnated in 1993), in 1994 its purchasing power plunged sharply for the first time since 1991 (Fig. 8).

From January till September 1994 the average wage was down 14.1% in real terms on the same period in 1993. **Wages in the self-financed sectors⁸** declined by 14.1%, in agriculture and forestry - by 13.4%, and in the **budget-financed sphere⁹** - by 16.9% in real terms.

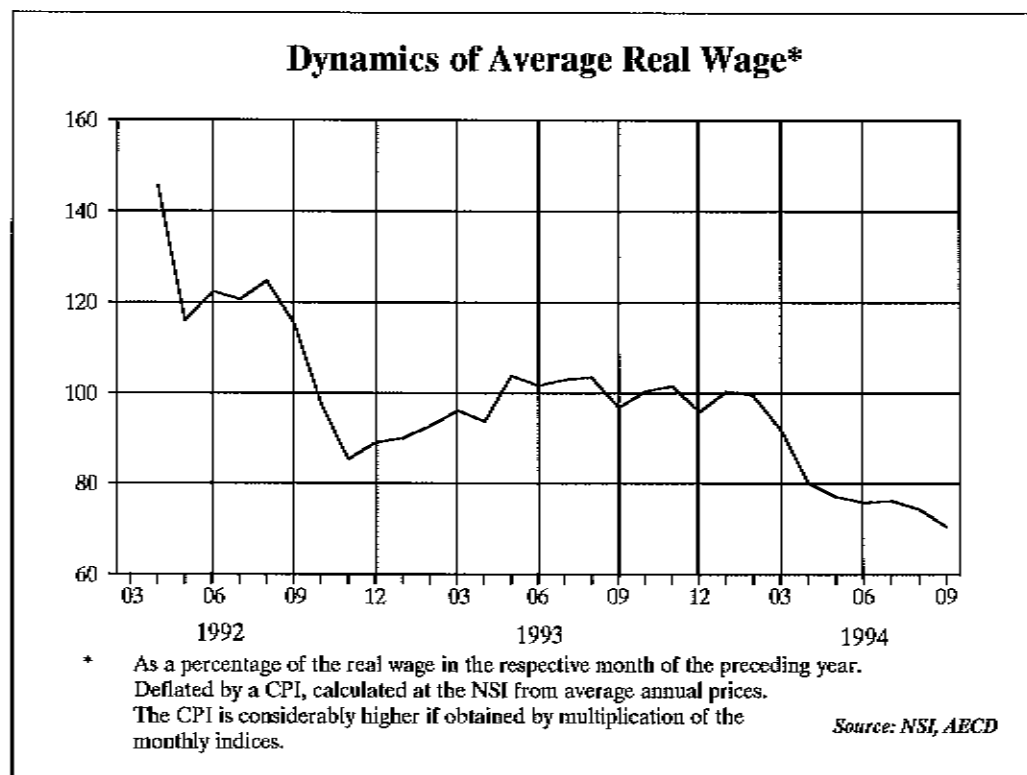


fig. 8

Due to the lower increase in budget-related wages compared to the self-financed sectors, 1994 witnessed changes in the relative wages (Fig. 9).

The drop in the relative wage in budget-financed sector in the first half of 1992 spurred trade-union pressure and the government was forced to ease the restrictive stance of its incomes policy. This had extremely grave consequences for the budget which was heavily burdened by interest payments. **With the danger of a new upward adjustment of budget-related incomes in early 1995, there are slim**

⁸ These are Industry, Construction, Transportation, Communications, Trade, Public Utilities, Finance, Credit and Insurance, and Others.

⁹ These are R&D, Education, Art and Culture, Health Care, Government.

chances for the consistent implementation of a new stabilization programme and the curbing of inflation.

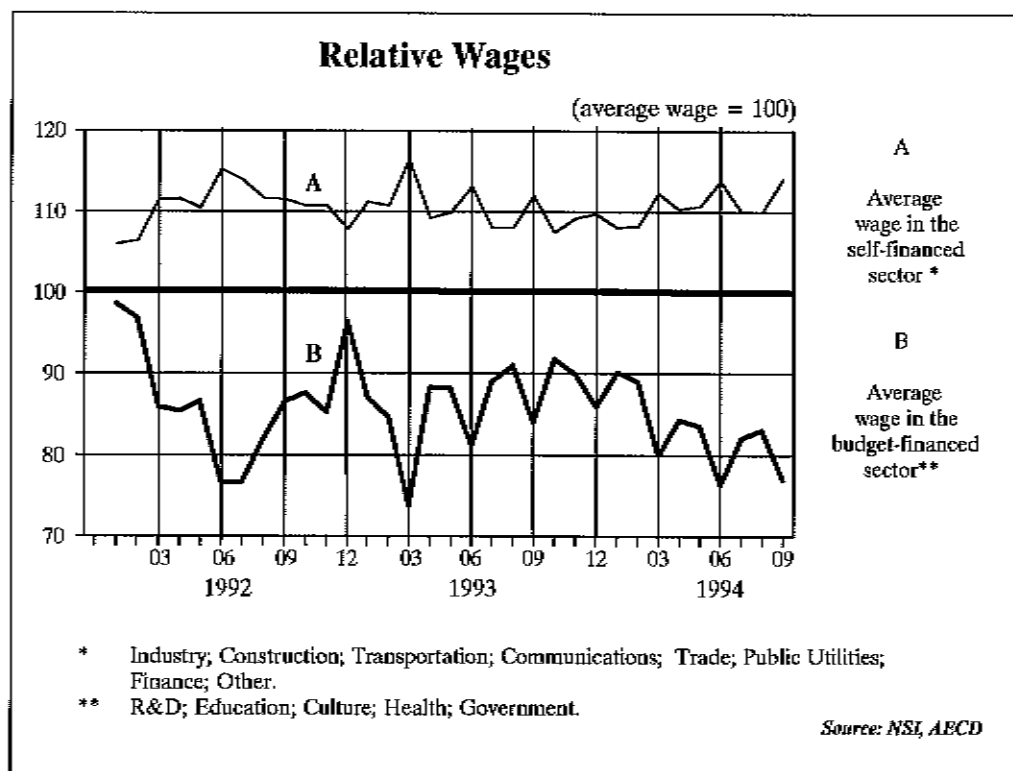


fig. 9

In 1994 inflation indexation on the other major source of household incomes - **pensions** - followed the semi-annual schedule introduced in the beginning of the year. Unlike the other budget-related incomes, the indexation coefficient of pensions was not supposed to be adjusted if the actual inflation exceeded sharply the forecast level. This pushed the relative share of budget expenditures for pensions from 25.8% in the nine-month period of 1993 down to 23.4% in the same period in 1994.

Wage and social security incomes account for two-thirds of household incomes. Clearly, in 1994 they plunged sharply in real terms, which reduced the rate of saving and the inflow of financial resources to the banking system. □

Inflation Tax

High inflation imposes a new model of behaviour on all economic agents: households, firms, banks, the budget. All try to prevent the real depreciation of incomes and assets and avoid paying the so-called inflation tax.

In 1992 and 1993 the inflation tax on interest-free money assets (paper and coin money in circulation and commercial bank reserves in the BNB) plunged to 10.8% and 8.1% of GDP respectively. (The price liberalization in 1991 raised the tax to 35.9% of GDP). In the first half of 1994 the downward trend of the tax was reversed and it reached 11.9% of GDP.

Government revenues (of both the BNB and the budget) from money printing (seigniorage) followed a similar dynamics. BNB seigniorage in 1992 and 1993 amounted to 7.6% and 2.1% of GDP, rising to 4.4% of GDP in the first half of 1994.

AECD estimates show that in the nine-month period of 1994 alone owners of interest-free and low-interest assets incurred over 125 billion leva capital losses (reduction in the real value of leva assets) due to inflation and negative interest rates on deposits. In this way **1994 witnessed a sweeping capital redistribution from households (as net creditors) to debtors for covering their losses and financing their deficits.**

The „flight“ from the leva had two basic manifestations: increased consumption, and purchase of foreign exchange which eroded the inflation tax base. In this way the use of inflation tax had a contradictory effect - the high tax rate (inflation) undermined its tax base (leva assets).

High inflation and BGL depreciation in 1994 had as an end result the dollarization of the economy and the disintegration of the monetary system.

Consumption, Rate of Saving, Currency Substitution

1994 was the first year since the onset of transition to witness growth in real household consumption (GDP data). Given the large incomes slump, the registered real growth of final consumer expenditures is attributed to the lower rate of household saving. Compared to 1993, it fell by some 3 percentage points to reach 27%. Adjusted for the interests accrued on household deposits (which are both income and part of household savings), the net rate of saving declined by 8 percentage points. While households spent some 19% of their non-interest incomes (adjusted for the exchange rate) in 1993, in the first half of 1994 their share fell to 11%. Thus, **1994 saw a change in households' behaviour: they saved less and less of their current incomes.**

For the first time since 1991 household **financial assets** (both leva and dollar-denominated) grew on a slower rate than inflation. In September 1994 (relative to December 1993) their increase amounted to 50.2%, while inflation over the same period reached 87.3%. Thus, their real decline (deflated by the CPI), was 19.8%. The rise in household leva savings in the nine-month period of 1994 was only 31.4% (Fig. 10).

The structure of household financial assets shifted towards foreign currency deposits. From 10.2% at the end of 1993 they rose to 21.9% at the end of September 1994. The USD-denominated assets increased by 74.6%.

In 1994 the potential income from foreign exchange savings (generated by the exchange rate dynamics) substantially exceeded the interest income from leva deposits. Each dollar saved in the beginning of the year earned a potential income of 87% (28.5 leva) by the end of September. If the leva equivalent of 1 dollar was put on a 1-month deposit at the beginning of the year, the interest income over the nine-month period would be just 44%

(14.4 leva). In 1992 and 1993 the potential income from 1 USD generated by the exchange rate dynamics was 2.7 leva and 8.2 leva respectively. At the same time, its leva equivalent earned 12.1 leva and 12.7 leva in interest incomes.

Over the nine-month period the foreign exchange deposits of households increased by 368.3 mn USD, of firms - by 350.9 mn USD, and commercial bank reserves in foreign currency - by 300.6 mn USD. At the same time, banking data registered 614.6 mn USD current account surplus over the nine-month period, 130.6 mn USD of which in net private transfers. This identifies **households (with 238 mn USD) and commercial banks as net buyers of foreign exchange (Fig. 11).**

Econometric analysis over the November 1991 - September 1994 period indicates a rather high exchange rate elasticity of currency substitution. Estimates show that 1% rise in the first differences of the exchange rate leads in the same month to 0.86% increase in the changes of the ratio between foreign currency deposits and total money assets of households (Fig. 12).

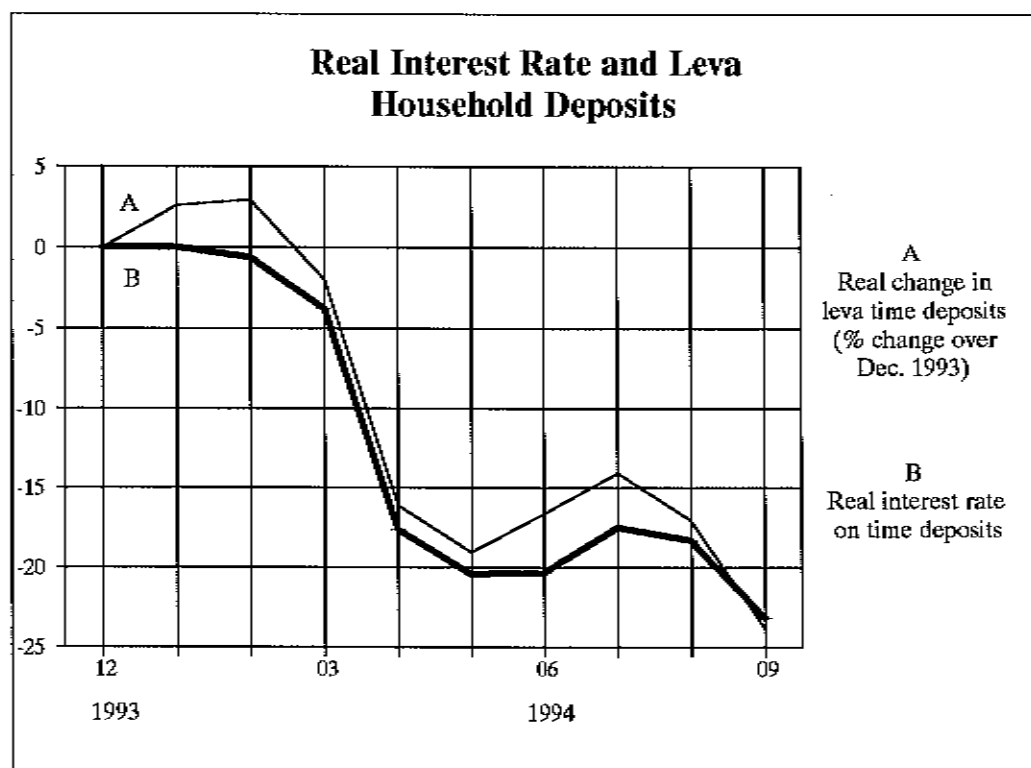


fig. 10

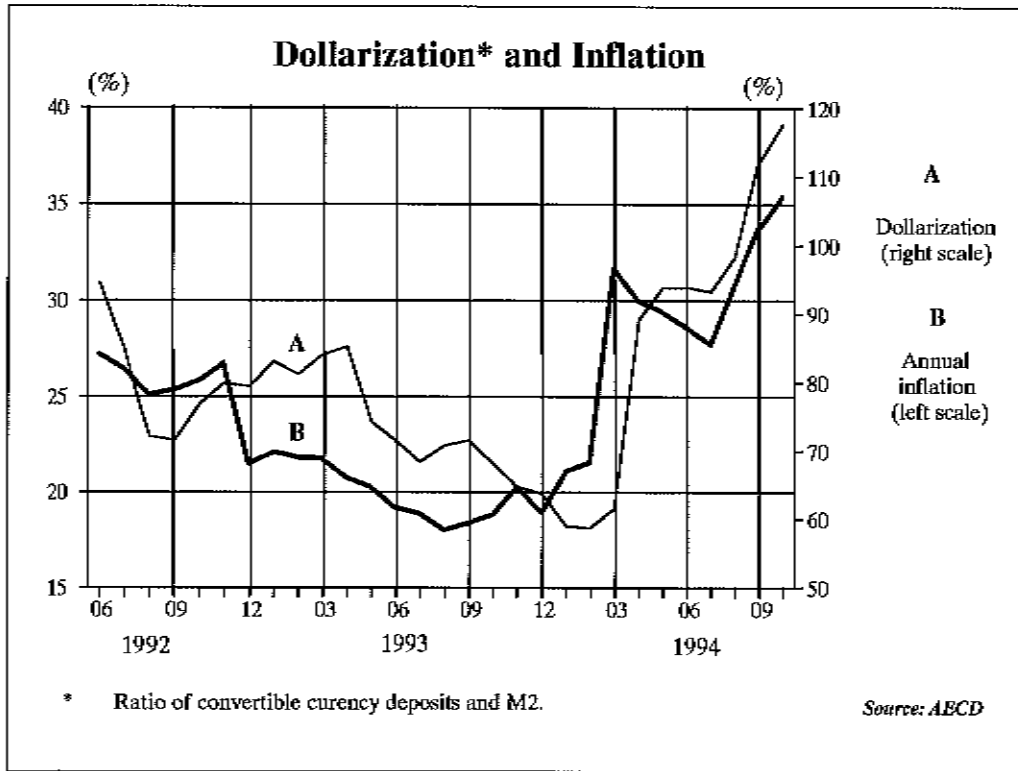


fig. 11

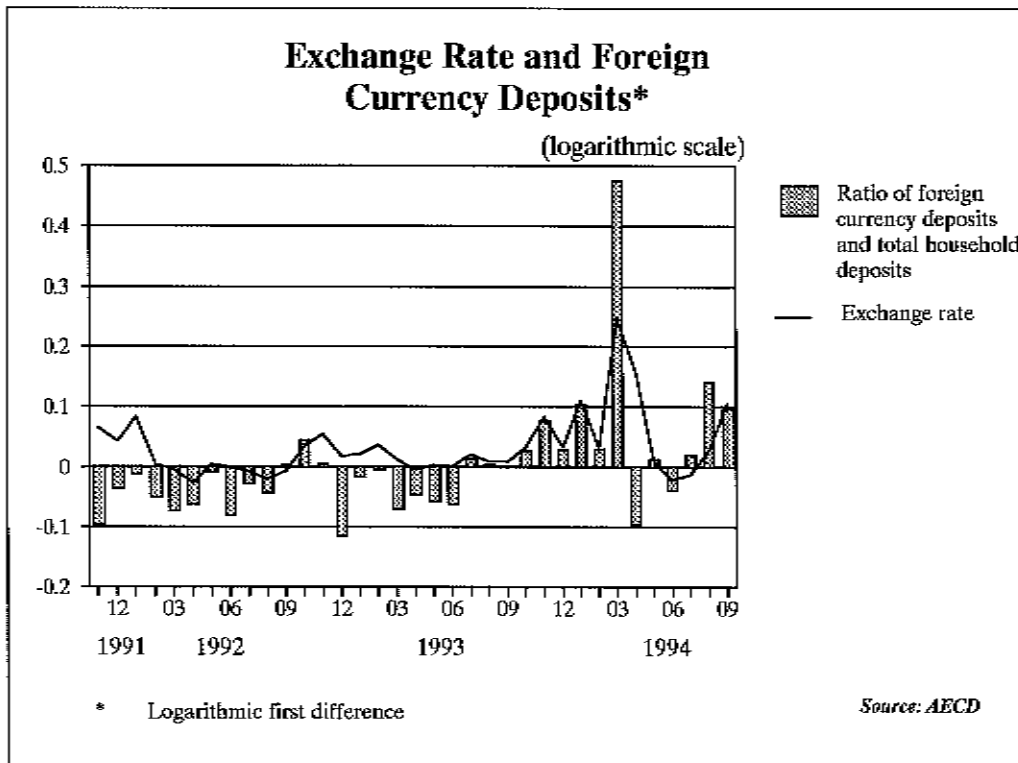


fig. 12

The outflow of funds from the banking system led to a relative decrease in **net financial assets** of households. In January-September 1994 the net liabilities of the government budget and non-financial enterprises grew on a faster rate than net household financial assets. The latter cover only 46.4% of the net financial liabilities of enterprises and the budget. (At the end of 1993 this ratio was 50.8%). Thus **the chances for financing the debtor sectors in the economy by internal resources grew smaller in 1994.**

Financing of State-Owned Enterprises

In 1994 the financial indicators of state-owned enterprises improved due to increased labour productivity and lower unit labour costs.

Qualitative Indicators in the Manufacturing Industry (average monthly values at 1992 prices)

	1992	1993	1994
<i>Labour Productivity (in thousand leva)</i>	15	17	20
<i>Unit Labour Costs (in leva)</i>	0.14	0.16	0.13

The decline in wages reduced their relative share in total expenditures of firms. From 14% in the nine-month period of 1993 it fell to 12.9% in the same period in 1994. If wages have kept their end-1993 level in real terms, real-term net losses would have sustained their level. Therefore, **the real-term decline in wages is the main reason for the improved financial conditions of state-owned enterprises (and hence for the bottoming-out of the economy).**

The Bad Credits Law had a favourable effect on debtor enterprises since the principal of non-performing credits (extended till 31.12.1990) was transformed into government debt and the full amount of interest due was written off.

The financial statistics of the state-owned sector identifies the group of firms affected by the Law and gives estimates on a number of parameters. Out of a recorded total of 6081 enterprises, 629 register credit arrears transformed into government debt by the end of September 1994. Despite their small number, these are relatively big firms providing 27.5% of sales revenues in the state-owned sector. Their financial conditions are still below the average, but a steady upward trend is visible. Over the nine-month period in 1994 (relative to the same period in 1993) their sales increased by 91.1%, while wages rose by only 42%.

With the improvement in their financial conditions, firms start to finance their expenditures by internal resources. The opportunities for self-financing are determined by the working capital¹⁰ of the firms.

Non-financial state-owned and co-operative enterprises fall into two distinct groups: with positive, and with negative working capital. The positive working capital of the first group amounts to some 25 billion leva. These enterprises account for about 37% of total sales and have better opportunities for self-financing of their current expenditures. They rarely resort to bank credits.

Above 80% of commercial bank credits outstanding are concentrated in the group with negative working capital, i.e. non-liquid enterprises. High interest rates crowd the potentially solvent firms out of the credit market, leaving room for those with liquidity problems. **The dominance of non-liquid enterprises on the credit market generates high risk for the lender banks.**

Interfirm credit is another source of financing. The shift from bank to firm credit is evident in the change of their ratio. At the end of September 1993 the ratio of payable arrears to suppliers and short-term credit was 92%, rising to 104.1% a year later.

A third source of financing is **the partial payment (or non-payment) of taxes due** and social security contributions. Despite the higher rate of tax payment in 1994, firms continue to use this source of liquid funds.

¹⁰ Defined as the difference between current assets and current liabilities, showing what part of current assets may be used to cover current expenditures.

The falling demand for bank credits was common for state-owned firms in 1994. According to NSI data, at the end of September 1994 the credit outstanding was up 18% on a year ago. Clearly, this rise was due to interest due, and not to new credits. In 1994 the short-term credit outstanding plunged sharply in real terms. Whereas it amounted to 18.1% of nine-month sales revenues at the end of September 1993, in the same period of 1994 it fell to 13.4%. Data indicate a negative net credit flow from the banking system to firms.

Interfirm credit and self-financing are not adequate substitutes for bank credits and cannot get production onto a sustainable growth path. If non-financial enterprises confine themselves only to self-financing, all possibilities for sustaining growth will soon be exhausted.

Actually, **bank credits were eliminated as a financing resource for state-owned enterprises. This reflected on commercial bank transactions, forcing them to seek other investment opportunities.**

Banking System

To end the active currency substitution and capital flight, the BNB was forced to **raise several times the base interest rate** and some other interest levels, and curb commercial bank refinancing. **The tight restrictions affected only part of the market and inflicted a heavy liquidity crisis on certain banks, while a large part of forex market participants remained beyond control.**

As a result, banking sector losses reached some 14 billion leva in the ten-month period of 1994. The banks with the largest burden of bad credits experienced difficulties in servicing their current liabilities. Their situation was critical and BNB financial aid was their only resort.

Leva credit operations are the main source of commercial bank losses. The banks are not able to service their liabilities since they receive only a third of their interest revenues from active operations. State-owned enterprises still pay only a small part of their interest due - 53.4% in the nine-month period of 1994, compared to 42.6% in

The minimum price of bad debt bonds set by the BNB is another factor for the deterioration of commercial bank liquidity. The actual market price of the leva bonds can hardly exceed 35-40% of their face value. In the last few months limited amounts of bad debt bonds began to be traded on the secondary market¹¹. By the end of November 1994 1.495 billion leva worth of leva bonds (about 6% of the total value of leva bonds) were purchased. Their price fluctuated throughout the period, and was often influenced by non-market factors. From 690 leva (per 1000 leva face value) in May it rose to 987 leva in July, then fell again to 725 leva in November.

On the other hand, the high minimum price of USD-denominated bonds made them quite unprofitable so they were practically not traded on the market. With the adoption of the regulations on the foreign debt bonds-equity swaps in November 1994, the dollar-denominated bonds (worth 1.806 bn USD) lost their attractiveness.

To improve the liquidity of bad debt bonds and partially alleviate the government debt servicing, it is necessary to **equalize the terms for converting into equity the foreign debt bonds and the USD-denominated bad debt bonds**. To this aim the artificial categorization of government debt into domestic and foreign should be replaced by a classification into leva and foreign currency denominated debt. Certainly, the equalization of terms and the increased attractiveness of bad debt bonds depends on the removal (or coordination with the Brady bonds rates) of the BNB-set minimum selling prices of the latter.

AECD estimates show that if the USD-denominated bad debt bonds are discounted by the factor used in discounting foreign debt bonds on the international financial markets, the price of the former should be about 40% of their face value. It would be still lower with the calculation of the additional risk premium as hedging against contingency changes in the regime for repatriation of income revenues and amortizations on the principal of these bonds or in the foreign currency regime. To equalize the terms the BNB should offer guaran-

¹¹ Data from the monthly bulletin of the BNB "Government domestic debt and securities".

tees that bond purchases by a foreign „portfolio“ investor allow him to repatriate interest in foreign currency.

The deposit outflow from the commercial banks and lower credit demand are a blow to the banking system. The money resources are channeled to parallel financial markets which are outside BNB control. This is the main reason for the loss of control over the money supply and hence, over inflation and the exchange rate.

Budget Deficit Financing

Budget revenues over the nine-month period **increased by 6% in real terms** on the same period in 1993, while non-interest expenditures (wage bill, pensions, subsidies, social assistance, maintenance, and investment in the budget-financed sector) plunged drastically by 32% in real terms. In contrast to 1993, the incomes policy in the nine-month period stabilized the government budget. The severe restrictions on the wage bill in the budget-financed sector trimmed its share in the consolidated government budget to 10.6% of total expenditures against 11.9% and 12.3% in 1992 and 1993.

The ever falling **real-term non-interest expenditures** and the growing interest payments on the domestic and foreign debt are a steady and inevitable trend. Interest expenditures contributed for 60% of the growth in budget expenditures for the nine-month period of 1994 (32% in 1993), while expenditures on wages, pensions, social benefits and subsidies accounted for 20% of the rise in nominal expenditures (35% in the first nine months of 1993). The primary surplus is so big that it covers almost half of budget interest expenditures. The annual cash deficit is expected to fall within the budget target, i.e. about 6.5% of GDP.

Compared to the last three years, the 1994 fiscal policy reversed the direction of the financial flows between the budget and the other economic sectors (Fig. 14).

The cumulative flows between the budget and the banking system, the Central Bank included, sustained their nominal level of 1993. There was no acceleration in the rate of budget debt growth related to

current deficit financing. However, the amount of debt, including the bad debt of state-owned firms that were transformed into government debt in early 1994 rose to a high value.

The relatively good condition of the budget is the result of a **temporary improvement**. Wages in the budget financed sphere, pensions and social benefits were partially compensated for inflation at the end of the year. This coincided with the seasonal year-end inflow of budget revenues, but would raise the expenditures level for 1995. In the beginning of 1995 the budget will be in great need for money, while the BNB restrictions made commercial banks extremely indifferent to government securities.

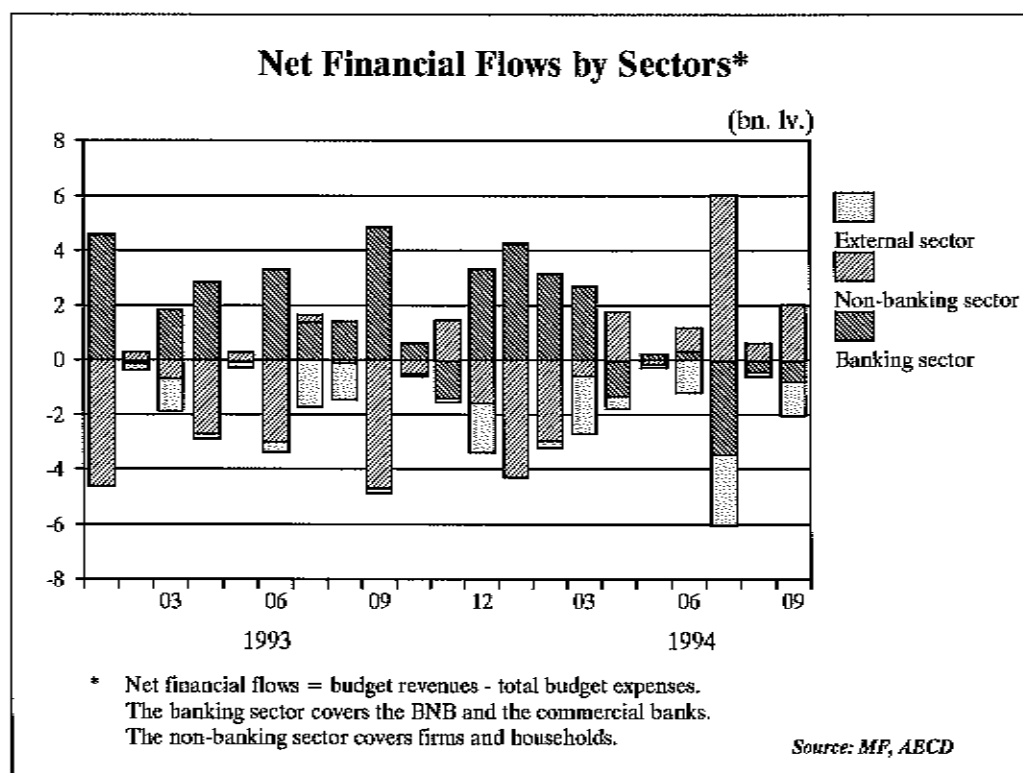


fig. 14

Since September 1994 the government securities roll over was interrupted. The budget lapsed in a liquidity crisis and was forced to seek direct credit from the Central Bank. Although this did not violate the Budget Act provisions, it indicates the full **financial destabilization of the economy**. For a normal financing of the cash deficit of the government budget, it should fall **below 6% of GDP**, as well as accept a **higher interest rate on government securities set at the market** of credit resources. □

1995: THE RANGE OF POSSIBLE DECISIONS

The above analysis leads to the following conclusions on **the sources of tension** in the economy in 1995:

- The change in relative prices and wages creates a potential for strong **inflationary pressure** in 1995.

- Industrial recovery is **unstable** since it is not based on investment in a radical technological and product innovation.

- The deposit outflow from the banking system and the currency substitution frustrates the banks' function as an intermediary in channeling financial flows. The emergence of parallel financial markets (outside Central Bank control) limits BNB's potential for efficient control on the money supply.

- BNB's attempts to curb currency substitution by severe restrictions on commercial bank liquidity **interrupted the rollover of government securities**. The budget lapsed into a liquidity crisis and resorted to direct BNB credits.

- The state of the Bulgarian economy in late 1994 requires mandatory measures for curbing inflation such as sustaining the **restrictive stance of the monetary and fiscal policies as well as suppressing incomes growth**. The efficiency of these measures depends on the following:

- Effective **bankruptcy procedures** for enterprises and banks (with guarantees for household deposits).

- **Reform in the budget-financed sector**. Budget expenditures have shrunk to their minimum under the old structure. The government debt burden raises the interest expenditures, and this requires a large primary budget surplus.

- Introducing **market interest rates on government securities** as a means for reviving their rollover. The BNB should **put an end to government budget financing** since it is an indirect source of commercial bank refinancing.

- Introducing a flexible system for **fixed price adjustment** to dispel the inflationary expectations of households as well as the expectations of monopolistic producers for budget subsidies.

- A **stable and open foreign trade regime**, especially with regard to agricultural and food products. This is imperative for acquiring GATT (WTO) membership.

■ The fight against inflation is not an economic target, but a **condition for economic growth and stability**. Debates now centre on an option for an **inflationary way out of the crisis** by relaxing the monetary and fiscal policies and raising credits and budget subsidies for loss-making „structurally important“ state-owned enterprises and agricultural producers. Such a policy will inevitably **induce hyperinflation**. The destructive effect of persistently high inflation is evident in the currency substitution and the loss of control on the economy as a whole, i.e. the present situation.

■ The economic policy in 1995 should be targeted at **restoring the credibility in the leva**, which cannot be achieved by piecemeal measures. It requires the implementation of a **comprehensive long-term** (at least 3-year) **programme for economic stabilization**. The programme should restore the confidence of households and domestic and foreign investors, to impose the necessary financial discipline and improve the predictability of the major economic parameters. There are two main options:

- **The 1991 programme** with a strictly observed coordination of the economic instruments applied.

- **A new stabilization programme** based on the exchange rate as a nominal anchor.

■ 1994 saw an unsuccessful attempt for applying the **1991 stabilization programme**. The failure occurred in monetary policy, since the process of currency substitution and the parallel financial markets limit the scope of BNB control over the money supply.

■ The usual antidote to intensive currency substitution is a **stabilization programme based on the exchange rate as a nominal anchor**. The instrument's advantage lies in its **clarity and transparency** (unlike the credit or money supply growth). Again, restrictive fiscal and incomes policies are the inevitable additional nominal anchors in support of the key one. The success of such programmes depends on the **confidence** in their consistent and strict implementation.

The choice of the exchange rate as a nominal anchor provides two options: crawling peg and fixed exchange rate.

■ **The crawling peg** seeks a gradual inflation decline by setting depreciation rates below the anticipated inflation for the period. The concentration of trading around the expected date for rate

depreciation should be avoided by **daily** rather than discreet devaluation of the exchange rate.

■ The fixed exchange rate is the **most desperate option** for using it as a nominal anchor. Its purest institutional form is the creation of an **independent and inviolable** „currency board“ to make sure the issuing of national currency conforms to clear preset technical procedures, and to guarantee **tough and uncompromising** Central Bank monetary policy. The BNB will not have the right to be „lender of last resort“ either to commercial banks or the budget.

Clearly, this option requires significant institutional and legislative changes which **are not quite feasible** in the near future. It is, however, a reliable remedy against hyperinflation. Since half-way measures generate hyperinflation, the „currency board“ may become an urgent necessity in the future.

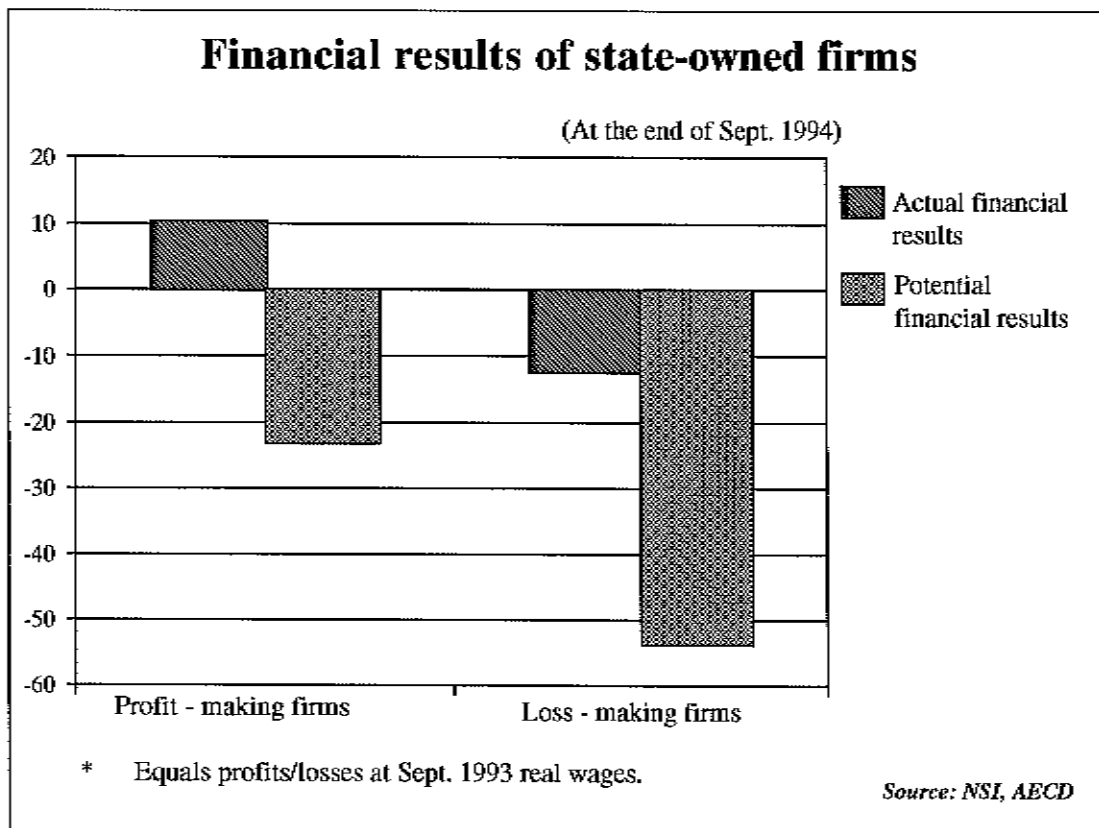
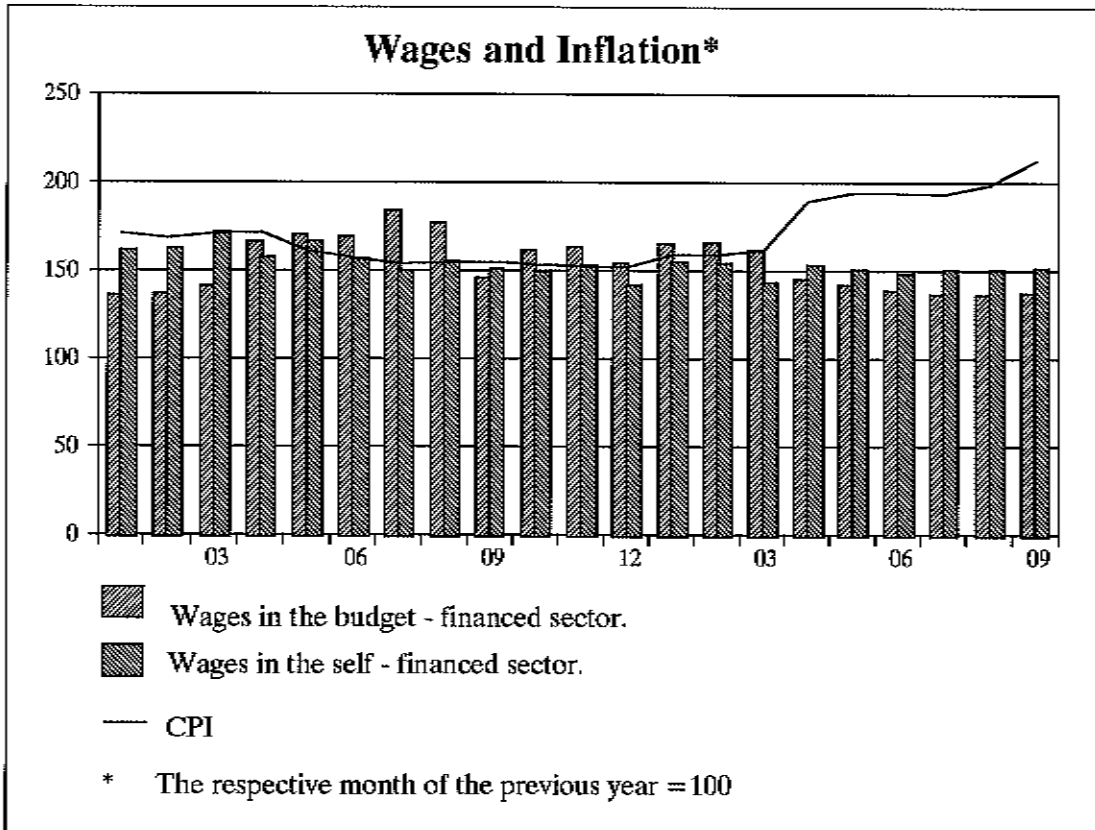
The choice of the foreign currency to peg the Leva to is of crucial importance. It may also be pegged to a basket of the currencies of Bulgaria's major trading partners. The daily adjustment of the rate to the currencies' trend on the international markets will sustain the steady relative **competitive power** of Bulgarian exports, but the exchange rate will lose its clarity and transparency. In case the Leva is pegged to a single currency, **the US dollar is the most appropriate one** since over 70% of Bulgarian foreign trade and interbank forex market transactions are denominated in USD.

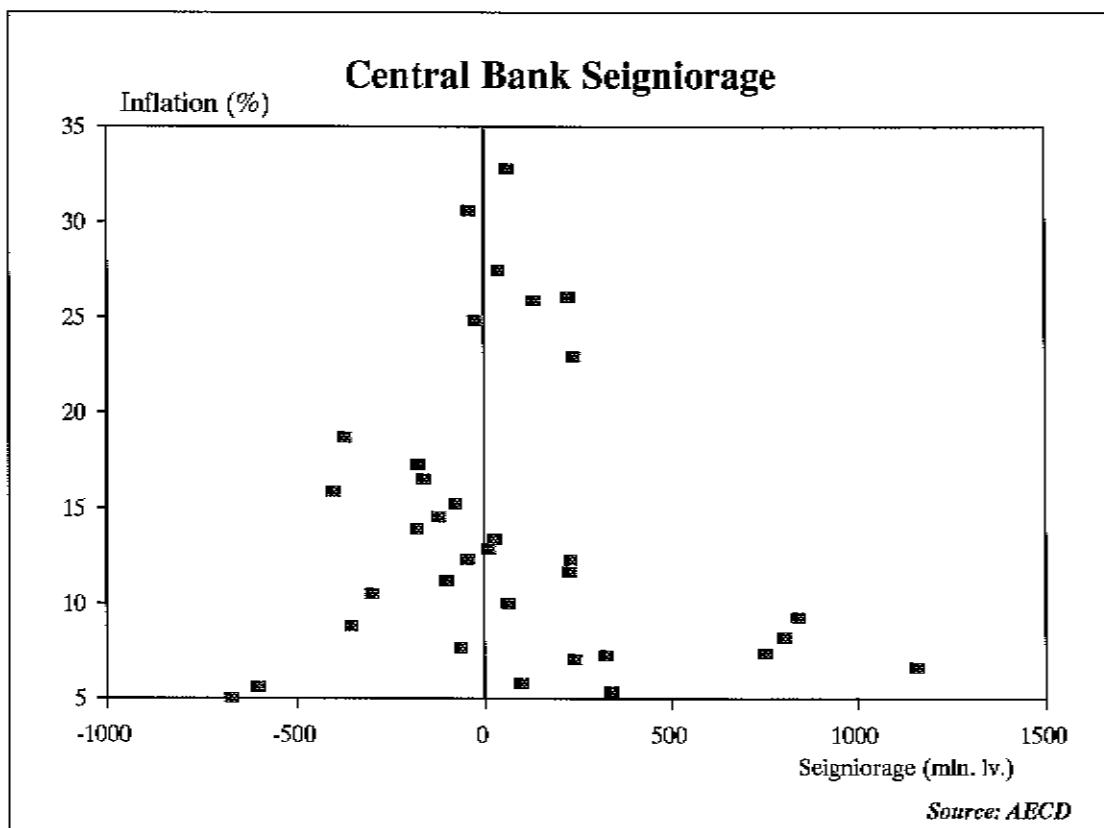
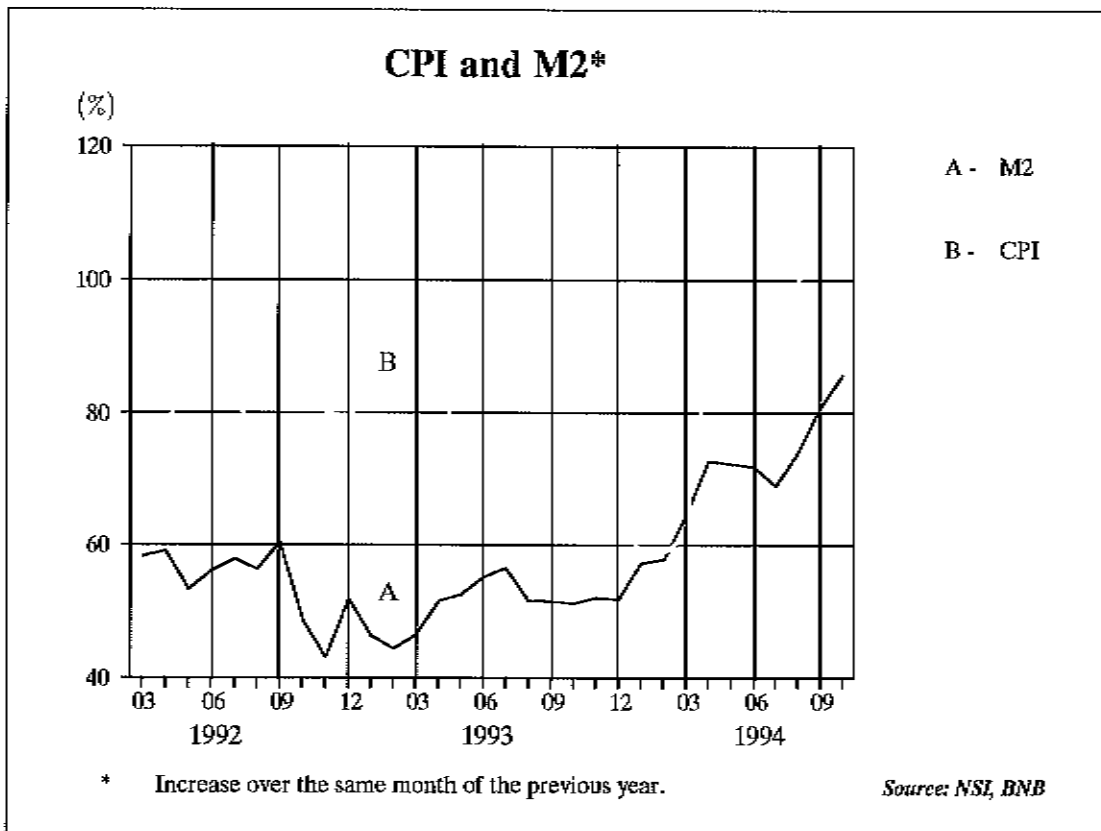
■ **The risk in applying a new stabilization programme with the exchange rate as a nominal anchor** stems from the possible failure to observe consistent monetary, fiscal, and especially incomes policies.

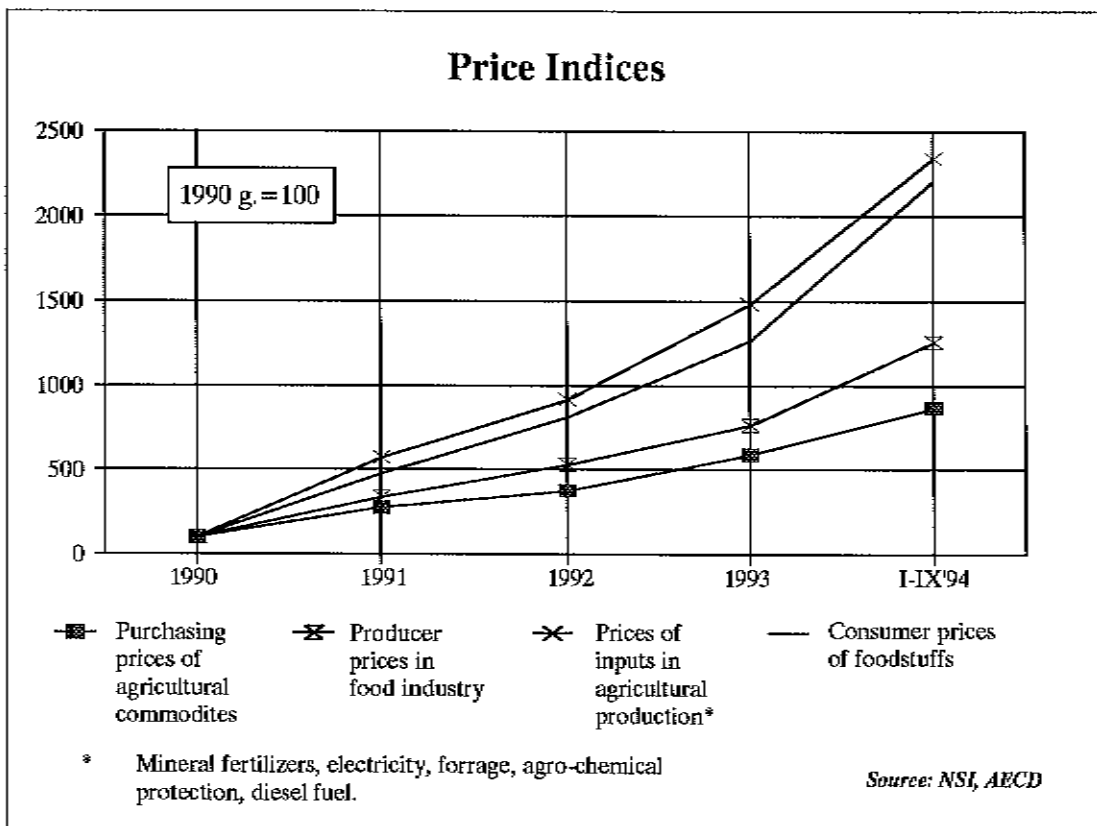
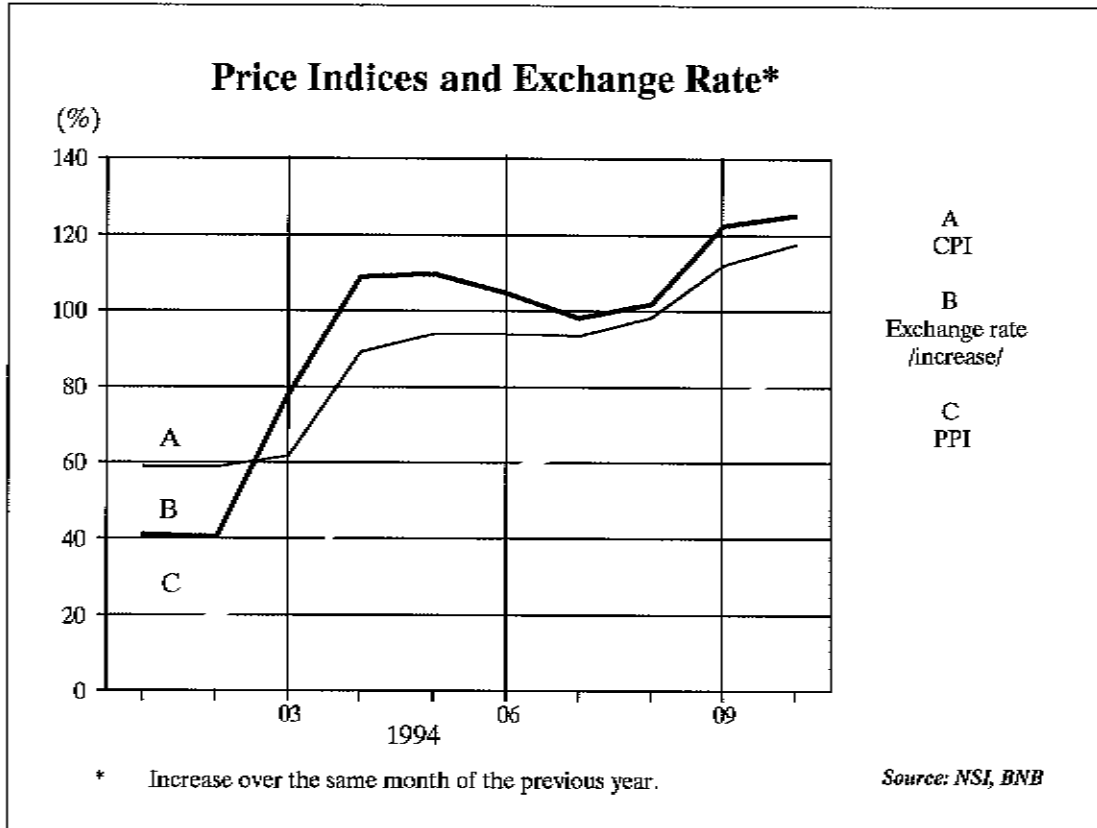
A fixed exchange rate will raise doubts in the intention and ability of the Government and the Central Bank to apply stringent anti-inflationary policy and sustain the exchange rate level. Economic agents will **attack the Leva** to test the seriousness of intentions so that any policy slippages will be detrimental to the stabilization. The risk of unsecured and untimely support by the international financial institutions should not be overlooked as well.

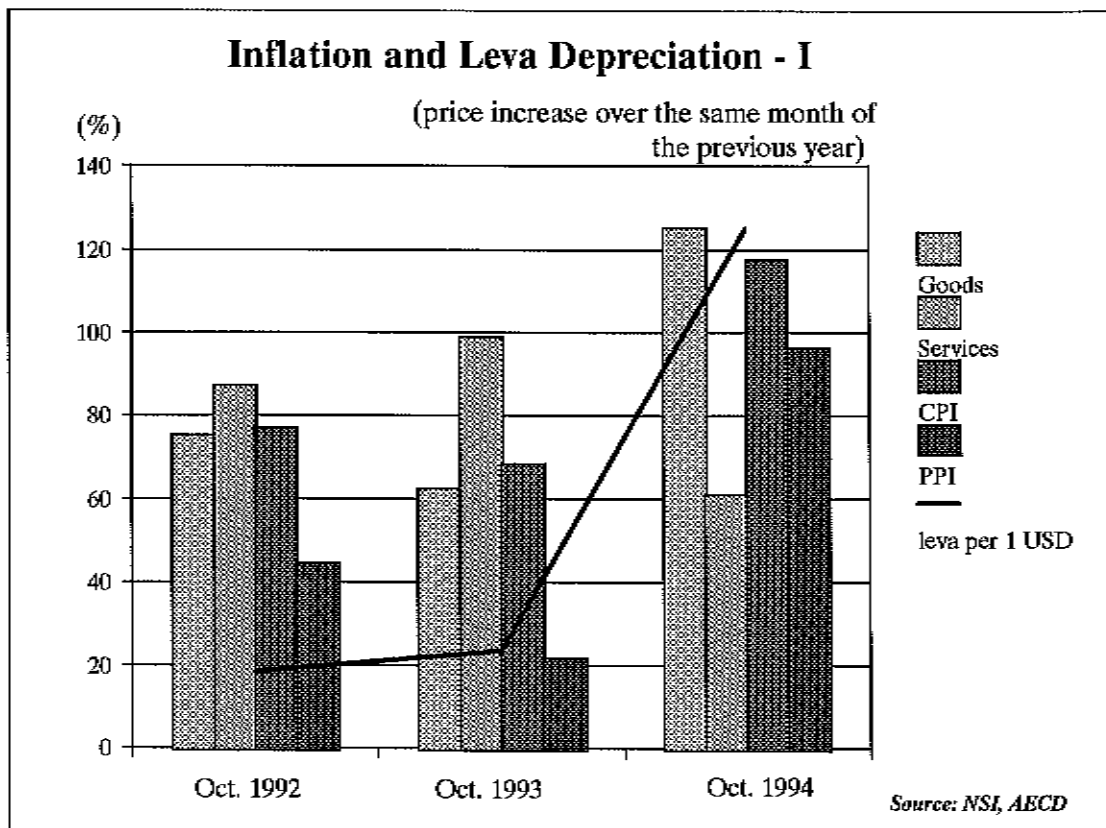
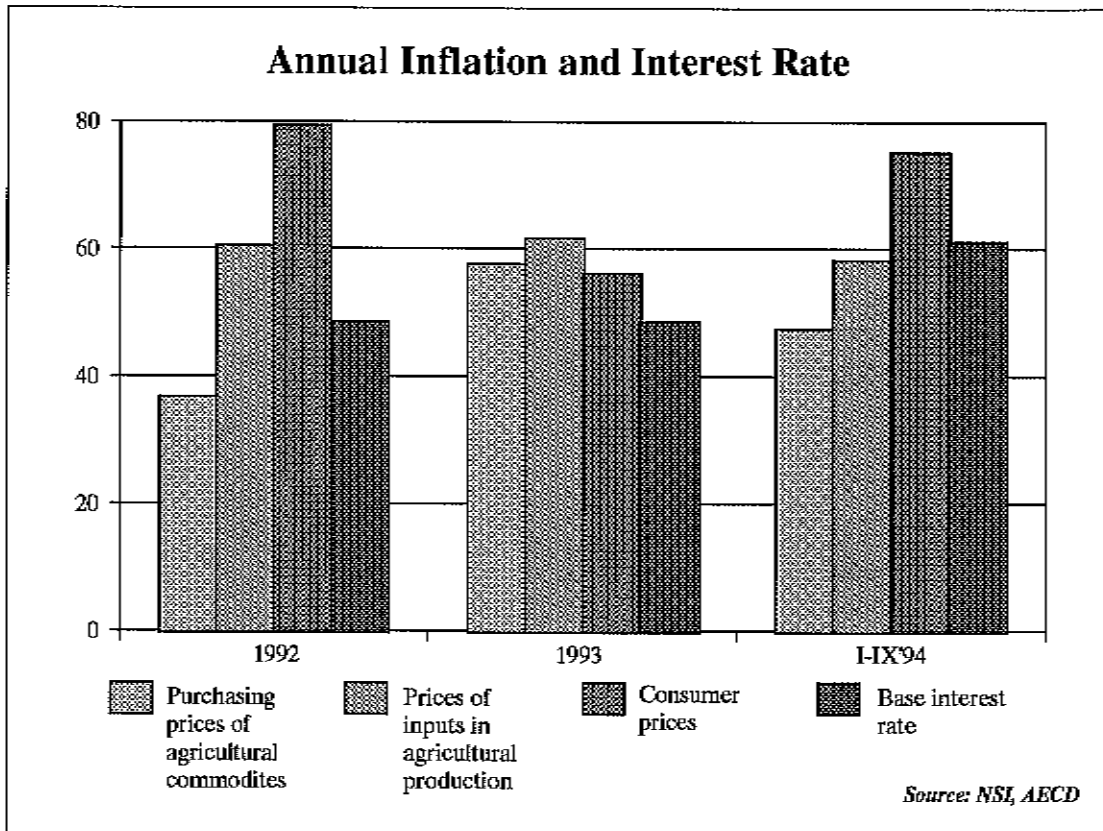
Any failure of the government and the BNB to sustain the rate will lead to much more intense and destructive forex market crises and stronger financial destabilization than under a floating exchange rate. □

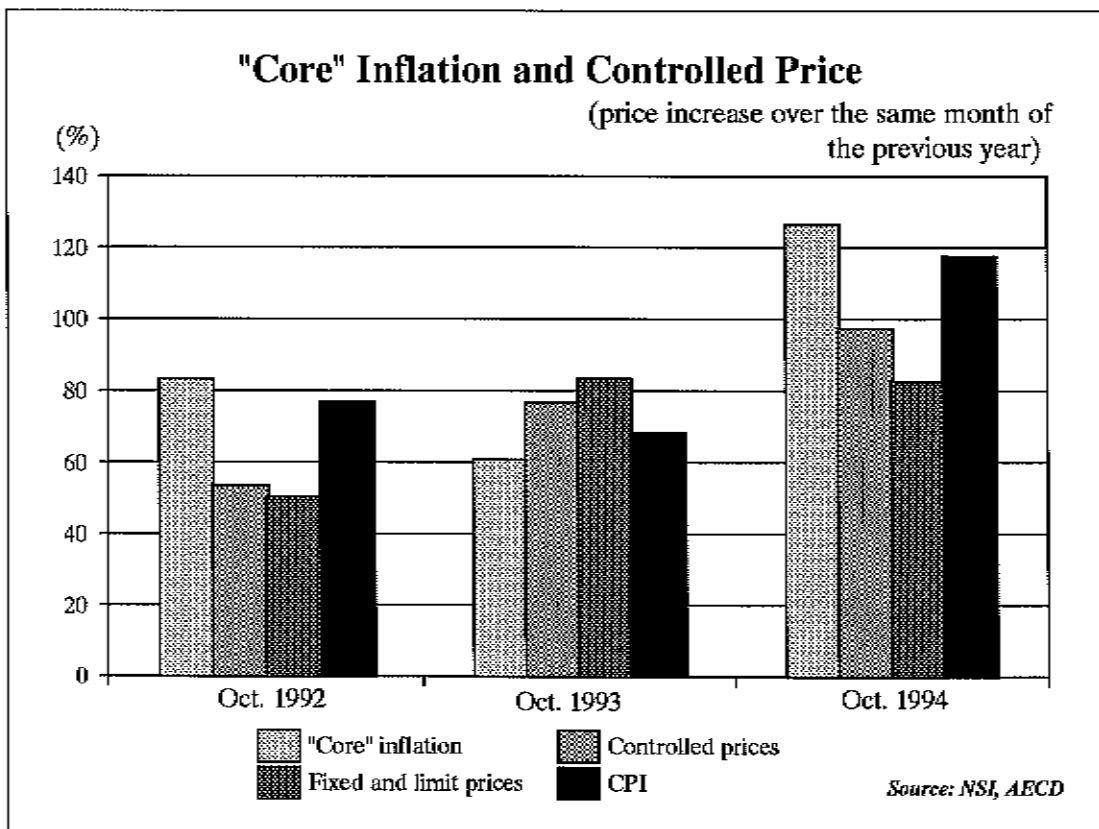
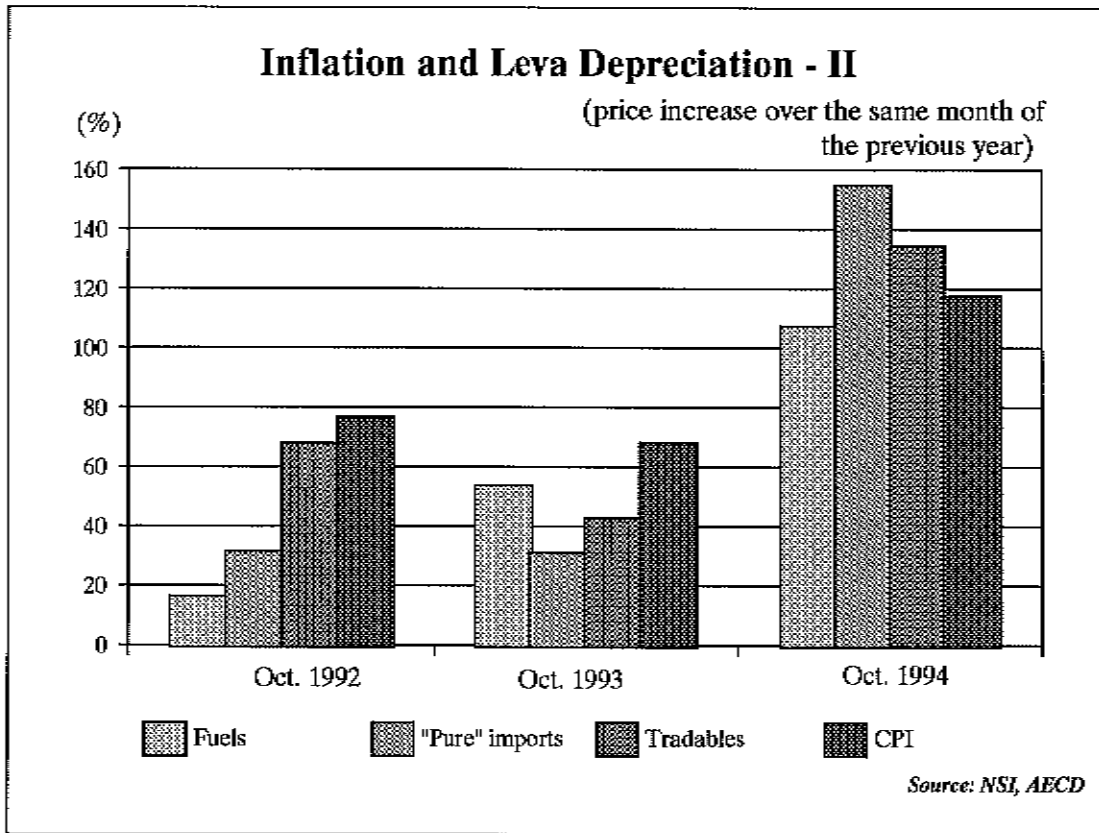
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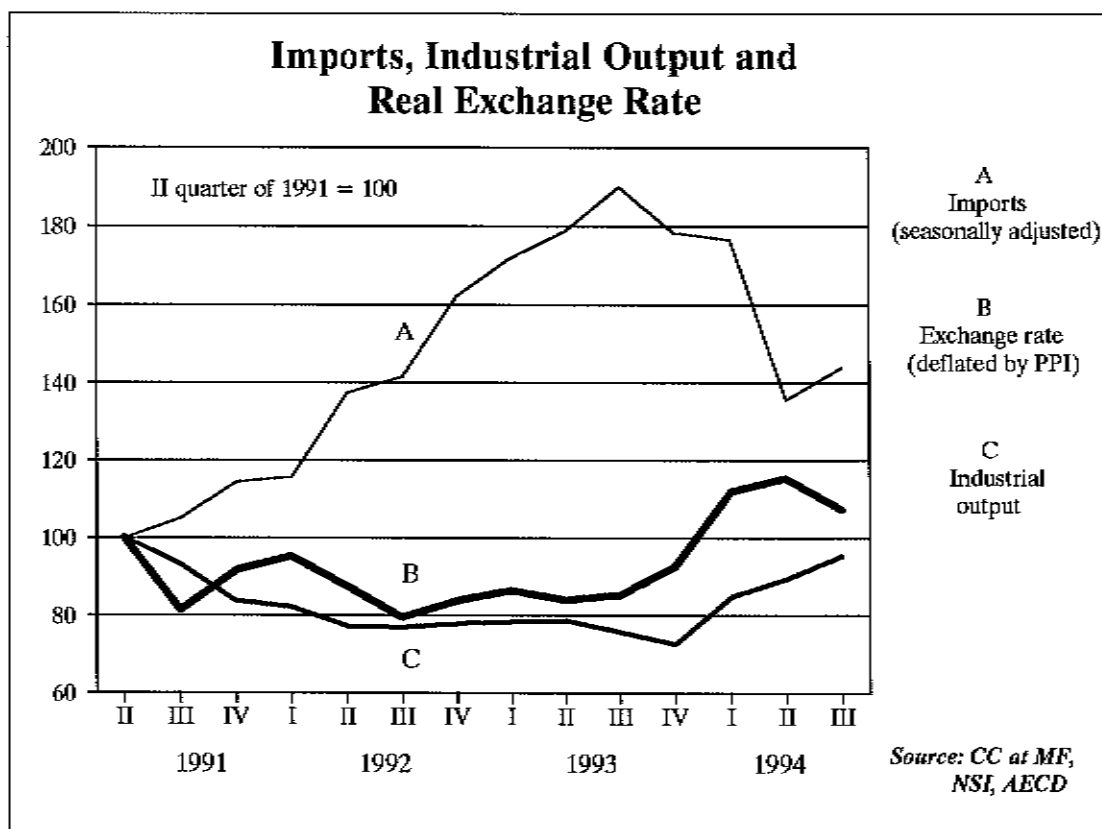
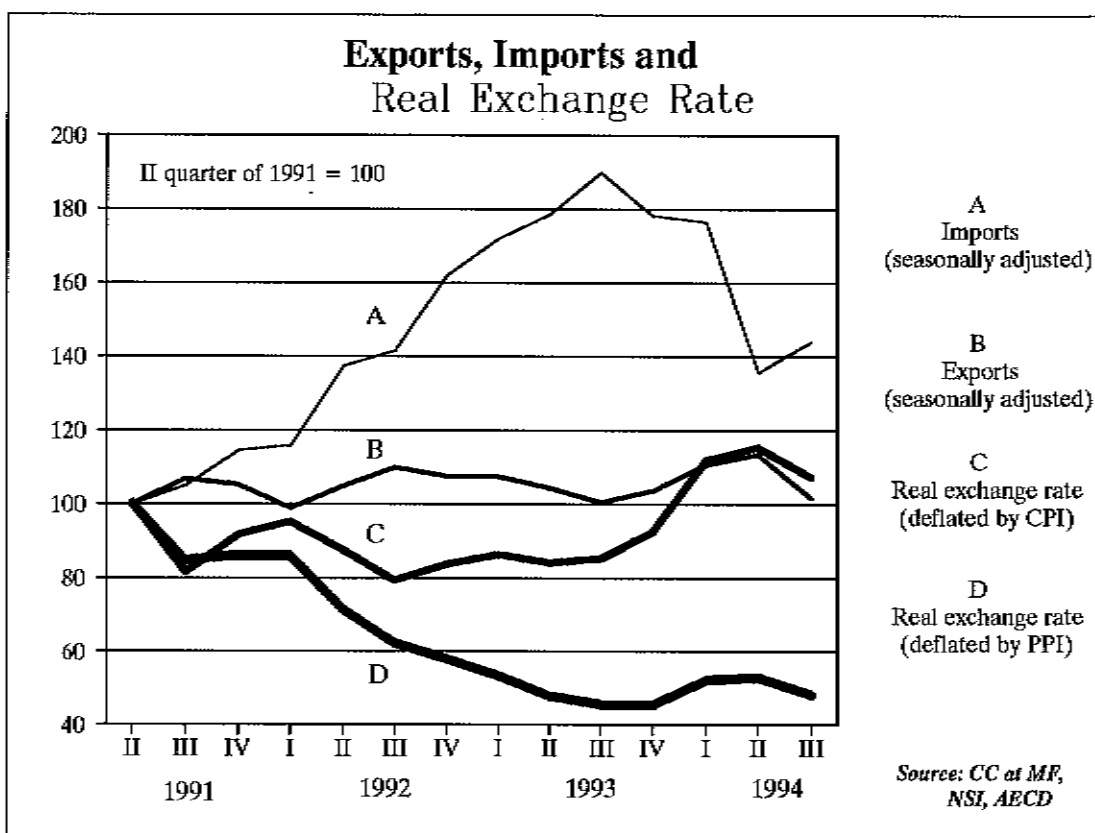


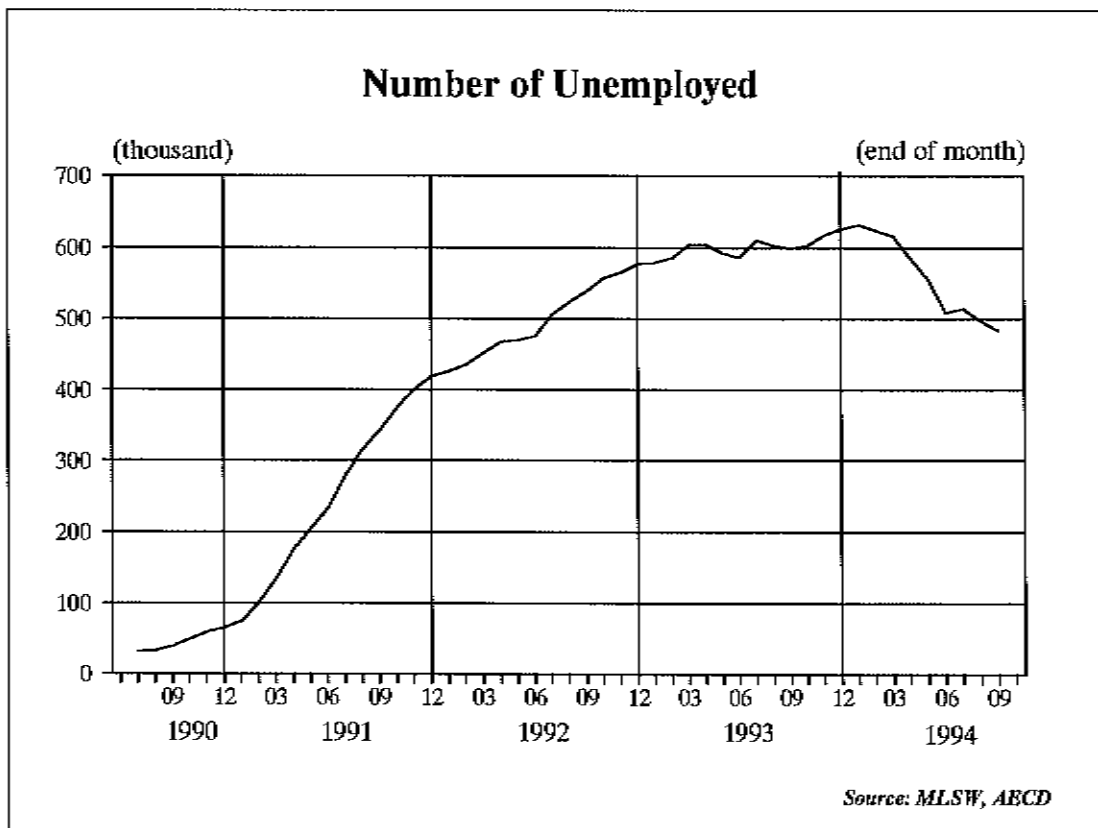
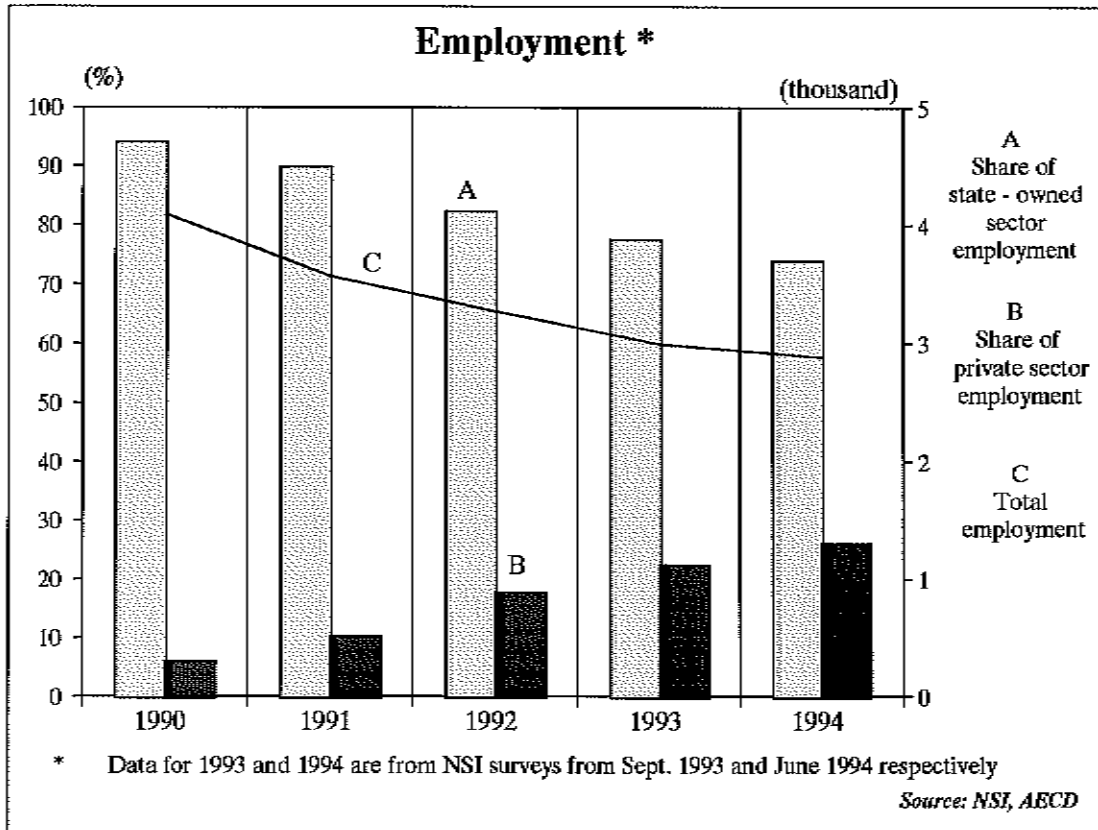


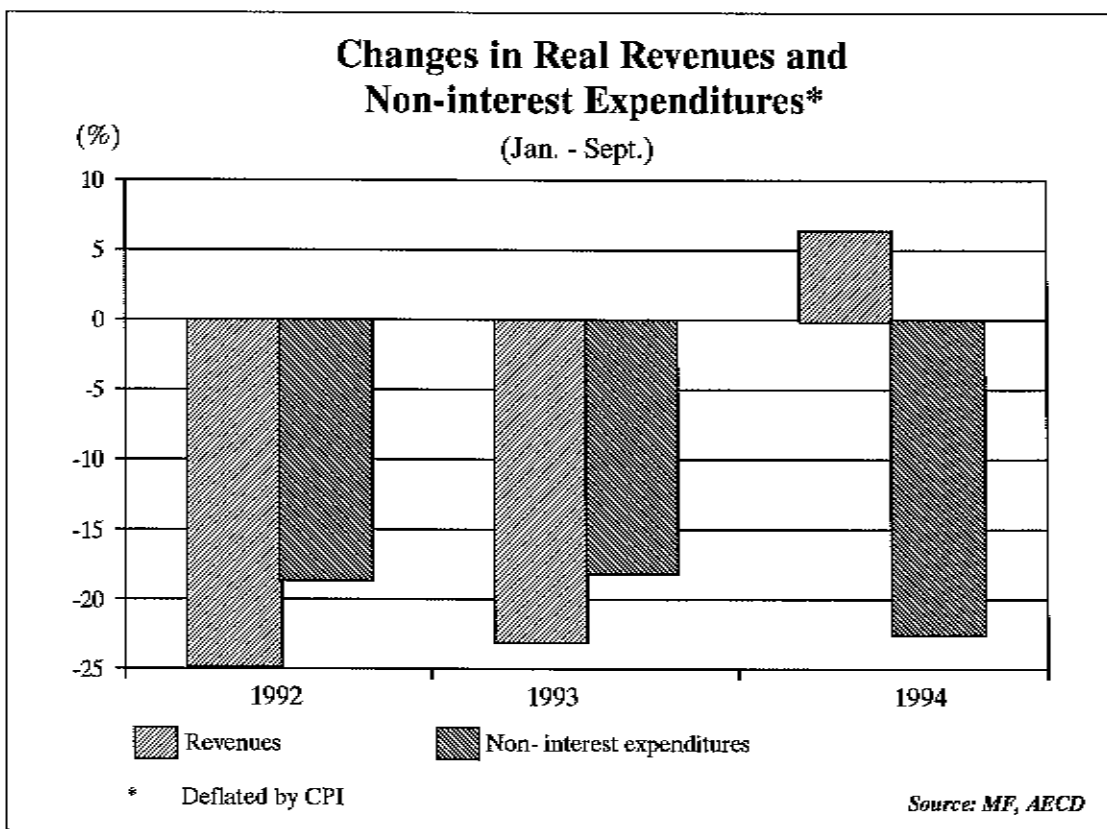
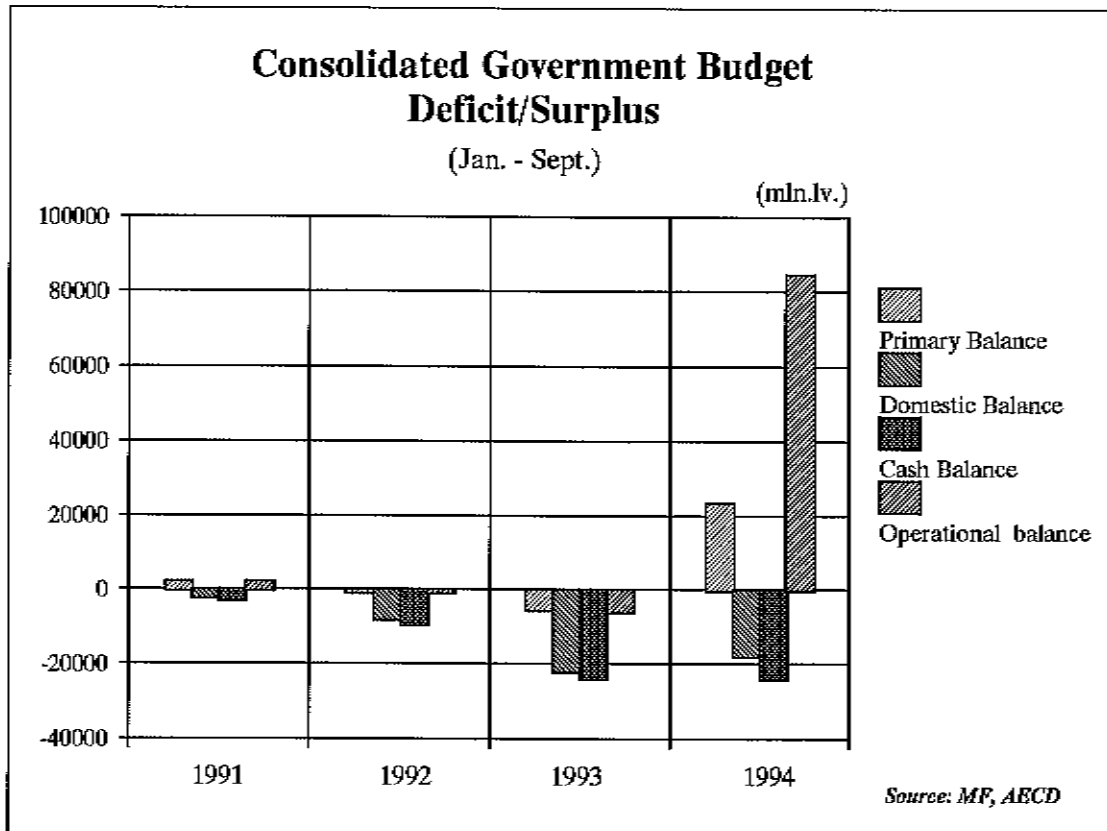


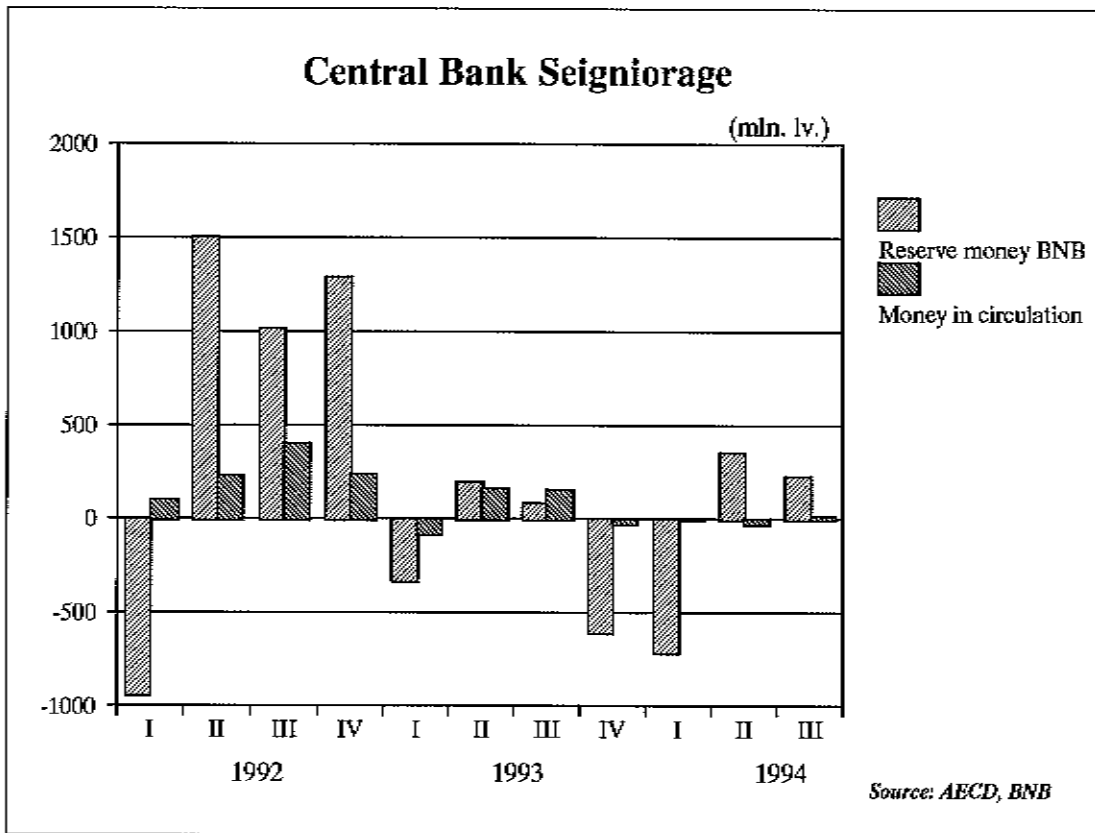












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