BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN THE FIRST HALF OF 1997

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THE BULGARIAN ECONOMY IN THE FIRST HALF OF 1997

Bulgaria's failures to achieve sustainable financial stabilization stem from the persistence of considerable fiscal and quasi-fiscal deficits which, combined with a macroeconomic policy of floating exchange rate and restrictive monetary stance carried out inconsistently until 1997 inevitably resulted in forex market crises and an incessant increase of interest rates. Through the monetary instruments applied (namely the base interest rate, the minimum required reserves and the exchange market interventions) the Bulgarian National Bank undertook to create conditions for the placement of an ever increasing government debt at lower budget expenses. As a result, the financial market was exposed to heavy pressures and ultimately collapsed in 1996 and the beginning of 1997. The attempts to curb inflation through administered prices and tight control of foreign trade (particularly the export of agricultural goods) led to a further slump in the economy and constantly increased firms' losses. In 1996 the process of simultaneous run away from the lev and uncontrollable money issue pouring into the economy fuelled up inflationary processes to culminate in the February 1997 hyperinflation.

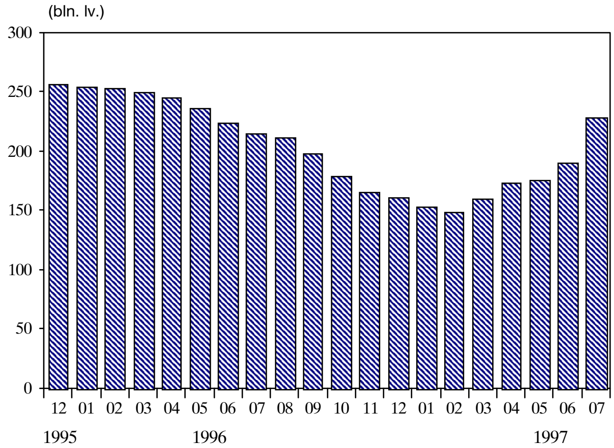
1. Accumulation of Inflationary Pressures in 1996

1.1. Run on banks

In 1996 the enormous outflow of resources from the banking system and the increase of credit arrears worsened the liquidity of the system and lowered further the capital adequacy of some banks. As a result of that, credit activity increasingly shrank and after some banks were put under a conservatorship the weak link between the credit market and the real sector fell down. Ultimately, the real sector was entirely isolated from the credit market.

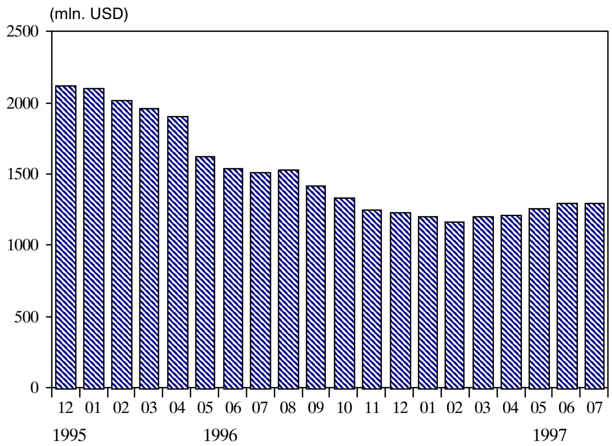
Dynamics of Time Deposits

(accumulated interest excluded)



Source: BNB

Dynamics of the Foreign Currecy Deposit



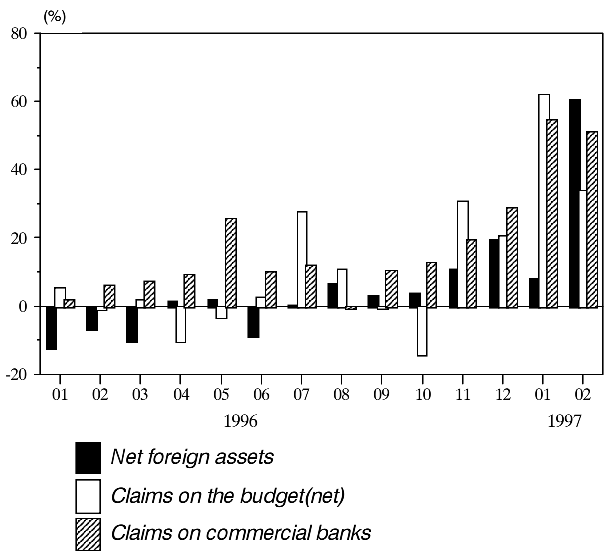
Source: BNB

1996 saw a net (adjusted for interest accrued) outflow of time leva deposits from the banking system amounting to Lv 108 bn. The Law for guaranteeing the deposits in case of bankruptcy passed in May 1996 aimed at ending the withdrawal of deposits from the banking system. Instead, it further panicked the market and the holders of foreign currency deposits in particular. The Law stipulated that the latter could either withdraw their deposits immediately in a leva equivalent and at a quite unfavourable rate of exchange, or receive them in convertible currency in four tranches every six months after the date the bank was put under a conservatorship. In fact, the Law gave new lease of life to the practice of transferring debts from the actual debtors to the state budget.

The rapid shrinkage of liabilities deteriorated the liquidity of the banking system and particularly of the banks with a large portfolio of non-performing loans. The banks with disproportionate foreign currency positions encountered additional difficulties due to the fast depreciation of the lev. The process of transferring losses from the commercial banks to the central bank and the state budget gained momentum while the array of instruments used to this end amplified. The banks' recapitalisation through their rehabilitation programs and the guaranteeing of deposits in the banks under a conservatorship turned into new channels, besides refinancing, for loss transfers.

In the period September 1995 to September 1996 the average monthly growth rate of the commercial banks' refinancing by the central bank had been 21%, uncollateralised deposits accounting for 90% of its amount. In practice, refinancing flowed into insolvent banks put later under a conservatorship.

Sources of Reserve Money Growth*



** Contributions of the sources to the percent change in the reserve money.*

Source: BNB

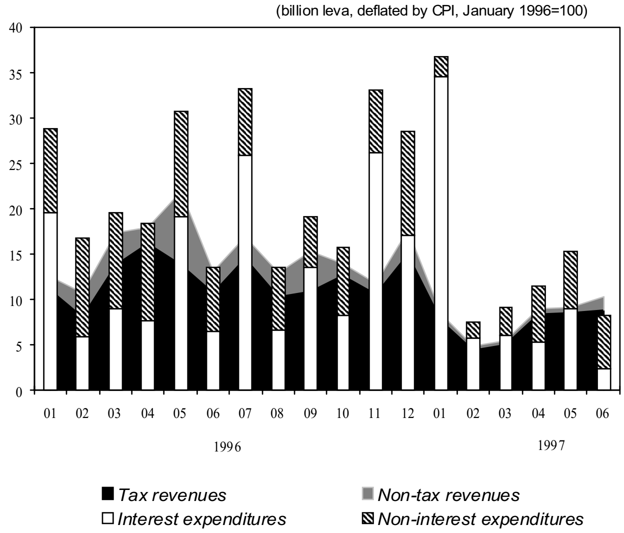
1.2. Budget deficit financing

The 1996 State Budget Act voted in February was amended three times throughout the course of the year. Thus, the expected cash deficit estimated at Lv 58 312.8 mn in the first bill was to grow up to Lv 206 012.1 mn in the end -1996 amendment.

The problems with budget deficit financing deteriorated with the pace of the economic crisis. Real budget revenue started to decline much quicker than budget expenditures due to the speed up of inflation thus creating further tension in the budget sector. The sharp depreciation of the lev, the transfer of commercial banks' liabilities to the state budget as well as the attempts of the central bank to strengthen the lev by raising the base interest rate resulted in soaring budget interest expenditures after June 1996. Non-interest expenses were cut much below the minimum needed thus paralysing the functioning of the entire budget sector.

Certain measures were taken in 1996 to offset the real drop in budget revenue. In July the value added tax (VAT) rate was increased from 18% to 22%. Excise duties were modified several times to make up for the eroding impact of inflation. The Profits Tax Law adopted in mid-1996 substituted Decree #56, however, it could not enter into force immediately due to the protracted preparation of the statute-book for its enforcement. The Law abolished the division of taxpayers to state and non-state introducing a uniform rate of taxation (36% to the state budget and 6.5% to the municipal budgets, or 26% to the state budget and 6.5% to the municipal budgets if profits are less than Lv 2 mn).

Real Monthly Revenues and Expenditures of the State Budget



Source: BNB, MF

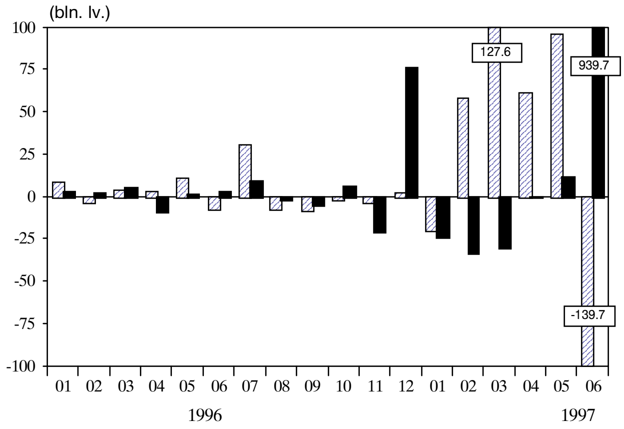
At the same time, the income tax scale was not modified. Therefore, by end-1996 the average tax burden on households' incomes grew enormously whereas the minimum salary increased beyond the non-taxable income. The average monthly income tax rate on the average salary increased from 13.7% in January 1996 to 24.6% in January 1997.

Notwithstanding the rise of the standard rates of taxation, real tax revenue fell by a larger percentage than the overall rate of economic stagnation in the country. The only possible explanation for this phenomenon is the successful tax evasion by some taxpayers and the increased unevenness in the tax burden distribution.

Budget deficit financing coinciding with an outflow of financial resources from the banking system added further pressure on the upward trend of interest rates and boosted the required rate of return on government securities.

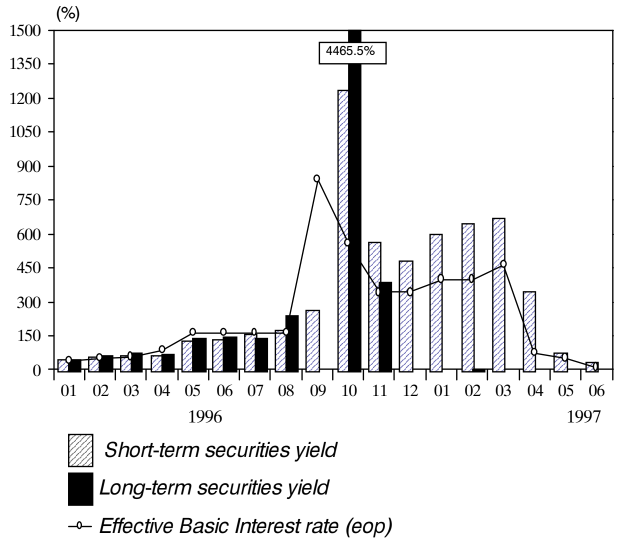
The maturity of government securities issued after June 1996 shortened steadily. The share of short-term government securities in the total debt issued to finance the budget deficit grew up from 60% to 80% in the beginning of 1997 to almost 90% in the following several months. The collapse of the banking system following the close-down of nine big banks in September 1996 forced the government to ask the central bank for a direct loan to cover the budget deficit. That additional money issue at the end of the year triggered the December 1996 – February 1997 hyperinflation crisis.

Net Financial Flows from BNB and Commercial Banks to the Budget



Source: MF, AEAF

Base Interest Rate and Effective Return on Government Securities



Source: BNB

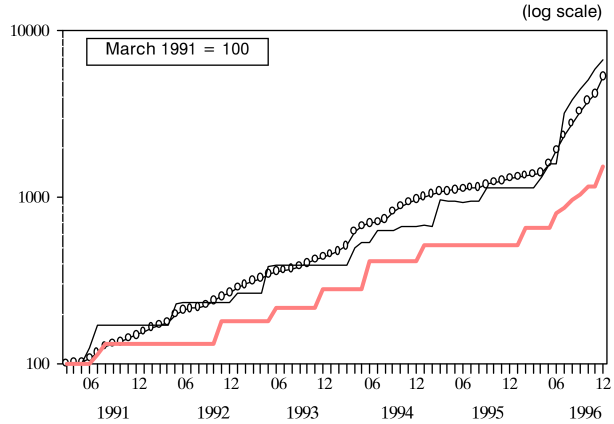
1.3. Prices and firms' liquidity

In 1996 the Government started a gradual adjustment of fixed prices in order to reduce losses in the industrial branches producing primarily goods and services with administered prices.

Prices of postal services were increased in February and then again in July whereas since April 1996 prices of electricity and fuels had been adjusted every month. Consequently, producer prices became a mighty inflationary factor.

It is somewhat difficult to estimate the pure impact of the price increase on the overall financial condition of state-owned enterprises. The impact on the industries with a large share of production with administered prices must have been positive thus lowering their losses. And vice verse, it must have been negative on the industries consuming the respective goods and services. The collapse of the banking system and the firms' losses on their accounts in the closed banks were additional factors influencing their financial results. On the other hand, the acceleration of inflationary processes and the depreciation of the national currency contributed to high book profits.

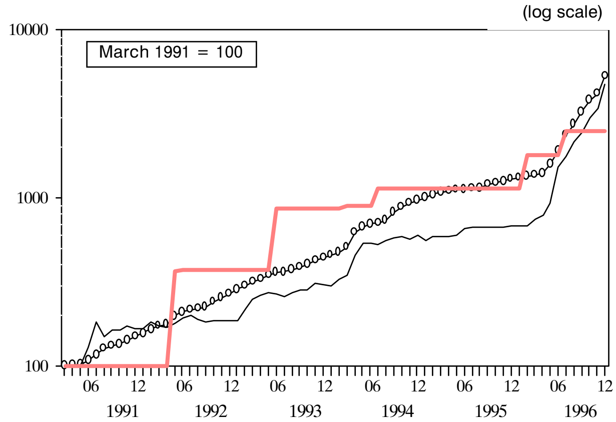
Consumer Price Index



Consumer price index

*Electricity, heating and coal (7.8%) **

*Railway transport (0.3%)**



Consumer price index

*Fuels (4.4%)**

*Postal, telephone and telegraph services (1%)**

* *The group's weight in the CPI in parentheses.*

Source: NSI, AEAF

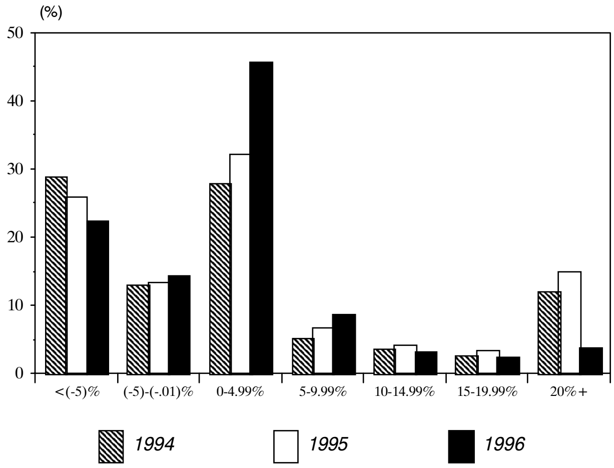
Notwithstanding the declining share of loss-making enterprises in 1996 the concentration of firms with negative to slightly positive profitability remained higher than the concentration of firms with considerable positive profitability.

The bulk of state-owned enterprises continued either to incur losses or realize negligible profit.

The 1996 financial data reveal that in spite of the efforts to strengthen financial discipline and reduce losses and debts most of the firms continued to benefit from the soft budget constraints.

Over 60% of the enterprises deferred payment of their obligations to the budget for more than 90 days while some 20% of them were falling into arrears with suppliers for three months. The banking crisis forced the firms to urgently demand their receivables, hence the earlier settlement with suppliers.

Profitability*



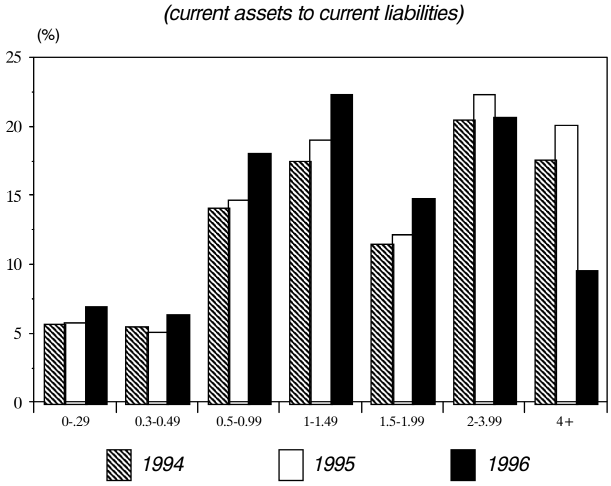
* The ratio of operating profits to sales.

Source: NSI, AEAF

Indicators of enterprises' liquidity in 1996 worsened on a year ago due to the crisis in the banking system. Thus, in 1995 some 25% of the non-financial firms in the public sector maintained a liquid assets ratio below one point while in 1996 their share went up to 31%. Over the same period more than half of them had a quick assets ratio under 0.3.

Current Ratio

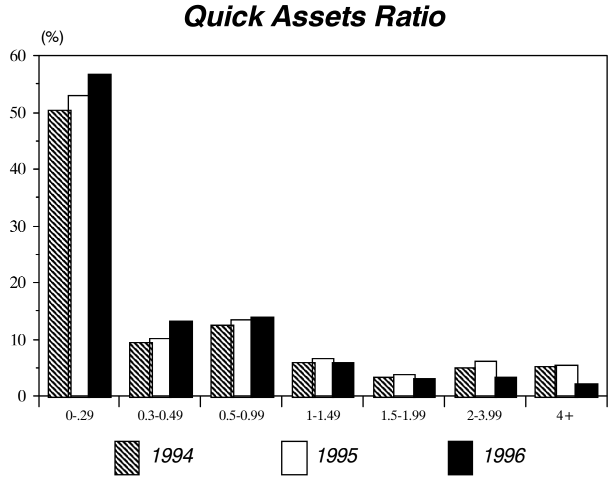
(current assets to current liabilities)



Source: NSI, AEAF

The quick assets ratio is of particular importance on the background of the overall confidence crisis in the national economy and the successive banking crises in 1996 since it reveals that the bulk of enterprises were directly in danger of falling into a liquidity crisis, and later of

Quick Assets Ratio



Source: NSI, AEAF

becoming insolvent.

Following the disintegration of the financial system in 1996 GDP slumped by 10.9% and investment in fixed long-term assets fell by 13.5% relative to the previous year.

2. The Panic on the Forex Market in January-February 1997

The crisis of confidence in the national currency and in the banking system peaked in the beginning of 1997. Excessive currency substitution and the withdrawal of foreign currency deposits worth USD 890 mn in 1996 brought about a significant capital account deficit and depleted the central bank foreign reserves by USD 753 mn.

The political instability that followed the resignation of the government in December 1996 intensified the negative expectations of the economic agents. The exchange rate at both the interbank and the cash forex markets leaped to Lv 3 000 per USD 1 as a result of the mounting pressure on the Lev. Having already lost almost two thirds of its foreign exchange reserves due to its massive interventions in support of the Lev, the central bank was forced to confine itself only to the application of the traditional instruments of monetary policy. Yet, in 1996 the use of the base interest rate as a means of hampering the exchange rate rise did not yield the expected results and the central bank finally gave it up in the beginning of 1997.

The depreciation of the Lev in January and the first half of February 1997 coincided with a very thin supply of foreign currency and even small amounts purchased shook the rate of exchange. The central bank attempted at curbing demand by limiting the liquidity of the banking system. At first, it raised the minimum required reserves by one percentage point and later temporarily denied the commercial banks access to them.

The change in the method of determination of the Lev/USD exchange rate in order to exert psychological pressure on the forex market players was the last measure to which the central bank resorted in the beginning of January 1997. The central exchange rate was again to be determined as a weighted average of the trade on the interbank exchange market but also taking account of the volumes traded. The new approach adopted the following criterion: the rate of exchange was not to be altered if the daily amounts of foreign currency bought and sold were less than USD 10 mn. By this regulation adopted on 6 January 1997 the central bank in practice introduced a parallel exchange rate considerably deviating from the market quotations.

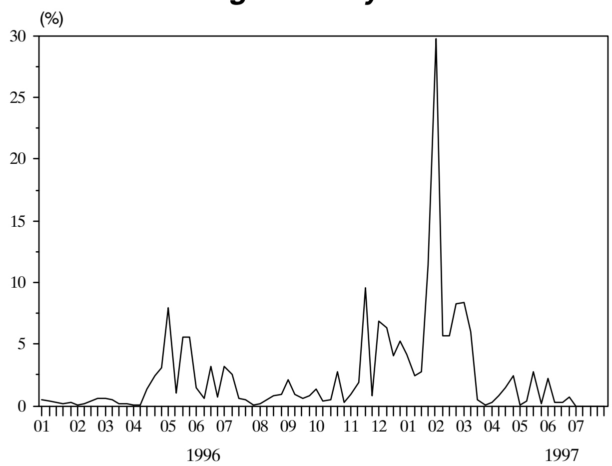
All attempts to slow down the soaring exchange rate in the beginning of the year failed and in the period 31 December 1996 to 12 February 1997 the lev depreciated to the dollar by 503%.

Exchange rate fluctuations peaked in February 1997. In the beginning of the month, in the presence of escalating social tensions, large-scale strikes and commodity shortages, the lev depreciated on the interbank market by over 20% average daily.

The resolving of the political crisis had a positive psychological effect on the market and the exchange rate at the interbank market fell by some 2% immediately after the main political parties worked out an agreement.

A new rise of quotations followed, yet it proved to be short-lived and the second half of February saw a clear-cut trend of Lev appreciation. The appointment by the President of a caretaker government enjoying relatively high public approval was the first step towards restoration of confidence in the national currency.

Exchange Rate Dynamics*



* *Weekly standart deviation of the exchange rate*

Source: BNB, AEAF

3. Changes in the Economic Policy since February 1997

The political vacuum in early-1997 brought about passivity in the management of even such institutions as the Bulgarian National Bank which, by virtue of Law, are independent of the legislative and executive powers. The signs of economic stabilisation that emerged following the political stabilisation of the country after

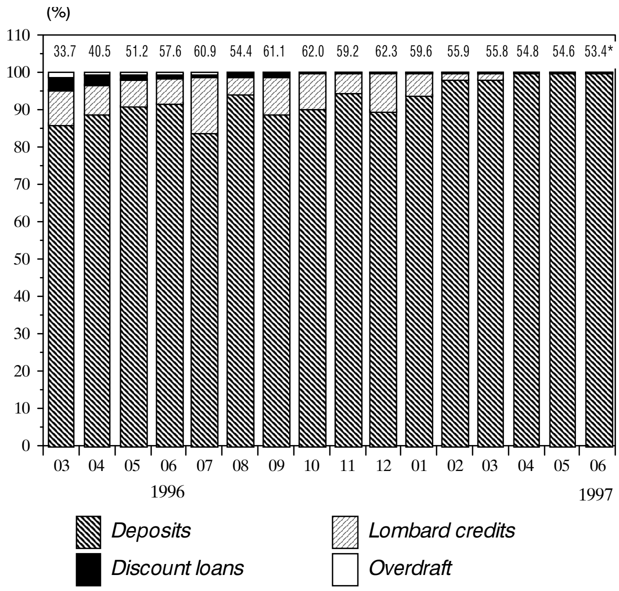
February verified the hypothesis of the political dependence of each and every economic structure and the important impact political and psychological factors exert on the Bulgarian economy in the short term.

3.1. Monetary policy and exchange rate

In the first six months of 1997 the central bank abandoned some of the major instruments of monetary policy and the mechanism of money supply displayed several distinct features of a currency board even before it was legally introduced. The Bulgarian National Bank suspended any uncollateralised refinancing of commercial banks, reduced the amount and shortened the term of Lombard credits against a collateral of government securities and commercial papers. According to existing regulations, the central bank allocated the required provisions having already classified as non-performing loans the uncollateralised refinancing outstanding granted in previous years to commercial banks in a bankruptcy procedure or under a conservatorship.

Direct central bank loans to the Government for the budget financing also marked a downward trend. In the period January 1997 to May 1997 net direct financing amounted to Lv 65.5 bn, i.e. less than budget payments to the central bank on direct credits and government securities interest and principal. That resulted in a negative financial flow from the Bulgarian National Bank to the Government.

BNB Refinancing of the Commercial Banks



* *Amounts outstanding, end of month (bn. leva). Preliminary data for the last month.*

Source: BNB, AEAF

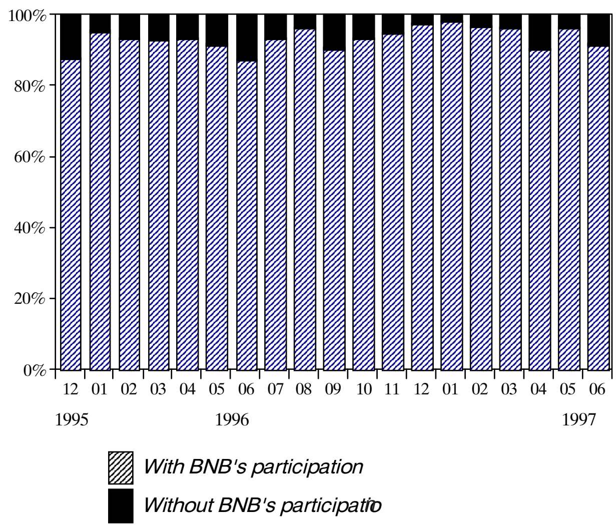
Since March 1997 the central bank's net foreign assets remained the only source of increase of reserve money. As of end-June

1997 net foreign assets amounted to Lv 2 260 bn compared to Lv 89.5 bn as of end-1996.

In January 1997 the central bank introduced a new method for its base interest rate formation linking it to the rate of return at the primary auctions of government securities. Thus, supply and demand of government debt started to determine the base interest rate transforming the latter from a monetary instrument into a consequence of the fiscal policy implemented. The Bulgarian National Bank gradually withdrew from participation at the primary market of government stock and since April 1997 refrains from purchases of new issues of government debt. The central bank reduced its participation at the secondary market of government securities to two-days repo deals of considerably lower volumes.

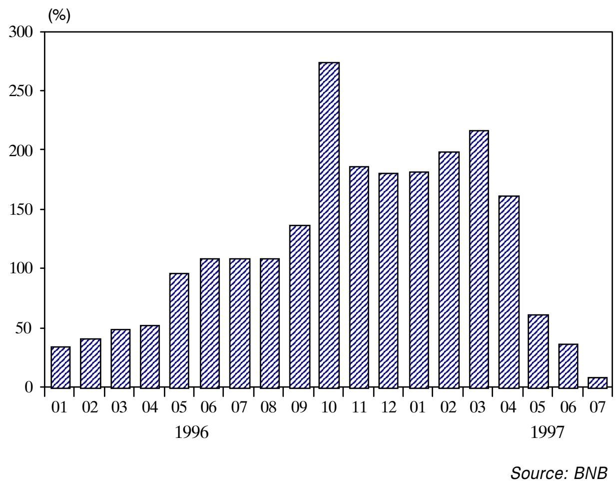
The high profitability of short-term government securities and the expectations for a relatively stable rate of exchange after the successful conclusion of an agreement with the IMF pre-determined investors' preferences to lev denominated assets. Since in May the Ministry of Finance exceeded by 49% the annual limit of government securities budget deficit financing, it embarked on a policy of negative net sales of government debt. This measure, combined with the suspension by the central bank of repo operations with the commercial banks

Open Market Operations



Source: BNB

Dynamics of the Base Interest Rate
(anual average interest rate)



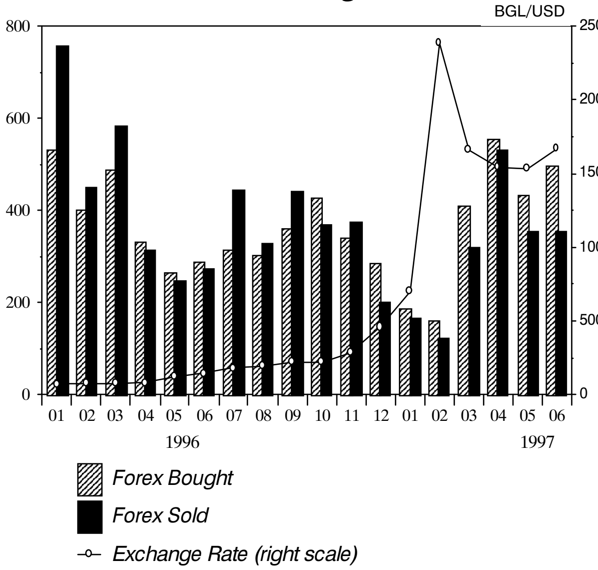
Source: BNB

induced since early-June high liquidity in some of the banks. According to the balance sheet of the Issuing Department of the central bank, the commercial banks maintained in July some Lv 300 bn of excessive reserves regardless of the suspended accrual of interest on their accounts in the BNB since 14 July 1997.

Since mid-June the base interest rate started falling steadily due to both the high liquidity in the banking system and the adopted monetary policy measures.

Positive expectations for the outcome of negotiations with the international financial institutions also calmed down the participants at the forex market. After several months of stagnation business recovered and in April the daily volumes of foreign currency traded drew nearer to their last year values. Higher supply of foreign currency was partly due to the high trade balance surplus recorded in the first quarter and the inflow of capitals in the second quarter. The growing supply of foreign currency resulted in the fall of the average monthly central exchange rate of the dollar to the lev by 30.5% in March and by 6.9% in April.

Volumes at the Forex Market and Exchange Rate



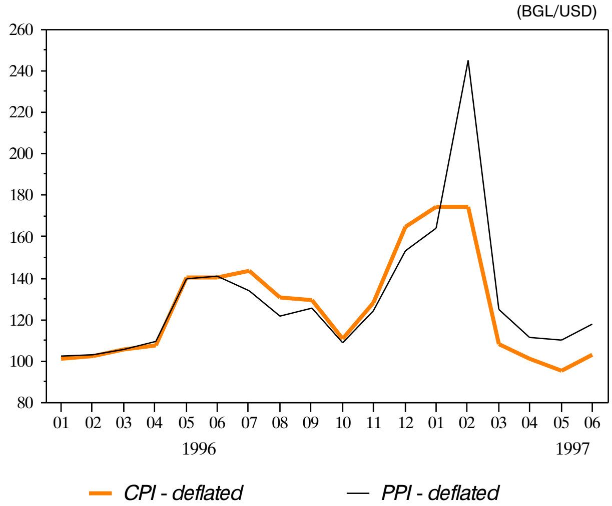
Source: BNB

The central bank intervened at the forex market as a net buyer in attempt to curb the nominal appreciation of the lev as the latter might result in a highly overvalued real rate of exchange before the introduction of the currency board. Thus, the central bank net purchases in the first five months of 1997 amounted to more than USD 340 mn. The central bank gross foreign reserves increased from USD 0.4 bn in January to USD 1.3 bn in June due to the purchases at the domestic forex market and the official external financial support. As of end-June 1997 the foreign exchange reserves formed the equivalent of three months imports of goods and services.

Cumulative real appreciation of the lev in the first half of 1997 amounted to 37%. Except for January and June when the nominal appreciation of the national currency exceeded the monthly rate of inflation, in the first six months of 1997 prices registered in general higher rates of increase.

The Bulgarian National Bank Law passed in June pegged the exchange rate of the lev at Lv 1 000 per DM 1, close to the then market rate. The pegged rate of exchange was an element of the currency board mechanism officially introduced on 1 July 1997. The choice of the Deutsche mark for a reserve currency was determined first and foremost by Bulgaria's aspiration for full integration into the European Union.

Real Exchange Rate



Source: BNB

Expectations that the currency board would guarantee stable macroeconomic environment have so far been justified. The pegging of the exchange rate eliminated the most important source of instability and created conditions for non-inflationary long term growth.

3.2. Incomes and social policy

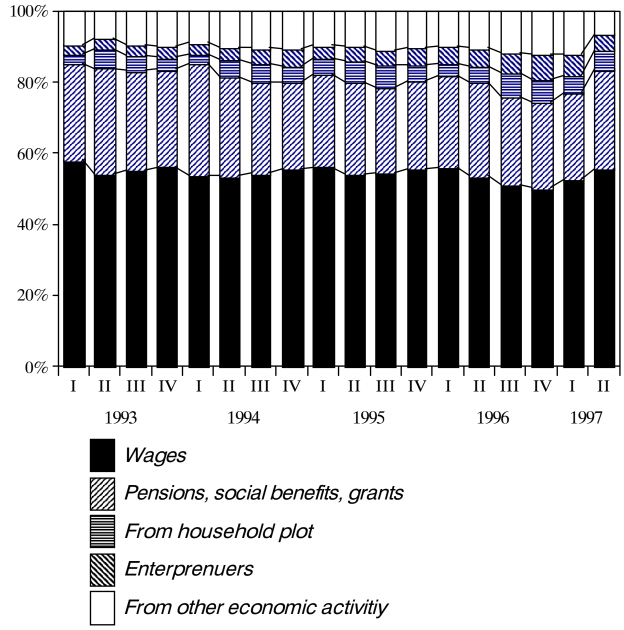
Government employees, pensioners, unemployed and people dependent on social aid from the budget suffered a great slump in their real incomes. After resolving the political crisis, the caretaker Government was forced to undertake urgent measures to compensate the impact of high inflation on real incomes. Real incomes[1] in Bulgaria have been declining since end-1993 yet, high inflation in early-1997 reduced them to zero values at one fell

[1] *According to statistical data on households' budgets.*

swoop. The structure of real incomes underwent changes due to their erosion and the relative share of incomes from salaries and pensions jumped to 80% of the total at the expense of the slump in the share of incomes from entrepreneurial economic activity.

Data on household budgets show that in February and March 1997 the share of expenditures for food in total household money expenditures exceeded 55%. Over the same period in 1996 the former accounted for some 40% of household money expenditures. The second quarter of 1997 saw a relative downward trend in food expenditures at the expense of the rising share of clothing and footwear expenditures. The registered shifts in the structure of expenditures are closely associated with the different price elasticity of consumption of various commodity groups. In the first half of 1997 the average money expenditure dropped 2.4 times in real terms on a year ago. Over the same period real expenditures for food fell 2.0 times, for clothing, footwear and personal belongings – 2.1 times, for housing – 3.4 times, for heating and electricity – 4.1 times, and for transport and communications –

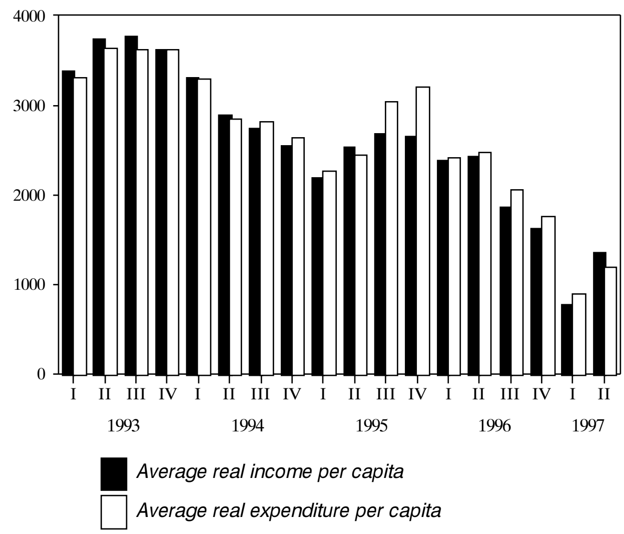
Households Money Income



Source: NSI, AEAF

Money Income and Expenditure per Capita

(base index January 1993=100)



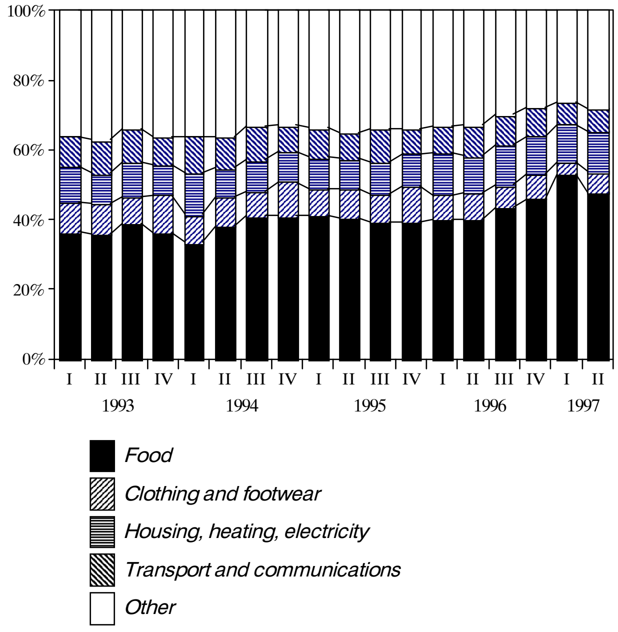
Source: NSI, AEAF

2.5 times on a year ago.

Incomes from salaries declined considerably in the first six months of 1997. In February the average monthly salary in the country hit its lowest in dollar terms (USD 25) since 1993.

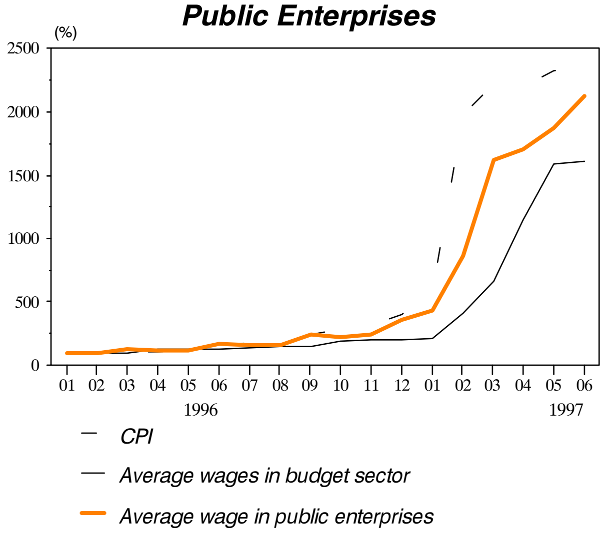
During the hyper-inflation months – January and February – the coefficients of variation of the average salaries in the public sector registered high values displaying a high ratio of differentiation due to the separate schemes of incomes adjustment implemented in the budget sector and the state-owned enterprises.

Households Money Expenditure



Source: NSI, AEAF

Dynamics of Consumer Price Index, Average Wage in Budget Sector and in Public Enterprises



Source: NSI, AEAF

Table 1

Coefficients of Variation of the Nominal Average Working Salary by Branches

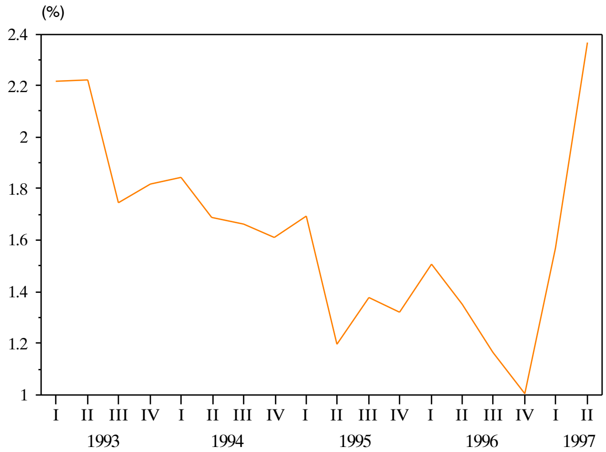
1997	Average salary with bonuses	Average salary without bonuses
February	69.88%	65.43%
March	64.16%	65.21%
April	51.34%	50.50%
May	41.02%	40.01%
June	38.64%	38.33%

After February the differences between the working salaries in the various branches have been gradually diminishing. In the first half of the year the highest pays were registered in the following industrial branches and activities: the production of coke, refined petroleum products and nuclear fuel; metallurgy, the production of chemicals and chemical products, synthetic fibres and rayons. The employees in the sectors Health care, Education and Public utility services received the lowest salaries.

Lessons from the recent past demanded a cautious approach to the adjustment of the various types of incomes so as to avoid the creation of sources of inflationary pressure due to any miscalculated increase of the former.

The first measure taken by the Government in the sphere of social policy and incomes protection was to review the system of target aid to low income households and social establishments with full budgetary support. The system was created to ease the burden of price rises of electricity, heating, water supply and fuels for heating on low income groups. The Government broadened its scope to encompass additional households and distributed through it the financial aid from the European Union.

Social Benefits in Households Income

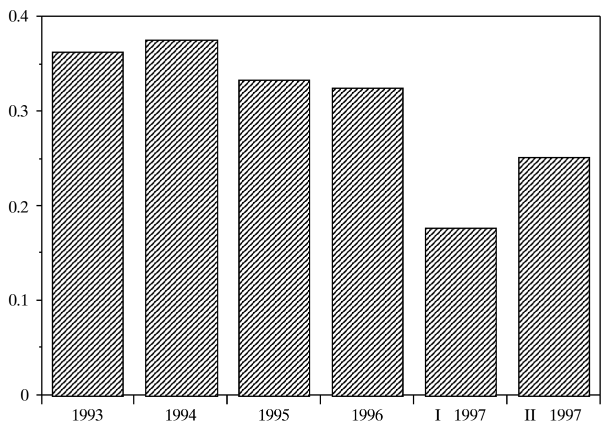


Source: NSI, AEAF

After January 1997 the compensation policy implemented was to grant a lump sum of money to all pensioners without changing the value of the social pension and all other pensions calculated using the methods of the National Social Security Institute (NSSI). According to this approach, pension incomes can be classified into two main categories – incomes from the pension and incomes from the inflationary compensation while, in practice, the latter exceeded the allowed upper limit of the maximum pension. In this way the differentiation between the various pensions received was practically erased. In the period

February 1997 to May 1997 the increase of pensions owing to the pension compensations was higher than the rise of consumer prices, yet insufficient to offset the drop in real terms of pension incomes since the last quarter of 1996. As stipulated by Government Ordinance No195 of 08 May 1997, the social pension was raised over five times in June, the amount of the compensation over the maximum pension had to equal one half of the social pension and the individual retirement pension was increased by 16%.

Replacement Ratio



Source: NSSI, AEAF

In June the Parliament voted an amendment to the Law on Pensions. According to its provisions, the average monthly gross salary, announced by the National Statistical Institute, in the calendar year preceding the year of adjustment is to be the basis for the regular updating of pensions. As an exception, the 1997 adjustment of pensions had to be based on the average salary in the first quarter of 1997. Even with this revising, the basis for the calculation of pensions remained twice lower than the average working salary in the second quarter of 1997.

In July the social pension was set at Lv 27 000 and the maximum pension was limited to three times the amount of the social pension, or Lv 81 000. According to the methods applied by the NSSI, a necessary condition for the receipt of the maximum pension is the individual social security income to have been at least twice higher than the average salary in the country in the respective period[2]. In practice, this provision makes the maximum pension hard to attain.

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[2] *It is mandatory for people retiring in 1997 to include the social security incomes in the respective months they have worked after 1 January 1997 in the selected three years for determination of their individual index. In case the pensioner's length of service exceeds the required minimum for the respective labour category, his individual social security income may be lower than twice the average salary in the country and still he may be eligible for the maximum pension.*

The underlying principle of the adjustment of salaries in the budget sector in the period January to June 1997 was the equal percentage of their increase (650%)[3]. In March the Government allowed higher compensations than determined, in case the number of employed in the respective establishment was cut by more than 10%.

Since the turn of the year the Government Regulation on the control over pay-roll funds increase in the enterprises with over 50% of state participation was amended several times. The financial results of the company regardless of any changes in the volumes of sales remained the principal criterion in the first quarter of 1997[4]. The enterprise was granted the right to allocate the pay-roll funds in conformity with its financial and economic condition and the revenue received, on condition that it paid off regularly its obligations to the state and municipal budgets, the Social Security Fund and the Training and Unemployment Fund, its net long-term fixed assets had increased relative to the previous year and it has made profit in the first quarter. If the enterprise improved its financial results and redeemed the above-mentioned financial obligations notwithstanding the losses realised in the first quarter or the subsidies received from the state or municipal budgets, the allowed percentage of the pay-roll funds' increase was up to 70% of the margin gauging the improvement of their financial results. The enterprises could apply the indexes provided in the Government Ordinance for the adjustment of their pay-roll funds.

The terms and conditions for pay-roll funds' increase have to be stated in the contracts between the management of the companies and the ministers or the heads of the respective institutions exercising the ownership rights of the state in those enterprises.

As regards the second quarter of 1997, the Regulation on the control over the increase of salaries imposed additional requirements on profit-making enterprises. They must not have financial obligations on interest and principal on bank credits

[3] *The increase, relative to the preceding month, was as follows:* ***February – 100%, March – 60%, April – 70%, May – 38%.***
[4] *Government Ordinance No68 of 27 February 1997.*

drawn, on dues under the Law on settlement of non-performing loans to municipalities and on the state dividend. In case the enterprises have such obligations then they must have started paying them off regularly. If the company fails to satisfy any of the above-mentioned conditions, pay-roll funds are adjusted by 70% of the actual inflation in the country relative to the selected base quarter (the index is published in the Regulation[5]) and a coefficient based on the change of the volume of sales of goods and services per capita relative to the selected base quarter. The last indicator is calculated following the methods of the National Statistical Institute.

The same rules of pay-roll funds' adjustment apply to loss-making enterprises and to those receiving subsidies from the state or municipal budgets and servicing the above-mentioned obligations. However, the coefficient based on the change of the volume of sales in the second quarter against the chosen base quarter depends on the percentage of betterment of the financial result. If the financial result is deteriorating or any of the dues are not being redeemed, the pay-roll funds are allocated within the financial means available yet, not exceeding the respective amount in the first quarter.

In the event the enterprise fails to respect the requirements of the Regulation, no tax on the pay-roll funds' increase is due. Still, the remuneration of the management is reduced by a triple amount of the minimum working salary in the country in the second quarter of 1997 for each percent of increase over the limit of the pay-roll funds.

3.3. Price policy and foreign trade regime

Following the initial price liberalization in 1991, successive governments have been introducing progressively tight price controls. In April 1997 the weight of controlled prices in the consumer basket amounted to 52%. In May the list of monitored food items was reduced, and the prices of liquid fuels were

[5] *Regulation on the formation of pay-roll funds in the second quarter of 1997 adopted by Government Ordinance No 218 of 19 May 1997.*

liberalized so that their retail prices have since been set by producers and the trade markups – negotiated with buyers. These changes diminished the weight of controlled prices in the consumer basket to 33% In July the ceiling prices of foodstuffs which had remained in the list of government-monitored goods were replaced by a price-setting methodology under which producers set the retail prices of their products. This new modification brought the weight of controlled prices in the consumer basked down to 12.8%.

The new price-setting method for basic foodstuffs and fuels has one significant drawback. It protects the monopoly of large producers and prevents traders from flexibly responding to changes in the market situation, thus creating a real danger of under-production and stable domestic market shortages for the respective goods.

Parallel to the domestic market, changes were also made in the foreign trade regime reflecting Bulgarian commitments under its international agreements with the European Union (EU) and the European Free Trade Association (EFTA), as well as under the free trade zones agreements with the member countries of the Central European Free Trade Zone (CEFTZ).

Trade policy measures taken in the first half of 1997 were necessary to respond to the changing situation and the new economic policy priorities coordinated with the international financial institutions.

In accordance with the international commitments of the country, on 1 July 1997 the Council of Ministers issued Decree No 270 on the liberalization of trade with certain agricultural products. Until then the existing export bans artificially sustained much lower domestic prices than international equivalents, thus de-motivating producers and creating conditions for illegal trading. The grain crisis from late 1996 and early 1997 explicitly indicated that inappropriate trade policy decisions destabilized the markets, thus causing substantial losses to the economy. Indeed, export liberalization was one of the conditions for a new World Bank loan for Bulgaria.

More important changes in the trade regime involved the lifting of temporary bans on agricultural exports, as well as the introduction of a registration regime for the export of cereals, oil plants and products, and of export charges on basic grain exports (wheat, maize and barley) amounting to 15% of the quotations on the main markets and international stock exchanges. The export of sunflower seed and oil was also allowed, subject to high export charges due to the wide wedge between domestic and international prices resulting from the extensive export bans.

In view of the anticipated domestic market shortage of basic products the government introduced a temporary free import of wheat, barley, maize, sunflower and sunflower oil. The customs duties on veal, chicken and pork were reduced. These are short-term measures and after their expiry (by the year-end) the previous clearly protectionist regime may be reintroduced.

The high degree of customs protection, reaching virtually banning levels for some products, distorts the domestic market by eliminating competition and strengthening the monopolistic structures. This facilitates the excessive increase in domestic prices and the creation of deficits due to low domestic production. The large dispersion of customs duties distorts relative prices and increases the difference between the domestic price structure and those of Bulgaria's main trading partners.

The issue of product deficits is addressed by crisis measures which entail frequent changes in foreign trade regulation and breed insecurity in the economic agents, especially in foreign investors and companies. The stability and predictability of the foreign trade regime is a key condition for the normal functioning of firms when long-term decisions can be made.

4. The Bulgarian Economy After the Inflationary Hyper-shock in February 1997

4.1. Collapse of the economic activity

The real sector felt the strongest blows in the first quarter of 1997. In January-March industrial output declined by 12.7% on a year ago. Compressed sales raised the level of finished goods inventories by 56% relative to the same period in 1996, which is a characteristic feature of depression periods.

The depth of the crisis bared the skeleton of the Bulgarian economy. In the first quarter of 1997 15 enterprises accounted for 43% of industrial output, 11 of which belonged to three industrial sectors – chemical and oil processing industries, metallurgy (ferrous and non-ferrous), and electricity generation. At the same time, 56% of enterprises in the public sector accounted for slightly over 1% of industrial output.

The limits to industrial production are due to the financial difficulties of producers and customers, and to the unstable economic environment. The rapid lev depreciation sharply raised the prices of imported raw materials and inputs, and inflicted a supply crisis on import-intensive industries.

The large shrinkage in domestic demand determined the 50% decline in domestic trade on a year ago, and the change in the structure of traded goods. The relative share of trade in foodstuffs began to increase at a faster rate.

Economic inertia transferred the negative impact of the first-quarter decline onto the values of half-year indicators.

In January-June 1997 industrial output decreased by 12.3% relative to the same period in 1996. Output declines were registered in all sectors with the exception of metallurgy and the extraction and dressing of metal, uranium and thorium ores. In half the industrial sectors the output drop for public-sector enterprises exceeded 30%.

Actual Output

(public and private sectors)

Source: AEAF

Finished goods inventories decreased in the second quarter, indirectly indicating a dampening of the crisis and the beginning of unstable demand recovery. The ratio of inventory change and sales in the period amounted to 2.5%, closing on the 1996 average.

The number of public-sector employed decreased by 43407 (2.7% with monthly peaks in February and June) in the first half of 1997.

The February drop in employment can be attributed to the deepening economic crisis and the traditional job decline in sectors with seasonal pattern of employment like agriculture and tourism. The aggravating economic crisis had the strongest impact on employment in the private sector, as well as in some public-sector branches like construction, public utilities, electrical engineering, pulp and paper industry, services.

The June decline in public-sector employment was rooted in the acceleration of mass and cash privatization (mainly of municipally-owned enterprises), entailing an increase in private-sector employment.

Employment in the budget-financed sphere increased in the first quarter of 1997, mainly in the Public Administration and Education sectors. The second quarter saw a gradual employment decline throughout the budget-financed sphere due to the programme for expenditure cuts in all sectors financed by the government budget and the related 10% job cuts. The overall second-quarter drop in employment in the budget-financed sphere barely reached 1%, indicating that the major employment cuts there were forthcoming.

The rapid increase in the number of registered unemployed from the second half of 1996 extended into the first months of 1997. The trend peaked in April when the level of unemployment reached 15.3% – value registered in early 1994. The rising number of registered unemployed was mainly due to the drop in private-sector employment. The decrease in the number of jobless in May-June resulted from rising seasonal employment in agriculture, forestry, tourism and transport. The expectations for a macroeconomic stabilization, acceleration of privatization, and output upswing create conditions for economic revival, and hence, for employment growth.

4.2. The state of the agricultural sector*

Economic policy changes, especially in price formation and foreign trade with agricultural products, have a positive impact on the agricultural sector. However, the sector is ridden with long-

* *Chapter prepared by Monika Koubratova.*

standing problems whose long-term solution depends solely on a clear strategy defining the goals and the means to achieve them. The goals should conform to the overall objectives which the Bulgarian government has identified in view of Bulgaria's wish to qualify for full membership in the European Union.

According to data from the National Statistical Institute (NSI) the share of agriculture in gross value added amounted to 11.5% (645.1 billion lev) in the first half of 1997, i.e. declining in absolute terms on a year ago. The private sector accounted for 91% of gross value added in agriculture.

The land reform is crucial for the development of agriculture, and its delay has become a key factor aggravating the situation in the sector. Land is a basic factor of production in farming, and unused land accounts for over 28% of farm land in Bulgaria. According to data from the NSI and the Ministry of Agriculture, Forests and the Agrarian Reform (MAFAR), by the end of August 1997 ownership rights were restored on 18.8% of land specified for restitution. Until end-August the restoration of land ownership rights under the Land Ownership and Use Act (LOUA) was completed in 47.4% of the territories in the country. Relative to end-1996 the number of issued title deeds[6] amounted to 36% of all title deeds issued until then, and the area of farm land involved – to 33% of all land with issued title deeds.

Since the beginning of 1997 the structure of crops underwent certain changes: area under grain crops subject to mechanisation increased at the expense of area under vegetables and perennial crops which are labour-intensive. The subsidized price of wheat in the spring of 1997, the anticipated export liberalization, as well as the subsidies financed by the „Farming" fund have obviously encouraged the planting of wheat crops on sufficiently large areas.

MAFAR data show that the private sector is predominant in the production of beans, potatoes, tomatoes, pepper, melons and water melons. Area under each of these crops has been diminishing, which is a clear signal for production and sale problems.

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[6] *As at 31 August 1997 186 551 title deeds for a total of 594 100 Ha were issued by virtue of decisions under Article 18 paragraph 1 and 2, and Article 27 of the Regulation for the application of LOUA.*

Table 2

Area under Some Basic Farm Crops, (in thousand hectares*)

	1995	1996	1997*
Wheat	1181.1	957.7	1224.4
Barley	396.2	260.5	279.1
Maize grain	475.3	477.8	429.0
Sunflower	586.0	499.8	447.5
Beans	42.7	41.6	28.6
Sugar beet	9.4	8.5	4.9
Potatoes	55.6	39.6	28.7
Tomatoes	29.8	17.3	9.4
Pepper	20.5	16.3	7.5
Melons and water melons	35.7	21.4	15.2
Cotton	11.5	12.9	15.2

* Operative MAFAR data as at July 1997. 1996 figures according to NSI data.

Although soils in Bulgaria are of low fertility, they are not being enriched for a number of reasons. The regime of temporary use of farm land due to the land reform delay, together with controlled prices of farm products, do not encourage intensive farming. Only 10% of area under spring crops are fertilized, mainly with nitrogen fertilizers.

Table 3

Mineral Fertilizers Used in Agriculture

Used mineral fertilizers (pure substance) per 100 Ha arable land	1993	1994	1995	1996	1997* Aug.
TOTAL	4927	3886	3658	3812	2102
Nitrogen fertilizers	3893	3503	3407	3610	2051
Phosphate fertilizers	883	318	236	194	50
Potassium fertilizers	151	65	15	8	n.a.

* Preliminary data as at 31.08.1997; Source: NSI

MAFAR data as of 31 August 1997 indicate a decline in the amount of purchased fertilizers on a year ago. The overall decrease in the amount of used fertilizers per 100 Ha arable land was about 7%.

Compared to fertilizers, the amount of chemicals used is still lower although they are required for the cultivation of certain crops. MAFAR data as of July 1997 indicate that 5%-10% of spring crops were treated with herbicides.

Machinery and trailers are still the biggest problem in soil cultivation, and mostly, in grain harvesting. 2062 combine harvesters were used in the last harvest, 2486 less than in the 1996 harvest. Technical equipment is worn out, and harvest losses greatly exceed the allowed margin in the EU countries.

NSI data indicate that for the last 5 years acquired fixed assets in agriculture fluctuated between 2% and 6% of all fixed assets in the economy.

Stock-breeding has remained in critical condition. The decline in the number of animals is paralleled by a relatively stable but low productivity. As a result, the amounts of milk, eggs, unwashed wool and other products have been declining.

Table 4

Farm Animals (as of 01.01.1997 in thousand units)

Kinds of animals	1995	1996	1997
Cattle	638	632	582
o/w cows	351	371	358
Buffalos	14	14	11
o/w buffalo- cows	7	8	7
Pigs	1986	2140	1500
o/w sows	219	234	157
Sheep	3398	3383	3020
o/w ewe sheep	2358	2386	2000
Fowl	19126	18609	16227

Individual farmers and land co-operatives are the main organisational structures in agriculture. As the land reform is still under way, these structures are temporary and may cease to exist in the near future. The last few years witnessed a certain degree of concentration of arable land in the larger individual farms.

Producers in both kinds of structures encounter similar problems:

- lack of stable and clear agrarian policy which does not allow producers to plan and forecast their activity in the normal way;
- lack of stable land tenure regulation due to the incomplete land reform;
- lack of agricultural credits;
- lack of a well-developed market and information infrastructure, especially of consultancy infrastructure on new products and technologies;
- lack of investments in the sector.

The instruments of government regulation in agriculture should be radically changed. Priority expenditures in EU countries are concentrated in the structural funds which are set to ensure regional development and abolish regional differences in the living standards. The utilization strategy of these resources conforms to the objective for regional diversification of economic activities, the agricultural sector included, corresponding to the needs and potential of each region. Therefore, agriculture and farm subsidies are only one element of regional development, and their development strategy takes into account issues such as environmental protection, unemployment decline, development of infrastructure and other economic activities.

4.3. Balance of payments

The negative expectations of producers generated in 1996 surfaced as declining production and exports in early 1997. The first quarter of 1997 saw a drastic decrease in foreign trade, mainly as a result of the import drop due to the forex crisis in the beginning of the year[7].

The 324 million USD trade surplus in the first quarter of 1997 was rooted in the 30% import decline due to its high elasticity to changes in relative prices. The analysis of exports indicates a very weak influence of the real exchange rate, so that their slight decrease (less than 1%) in early 1997 may be attributed to the

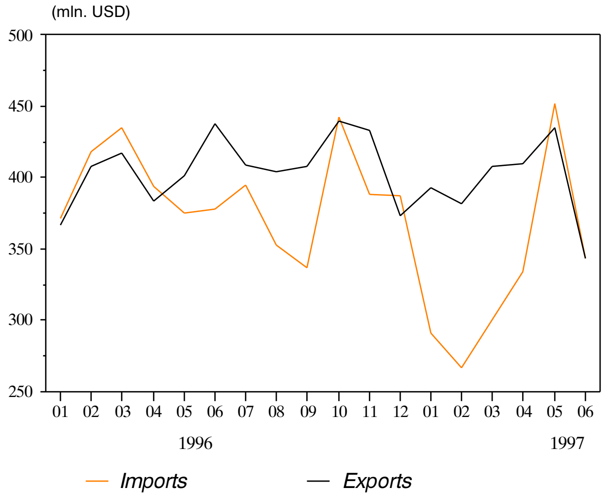
[7] *Foreign trade figures are preliminary.*

unstable economic environment and the problems in the banking system which frustrated the access to credits.

The import of consumer goods is particularly sensitive to the appreciation of the exchange rate (50% drop). However, the import of investment goods has also fallen by half since the beginning of the year. The import of raw materials decreased by 31%.

The downward trend reversed in the second quarter. Imports began to rise at relatively high rates: 7% in April and 8.5% in May on a year ago[8]. The import decline extended through April. May, however, registered an increase of 20%.

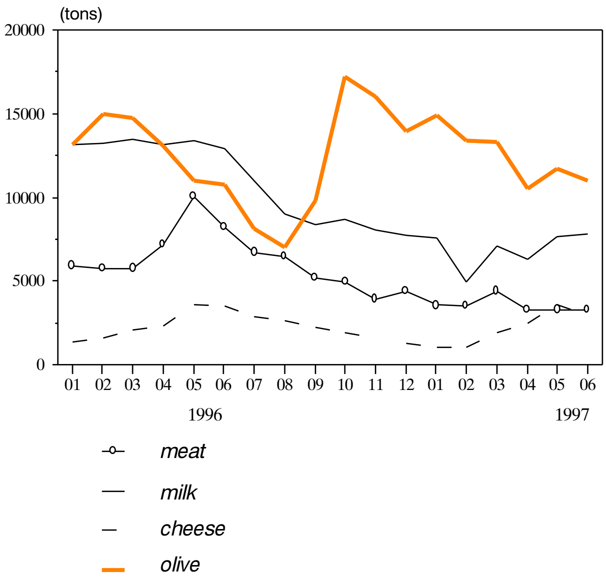
Exports and Imports



Source: BNB

Higher growth rates of imports compared to exports, and a deteriorating trade balance may be expected by the year-end as a result of the real BGL appreciation and the incomes rise in dollar terms (the average wage in USD grew from 45 to 94 USD over the January-June period). Imported goods will thus become relatively cheaper and in greater demand.

Produced Quantity



Source: NSI, AEAF

Imports of some basic foods may increase due to deficits related to output decline.

[8] *The June figures indicate a large decline in export volumes. This, however, is due to the fact that most customs declarations have not been processed and therefore, not all trade operations have been registered.*

In addition, the expected economic revival will generate higher need for import of raw materials and energy resources, and the restructuring of the real sector will increase the import of capital goods.

Table 5

Relative Share of Commodity Groups in Exports and Imports (%)

№	Commodity group	Exports		Imports	
		6m1996	6m1997	6m1996	6m1997
1	Live animals and animal products	2.41	2.36	0.93	0.64
2	Plant products	1.96	1.09	2.09	3.87
3	Plant oils and animal fats	0.36	0.76	0.48	0.27
4	Food industry products, beverages, tobacco	13.16	8.99	7.14	3.33
5	Mineral products	7.89	10.63	27.63	33.44
6	Products of chemical industry	17.88	17.38	10.99	9.68
7	Plastics, rubber, and products	3.84	3.93	3.87	2.87
8	Leather and leather products	0.83	0.83	1.23	1.55
9	Timber, cork, and products	1.50	1.80	0.50	0.43
10	Wood-pulp, cellulose, paper	1.46	1.30	3.49	2.49
11	Textile materials and products	9.76	11.22	8.89	11.93
12	Footwear, hats, umbrellas, artificial flowers, etc.	2.12	2.36	1.14	1.14
13	Products of stone, gypsum, cement, glass, etc.	1.71	1.86	1.26	1.05
14	Precious stones and metals, jewellery, mints	0.27	0.12	0.05	0.05
15	Non-precious metals and products	19.28	21.79	6.47	5.52
16	Machinery, equipment, electrical appliances, and spare parts	6.63	5.52	10.69	13.60
17	Transport vehicles	5.58	4.37	9.57	5.81
18	Optical, photographic, medical instruments and equipment, etc.	2.01	2.40	2.36	1.38
19	Arms ammunition, and parts	0.02	0.03	0.01	0.01
20	Assorted goods and products	1.22	1.14	0.89	0.54
21	Objects of art, antiques	0.11	0.14	0.33	0.42

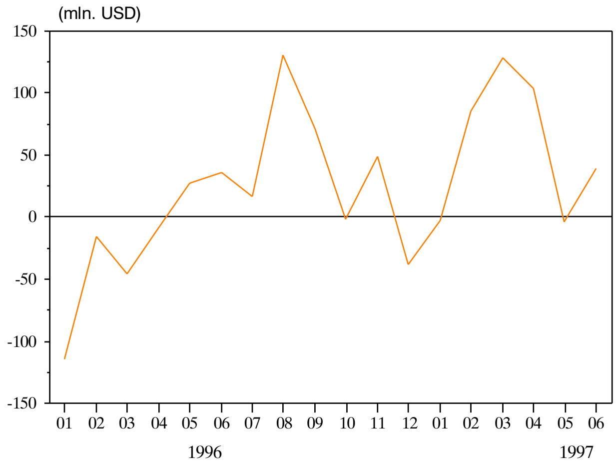
Early foreign trade figures for the first half of 1997 do not reveal any substantial changes in the commodity structure of exports and imports. Non-precious metals, chemical industry products and machinery again have the largest relative share in exports.

Considerable decline was registered in plant products, due mainly to compressed exports of oil seeds and, to a lesser degree, of fruits and vegetables. The export of foodstuffs, especially of beverages and tobacco, dropped (by 24% and 37% respectively). On the other hand, mineral and non-precious metal exports grew by 39% and 17% respectively. Textile exports also increased (19%), reaching 11.2% of total exports. A slight rise was registered in chemical exports.

The largest decline among commodity groups with large relative share in imports was registered in transport vehicles (47%), while increases were recorded in the import of mineral products (4.9%), machinery and equipment (10.3%), and textile materials (16%).

In the first half of 1997 the balance of payments ran a current account surplus of 354 million USD compared to the 121 million USD deficit in the same period of 1996. Although the large surplus was generated by foreign trade, the balance of services also improved. Interest revenues increased by 29 million USD due to the rise in forex reserves, while interest payments declined by 48 million USD. The ratio of interest payments to revenues from the export of goods and non-factor services dropped from 10.1% to 8.6%

Current Account



Source: BNB

Having registered a peak 6-year deficit in 1996, the capital account ran a 207 million USD surplus in the first half of 1997. The direction of capital flows reversed as a result of the economic stabilization at the end of the first quarter. The withdrawal of foreign currency deposits continued in January and February. However, restored confidence in the lev and the banking system discontinued this trend, and April-June saw a 61 million USD increase in household and corporate foreign currency deposits. The success of the stabilization programme of the interim government was conditioned by the new stand-by agreement negotiated with the IMF and the readiness of the World Bank and the European Union to lend financial support to the country.

The conclusion of several large privatization deals substantially contributed to the capital operations surplus. Direct foreign investments reached 282.2 million USD, an increase of 315% on the six-month period of 1996. Portfolio investments also grew due to stronger interest in Bulgarian government securities. The market value of government securities bought by non-residents reached 154.5 million USD in the first half-year period.

Bulgarian medium- and long-term debts to foreign creditors registered an overall decline of 46.8 million USD, but debt to official creditors increased. Debt repayments decreased the amount of short-term debt by 22.7 million USD.

Foreign deposits of commercial banks soared by 319 million USD unlike 1996 when they declined by 154 million USD over the same period.

In the first half-year period the BNB managed to increase its foreign exchange reserves by 860.9 million USD due to the substantial current and capital account surpluses and the 133 million USD net IMF financing. The improved balance of payments in the first half-year period of 1997 largely facilitated the introduction of the currency board, allowing the BNB to accumulate sufficient forex reserves for full coverage of reserve money and prevention of any future crises of confidence in the banking system.

4.4 The budget and the government debt

High inflation and the problems of budget deficit financing influenced the structure of budget expenditures.

Table 6

Structure of Budget Expenditures over the First Six Months of the Corresponding Year (%)

	1994	1995	1996	1997
Expenditures	**100.0**	**100.0**	**100.0**	**100.0**
Non-interest expenditures	59.2	49.1	47.1	39.0
Interest	40.8	50.9	52.9	61.0
domestic	37.1	40.9	43.5	49.8
foreign	3.7	9.9	9.4	11.2

Budget policy since 1994 has given priority to government debt payments, with non-interest budget expenditures being a residual amount. According to this principle, real-term expenditures for the budget-financed sector and social expenditures had to decline on a faster rate than overall budget expenditures and revenues.

Table 7

Rates of Change of Real Budget Expenditures and Revenues in the First Six Months of the Corresponding Year (%)

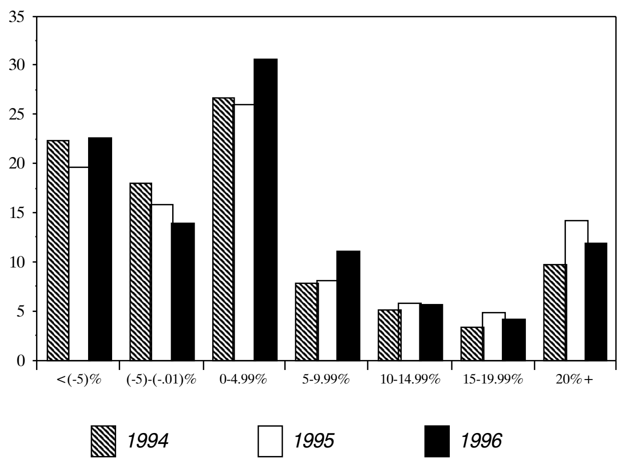
	1995	1996	1997
Expenditures	-7.70	-7.93	-39.22
Current non-interest expenditures	-23.42	-11.79	-49.62
Capital expenditures	-46.07	36.42	-92.18
Interest	15.14	-4.19	-29.97
domestic	1.85	-2.12	-30.45
foreign	149.15	-12.73	-27.75
Revenues	-17.32	-6.23	-45.21
Tax revenues	-10.87	-7.04	-36.41
Direct taxes	0.86	-7.75	-26.70
Income tax	-5.20	-12.44	-32.70
Profit tax total	-4.60	11.24	14.80
Indirect taxes	-16.53	-6.63	-42.21
VAT	1.44	-5.90	-36.47
Non-tax revenues	-35.08	-3.13	-77.42
BNB profit remittance	-51.09	-10.88	-100.00

The dynamics of real revenues indicates a real-term increase in profits-tax revenues in the first half of 1996 and the first half of 1997 due to the accounting practices in the country. As a result, state-sector companies registered considerable revenues. The main reasons for this accounting result are the depreciation of the national currency and the acceleration of inflation. Arbitrage revenues and the accounting of costs of raw materials at their purchase value generated fictitious profits on which real profits tax was levied. This method of profit accounting enabled the budget to partially offset the decline in other real tax revenues, but influenced the operation of the economic system (the financial and non-financial sector) by expanding its decapitalization.

A substantial part of profits tax revenues has also resulted from the lack of market valuation of the assets of state-owned enterprises which are, in fact, the main taxpayers. Asset revaluation is necessary since low depreciation allowances do not let enterprises sustain and renew their assets, as well as make new investments. The low depreciation level in the economy and the lack of investment credits force the conclusion that profits are the only source for sustaining or renewal of used production facilities. Practically, most companies cannot reproduce their production facilities due to bad financial results.

Inflation has also affected the distribution of incomes tax received from taxpayers. Clearly, incomes tax revenues have not increased in real terms, although hyper-inflation in early 1997 raised the average tax rate to about 25% and the minimum wage exceeded the non-taxable minimum. The latter was increased 7-fold in February, bringing only temporary decline in the share of incomes tax in wage incomes.

Capitalization of State-owned Assets



Source: NSI, AEAF

In early 1997 the term of maturity of government securities began to decline rapidly. Until the end of 1996 the shortest term was 3 months and this issue accounted for 2.11% of total debt issued to finance the deficit, while in December its share went up to 23.3%. Under market pressure and the need for credit the Ministry of Finance (MF) began to offer shorter-maturities issues since January 1997 – firstly one-month, then 7-day issues, and even considered issues of customer-ordered terms. In end-January the share of issues falling due in three months or less reached 45%, rising to 59.4% in February, 73.4% in March, and 76.3% in April. With the end of the crisis the share of shortest-term issues fell to 71.1%, in May further declining to 57.4% in June, while 7-day issues were gradually terminated.

Table 8

Government Securities (GS) Turnover in the First Six Months of the Corresponding Year

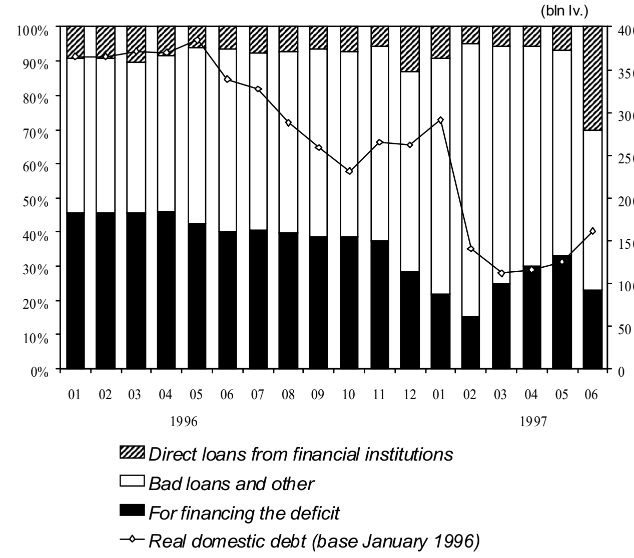
(Government securities issued to finance the budget deficit in billion lev)

	1996 H1	1996 H2	1997 H1
Issued	110.6	293.5	3652.8
Matured	68.1	189.7	3088.9
Net issues	42.5	103.8	563.9
GS in the beginning of the period	154.8	197.3	301.1
GS at the end of the period	197.2	301.1	865.0
Issued/GS in the beginning of the period	71.5%	148.8%	1213.2%
Matured/GS in the beginning of the period	44.0%	96.2%	1025.9%
Net issues/GS in the beginning of the period	27.5%	52.6%	187.3%
GS at end-period/GS in beginning of period	127.5%	152.6%	287.3%
Short-term GS at end-period	59.7%	74.6%	88.5%
Long-term GS at end-period	40.3%	25.4%	11.5%

Hyperinflation in February 1997 changed the real volume and structures of the domestic government debt.

Despite high nominal interest rates a large part of the debt was „wiped off“. There was no substantial change in the forex component of the debt whose share expanded sizably, reflecting the exchange rate trend. However, despite its large nominal amount, it consists mainly of the dollar-denominated bonds issued under the Law on Settlement of Non-performing Debts (Art.5), on which an

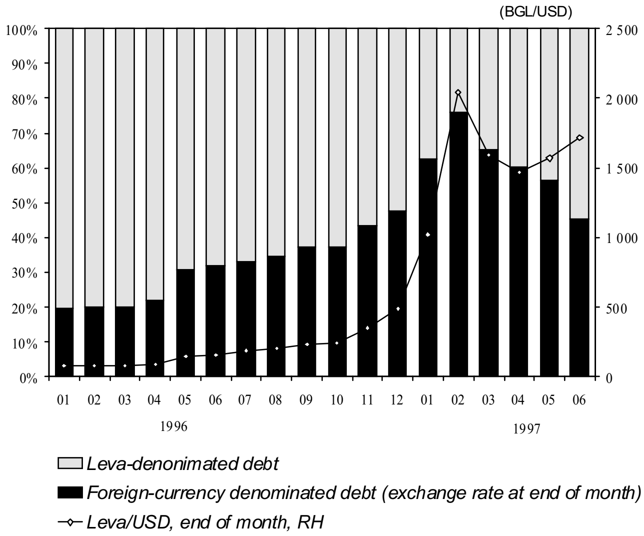
Domestic Government Debt by Type of Debt



Source: BNB, MF

averaged 6-month LIBOR is paid. In July a 27 million USD interest falls due on the 892 million bad-debt bonds available as of end-June 1997. At the same time, this type of securities can be used as payment in privatization deals, and a large share of them may be repaid in this way.

Foreign-Currency and Leva-denominated Debt



Source: BNB, MF

4.5. The banking system

Following the isolation of almost all banks with negative net value in which a large part of credit arrears were concentrated, the banking system as a whole began to show signs of stabilization. The segmentation of the system from 1995 till mid-1997 underwent considerable changes. The distribution according to the volume and kind of assets was paralleled by an expanding group of inoperative banks whose share in commercial bank assets amounted to 27% as of December 1996. As a result of the deduction of their liabilities and receivables, their share in the volume of assets gradually declined to 11% in 1997.

Big state-owned banks set up as result of large-scale consolidation programmes still account for the largest share – at the end of the first six-month period of 1997 they held 73% of assets, 80% of deposits of non-financial institutions, and 90% of commercial bank investments in government securities. Their share will decline with the progress of the privatization programme whose first stage was the sale of two-thirds of the United Bulgarian Bank to foreign investors. The capital adequacy of each of these banks is positive, although for some it falls below the 8% normative limit set in Regulation No 8 of the BNB.

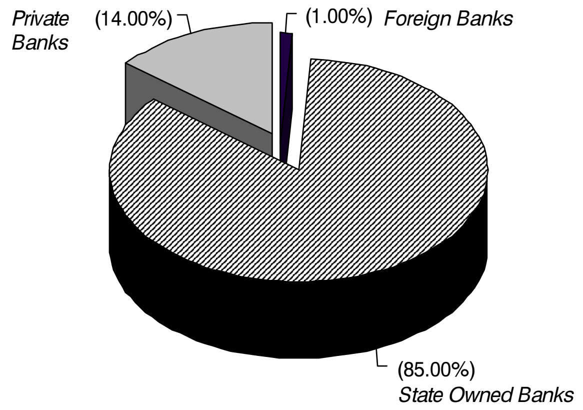
The share of private banks in the assets total amounted to 11% in end-June. Its lower level relative to 1995 was due to the placement of certain banks in receivership. Private banks have attracted 12% of the deposits of non-financial institutions and 5.5% of government securities held by commercial banks. Foreign banks and their branches have steadily increased their market share. In 1995 they accounted for only 1% of commercial bank assets, while in June 1997 their share amounted to 5% and is expected to rise at higher rates.

Commercial banks' profits in 1996 amounted to 140 billion lev. Adjusted for net arbitrage revenues, the operative balance turns negative. Bank losses in the first six-month period of 1997 would have been larger if net arbitrage revenues were negative.

The uneven depreciation of the lev in the beginning of 1997 led to a manifold increase in the lev equivalent of assets denominated in foreign currency. In end-1996 the structure of assets and

The Banking System: Structure of Assets

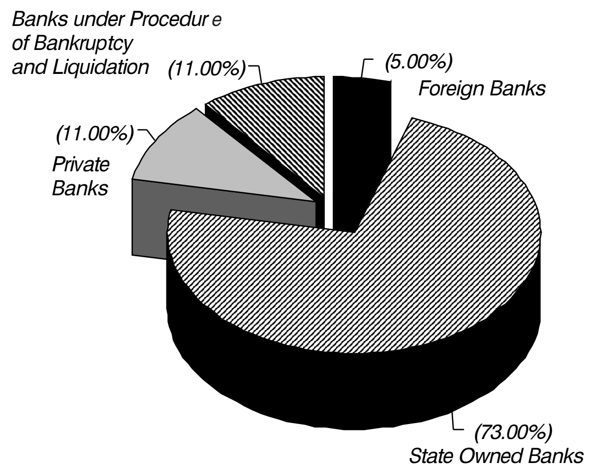
(as of December 1995)



Source: BNB, AEAF

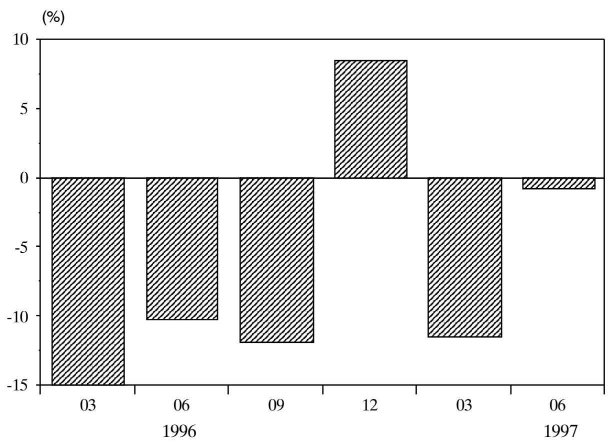
The Banking System: Structure of Assets

(as of June 1997)



Source: BNB, AEAF

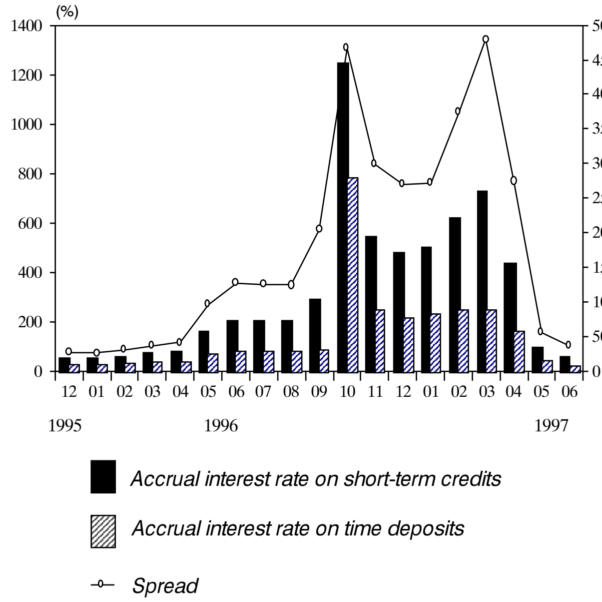
Profits/Losses of the Commercial Banks as a Percentage of GDP



Source: BNB, AEAF

liabilities were clearly disproportionate. 61% of liabilities and 75% of assets of commercial banks were denominated in convertible currency. Open foreign exchange positions generated quick arbitrage profits, the largest being registered in banks with foreign currency-denominated bad debt bonds in their portfolios.

Interest Rates Spread

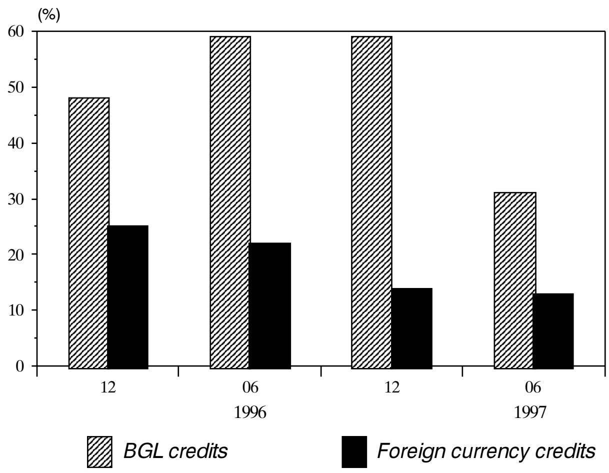


Source: BNB

The high base interest rate widened the scissors between interests on deposits and credits. The interest spread was very large both in nominal terms and as percentage of the base interest rate.

The hyperinflation wave in January-February 1997 depreciated the lev-denominated liabilities of commercial banks, thus facilitating their servicing.

Share of the Overdue Credits as at the End of the Period*



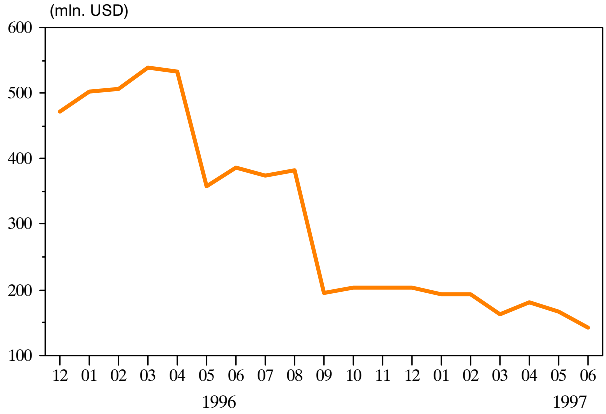
* Banks under conservatorship excluded

Sources: BNB, AEAF

Credit distribution by rate of collection indicates a higher rate of credit portfolio deterioration in private as compared to state-owned banks. At the end of the first six-month period of 1997 only 11% of private bank credits were regular. At the same time, the share of credits in the A category increased considerably[9].

[9] *Since Regulation No.9 on credit classification and normative provisions refers all foreign currency receivables (not referred to a higher-risk group) to the A category, old lev credits may have been transformed into foreign currency credits. However, the dynamics of lev and foreign currency credits in the first half of 1997 indicates the reverse trend. Relative to December 1996, foreign currency receivables declined by 42 million USD, while lev receivables increased over the same period. This questions the accuracy of reported figures and indicates that credit collection is overrated.*

Dynamics of the Overdue Foreign Currency Credits*



* Banks under conservatorship excluded

Source: BNB, AEAF

Foreign banks have not changed their credit policy despite signs of financial stabilization. They still attract resources from local economic agents and channel the bulk of their assets to foreign operations. In end-June extended foreign currency credits for capital investment and current assets amounted to only 38 million USD, and lev credits – to 1 billion lev, while foreign deposits grossed 85 million USD over the same period. Household deposits in foreign commercial banks did not increase in the first six-month period. On the other hand, corporate foreign currency accounts registered an increase of 30 million USD, reaching 92 million USD. A similar dynamics characterized outstanding balances on corporate lev accounts.

The credit policy of foreign banks will be conditional on the success of the structural reform, as they may be encouraged to rechannel their active operations to the real sector in the Bulgarian economy. This move would give enterprises wider access to new credits, increase bank competition, and lower their interest rates.

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