

Part Six

FOREIGN DEBT AND FISCAL IMPACT ON THE CURRENCY BOARD OPERATION

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1. Foreign Debt Impact

The currency board introduction created conditions for an overall change in the economic situation in the Bulgaria. The Bulgarian National Bank (BNB) deprived itself from maintaining a monetary policy. The government cannot rely on direct financing by the Central Bank any more. The commercial banks should forget the refinancing as a means of covering the non-performing loans. The short-term goal is financial stabilization; the long-term one - preconditions for dynamic economic growth. Financial stabilization (at least during the first year of the currency board operation) is possible only together with massive foreign investment. It is estimated to reach \$ 1,000 mln. for 1997, and \$500 mln. for 1998. This apparently leads to an increase in the size of the foreign debt and the cost of its servicing.

1.1. Size, Structure and Problems Connected With the Foreign Debt and Capital Outflows

The foreign debt problem emerged in the late 80ies. Neither its size, nor its servicing used to cause any trouble. In mid-80ies it was slightly above \$1,000 mln., while in the end of the decade it exceeded \$10 mln.

Table 1. Gross Foreign Debt

	1991	1992	1993	1994	1995	1996	1997/*
Gross foreign debt (A+B)	22301.1	13857.7	13889.4	11411.4	10229.2	9571.4	9742.6
A. Long-term debt	2676	3167	3256.6	9267.9	8841.3	8285.4	8191.4
State or guaranteed by the state	2274	2658	2740	8755	8499.7	8089.0	8035.7
Non-guaranteed	402	509	516.6	512.9	341.6	196.4	155.8
I. Official creditors	1872	2256	2338	3216	3084.6	2919.0	2895.7
1. Intern. financial institutions	744	1099	1157	1825	1657.1	1714.5	1788.1
International Monetary Fund	401	590	632	941	716.7	584.6	701.4
World Bank	142	152	155	396	410.6	455.8	480.9
European Union	201	357	357	444	460.6	495.5	441.7
EIB, EBRD	0	0	13	44	69.2	178.6	164.1
2. Bilateral credits	1128	1157	1181	1391	1427.5	1204.5	1107.6
Paris Club and non-prolonged debt	1128	1095	1100	1240	1237.6	1034.5	946.1
Other bilateral credits	0	62	81	151	189.9	170.0	161.5
II. Private creditors	804	911	918.6	6051.9	5756.7	5366.4	5295.7
Brady Bonds	0	0	0	5137	5005.4	4984	4984
Bulbank Bonds	402	402	402	402	409.7	147.2	126.8
Commercial Banks	402	509	511	479	273.3	155.9	111.7
Other private creditors	-	-	5.6	33.9	68.3	79.3	73.2
B. Short-term debt**	9625.1	10690.7	10632.8	2143.5	1387.9	1285.9	1551.2

Source: BNB

* As of 30th June

** Including deposits of non-residents in local commercial banks, T-Bills and overdue debt

The reasons for its fast increase are both internal and external ones. Among the external ones the political factors were of the greatest importance. Despite the proclaimed “Crusade against communist” at that time, the countries from the Soviet bloc had easy access to both private and official credits. The low interest rates after 1994-1995 were an additional incentive for the increase of the debt. On the other hand, the obvious economic disturbance in the socialist countries and the progressively decreasing access to cheap resources from the Soviet Union forced most of them to actively borrow hoping to delay the economic collapse of the system. Bulgaria, Poland and Hungary were to suffer most. The internal factors were the fundamentally mistaken economic policy, unrealistic exchange rates, decrease in hard currency incomes, the aggravated “terms of trade” because of the unfavorable foreign trade product structure - import of processed goods and export of agricultural products. Another reason for the fast accumulation of the debt was that it was not invested properly in order to make possible its repayment. The loans were not used for development of production of tradable goods but for maintaining the living standard (mainly covering the budget deficits) - i.e. “consumed”. Probably part of them have gone back abroad¹ arising additional problems:

- The potential for economic growth declines - the level of domestic investment shrinks, and at the same time the connection between savings and investment is cut. Kept abroad, that capital is not used for import, which at certain conditions could induce growth.
- Tax base contracts, the budget revenues decline, therefore the ability of the government to invest and to service the debt also decrease.
- The contraction of the tax base is usually followed by increase in tax rates which additionally de-stimulate economic activity

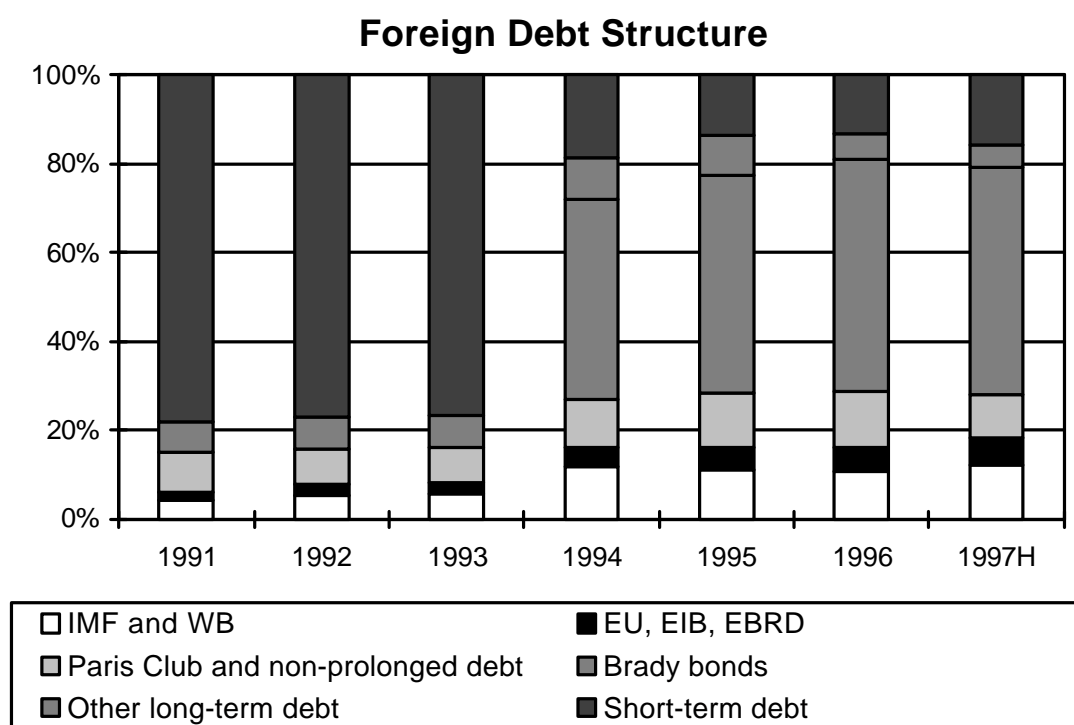
¹ There is a problem with the definition of “outflow of capital”. One and the same process is referred to differently in developed and developing or transition countries. The outflow of capital in the developed countries is considered to be investment abroad, while in developing countries and transition economies it is considered as escape of capital. It is obvious that a precise distinction between investment abroad and capital outflow should be made. In the first case what happens is maximization of profits while in the latter one is escape due to political or/and economic instability, corruption, etc., aiming at hiding capital rather than at maximizing the profits. Empirical evidence proves it is quite natural that capital flows from countries with excessive financial resources to countries where it is deficient. Therefore, in a case of capital flows from developing or transition country to developed country we have escape of capital rather than a normal investment. Another argument in favor of this statement is the fact that countries with huge level of capital outflow usually undertake programs stimulating and attracting foreign capital.

Table 2. Debt Indicators

	1991	1992	1993	1994	1995	1996
Debt/GDP	161.9	161.1	131	118.9	78.7	99.1
Debt/Exports (goods and services)	297.4	275.7	283.6	219.8	151	158.8
Debt Servicing/GDP	3.2	5.1	4.0	15.1	7.3	10.8
Debt Servicing/Exports	5.8	8.8	8.7	27.9	13.9	17.2

Source: BNB

Graph 1



Source: BNB

1.2. Macroeconomic Impact of Foreign Debt Servicing

The important question now is whether Bulgaria can service its debt, and if yes, at what price. Also, is it recommendable its further increase, and are there any dangers of default?

The Table below shows some calculations which estimate the ability of the state to service its debt. The figures **do not stand as a concrete forecast**, but rather as a basis for evaluation of trends in analyzing the problem.

Table 3. Foreign Debt Servicing and Selected Macroeconomic Indicators by year 2000

	Unit	1997	1998	1999	2000
1. Foreign Debt Servicing	USD mln.	1095	1100	1300	1200
2. GDP at current prices	BGL bn.	16750	23000	26840	30300
3. Exports	USD mln.	4850	5086	5490	5930
4. Debt Servicing/GDP	%	10.9	8.6	8.9	7.1
5. Debt Servicing/Exports	%	22.6	21.6	23.7	20.2
6. Interest Expenditures/Budget Expenditures	%	26.3	15.2	16.2	15.7
- domestic debt	%	17.9	5.8	5.5	5.3
- foreign debt	%	8.4	9.4	10.7	10.4

Source: BNB, Bulbank, commercial banks, IMF, estimations of the author

Total amount of payments on the foreign debt is \$ 4,700 mln. by 2000, varying between \$ 1,100 mln. and \$ 1,300 mln. annually.

In 1999, when the loans contracted after 1990 start to mature, the burden reaches its highest level. All new loans will additionally increase the servicing. The unsettled debt to Polish and Russian banks act in the same direction. The fluctuations on the international credit markets will also influence the cost of the debt servicing.

When compiling the Table we take into account the following assumptions:

- The GDP dynamics by 2000 will be positive. This will happen if a favorable economic and legislative conditions for export were in place, given the inevitable increase in imports. Under the contemporary macroeconomic situation the decline of the invested GDP (compared to GDP spent) should be stopped, without decreasing once again consumption. A gradual increase in accumulation should begin together with an increase in foreign direct investment.

- Inflation, measured by CPI, is expected to fall down, but by the end of the century it will be probably above the levels in Germany, given the fact that the reserve currency in Bulgaria is DEM. GDP deflator will also decrease and by year 2000 it is expected to reach 8-9%.

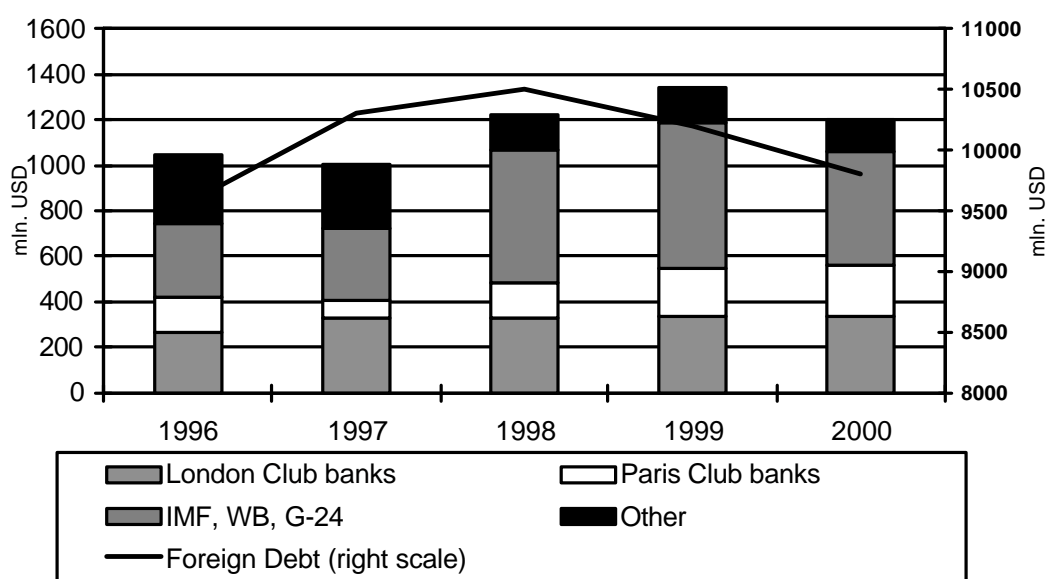
- The budget deficit will also gradually decline, and by 1999 a balanced budget can be expected. This requires expansion of the tax base as well as increase in tax collectibility, after the tax rates are decreased (starting from 1998)

- The nominal exchange rate against the DEM will remain unchanged, and given the higher domestic rate of inflation, the Lev will appreciate. The increase of labor productivity therefore should grow faster than the appreciation rate in order to stimulate exports

- The export growth rate will be almost double the GDP growth rate. If stagnation and chaos in the trade with the CIS and CEE countries continue, and the EU doesn't change its import policy, these rates will be put under question. A great national effort will be needed to accomplish that goal.

Graph 2

Foreign Debt and its Servicing by 2000



The features mentioned above suggest the following effects on the foreign debt servicing:

First, the foreign debt servicing seriously aggravates the ratio between the GDP - produced, and GDP - consumed. It is obvious that during the next couple of years the country will have a significantly trimmed GDP for domestic spending. This means restricted capabilities for maneuvering in all issues connected with consumption and capital accumulation. There is no other solution of that problem than mitigating the consequences through reasonable political and macroeconomic decisions. **This requires modesty in new long- and medium-term borrowing.** By the end of the decade new loans should not exceed the payments on servicing the old debt, given a stable growth of the foreign direct investment.

Secondly, the share of consumption in GDP falls down. Bulgaria has no other choice than “forcing” investment activity in the second half of the decade as well as during the next decade through structural and technological renovation of the production capacities. This will,

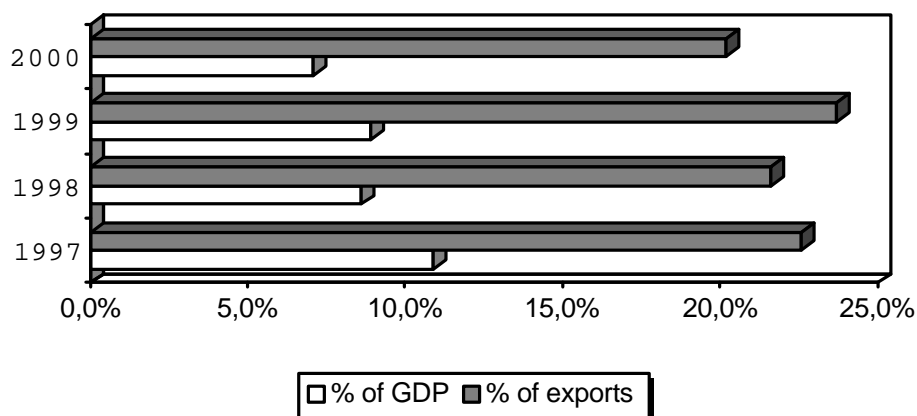
of course, happen in the frame of the domestic spending of the GDP, and will increase contemporary consumption in order to increase the future one. The distribution of the GDP by spending is not related to the foreign debt only at first sight. The foreign debt influences the base for distribution. Besides, without settling the pending foreign debt a massive inflow of foreign capital is hardly probable. Also, the country will remain in isolation on the international commodity, credit and capital markets. Under such an isolation an economic revival and GDP growth is impossible during the following couple of years.

Third, debt payments will seriously affect the ability of the state to implement significant social programs. The stabilization of real incomes will be further hindered. A serious increase in real incomes is hardly to be expected by the end of the century, unless in case of extremely positive coincidence of circumstances.

Fourth, the share of GDP spent on servicing the debt is relatively high (Chart 2). During the following couple of years a significant improvement of that ratio could hardly be expected.

Graph 3

Foreign Debt Servicing



Fifth, the share of the debt servicing payments of export revenues is also very high. While in 1991-1993 it ranged between 1.5 and 6.0%, in 1997-2000 it will reach 20-23%. A slight decline is expected after 2000, but it will remain 13 to 14%. In 1991-1993 that ratio was 15% for the developing countries, and 12,6-14,8% for the CEE countries².

² IMF, World Economic Outlook, Part I. Main Report, p.57

Sixth, the share of debt servicing in the total amount of the budget expenses remains high. Until 1994, the share of the foreign debt payments in the budget expenditures was negligent. The reasons are well known. However, after the country resumed servicing its foreign debt, the share of those expenditures rose significantly. Moreover, at present the payments to the London Club consist only of interest. After 2001, repayment of the principle should start, causing difficulties to the state budget. The problem becomes more complicated when the domestic debt is added. During the next couple of years its size will be determined by controversial factors. On the one hand, the negative real interest rates will diminish its real size and therefore, the cost of its servicing. The basic interest rate (BIR) will fall down together with the decrease in inflation (hopefully) which will also act in the same direction. On the other hand, it is not impossible that the non-performing loans, accumulated in the economy after 1991, are converted into government debt some day.

Regardless all indicators mentioned, the period of 1998-1999 is crucial for the servicing of the foreign debt. Under the current repayment schedule Bulgarian economy is unlikely to bear that burden. Some could argue that the problem can be resolved through new loans to cover the peak payments. But this is possible only with a normally functioning economy. It is not a solution for the immensely indebted Bulgarian economy.

It is obvious that the country has reached its potential to pay to its foreign creditors. It is possible that given the payments on new loans it could be even exceeded. Going into the same situation as the moratorium of 1990 is disastrous for the economy. These problems presuppose relevant solutions to be found before the critical moment occurs. They might be:

1. Negotiations for rescheduling the debt.
2. New borrowing to finance payments on old debt - there is a strong probability of entering a vicious circle.
3. Accelerating debt-equity swaps.

1.3. Pros and Cons of the Debt-Equity Swaps.

The absence of any foreign property in Bulgaria until the last few years left the impression that it is dangerous for the independence of the country.³ The international experience, however, has proved that such practice is not so frightful. The swap operation has been unjustly underestimated and deserves more serious attitude.

³ A question worth answering is if it is worse for the economic independence to swap equity for debt or to implement programs written abroad.

Debt-equity swaps make all agents better off. Bank creditors regain part of their claims by selling them on the secondary market, or become owners, if they also act like investment banks. For the debtor the main advantage is a decrease of obligations and increase in investment. That leads to improvement in the respective indicators in the balance of payments, both in the current account - because of the decreased interest payments, and in the capital account - because of the decrease in the principle. On the other hand, by decreasing the debt, most of the reasons repelling foreign investors, will disappear. Another important advantage is a “boom” of investment. Experience has proved that after swap deals, investment in new or already existing companies increase significantly. This itself leads to modernizing technologies, improvement in management skills, opens the door to new markets and sources of financing. Apart from that, the list of advantages may be continued:

- Debt-equity swaps are a good solution to the problem with capital outflows.
- A successful start in the debt-equity swap program leads to increase in the price of the debt bonds on the secondary capital market. This improves the creditability in the country and stimulates inflow of “fresh” money.

Together with all advantages mentioned above there is also a number of shortcomings of this technique. The positive effect on the balance of payments can be exhausted. Sooner or later, foreign investors should start to repatriate their profit, and in some cases the whole capital. When dividend payments exceed the interest payment, avoided by the scheme, the current account will aggravate, without that effect being compensated by an adequate improvement of the capital account.

The positive impact of the debt-equity swaps should not be exaggerated.⁴ Its low efficiency in solving the debt problem, compared to other instruments, is due to the fact that the biggest part of the profit stemming from the discounted price of the bonds on the secondary market, goes to investors or intermediaries, while under other techniques it goes to the country-debtor.⁵ Another inconvenience is the possibility for legalizing illegally evaded capital. The opportunities for corruption and speculations should also be taken in consideration. There are a number of cases of illegally exported capital, used for buying bonds on the international markets and then converted into equity, using the preferential regime.

⁴ Only one single country in the world - Chile - managed to decrease significantly its foreign debt through debt-equity swaps - about 15-20%.

⁵ One should never forget, that in debt-equity swaps the foreign debt is bought for national currency, while otherwise it should be paid in hard currency.

There is a common belief that debt-equity swaps should be avoided when probability for “fresh” investment exists - i.e. new money is always better than settling old obligations. Some critics even argue that these operations are unprofitable for the country because if an investor is willing to do business in the country, he will with or without using foreign debt bonds. This might be true for countries attracting huge investment interest with high credit rating. Unfortunately, Bulgaria is not among them. This could be proved even by the size of the foreign direct investment during the last 4 years compared to that in Poland, the Czech Republic, Hungary. Therefore, the debt-equity swap program will make possible for the foreign investors to rediscover our country.

Another unfavorable factor is the possible increase in inflation caused by an increase in money supply. It could be avoided by competent operations with T-Bills. And, finally, it could face a strong resistance by the local entrepreneurs because of the different starting conditions for investment before different categories of potential investors. The only solution to that problem is to allow local persons to participate, but as mentioned above, that might be quite a risky enterprise.

During the last three years different governments showed explicit interest in the matter and made first steps to regulate the process. According to the Regulation adopted by the caretaker cabinet, led by Reneta Indjova, foreign debt bonds could be used in privatization of state-owned enterprises, whoever was their holder. The BGL equivalent of the bonds is calculated as the average BGL/USD exchange rate for the last six months before the privatization contract is signed. The restrictions are: obligations for investment, forfeits on privatization contracts, taxes, are not allowed to be paid with foreign debt bonds. Municipal property could also not be bought against bonds. When a public offering of shares of SOE is initiated, payment with foreign debt bonds cannot be done. No restriction on repatriation of profit and capital after a debt-equity swap is provided by the law. This is quite favorable to investors, but is hardly successful for the country.

A point of interest is also the access of local persons to the Brady bonds' market. The principle here should be equal treatment of all participants. The latter however, is impossible due to two reasons: (1) though illegal, export of hard currency abroad is possible, and, (2) local persons can set an off-shore company which according to the law is a foreign person, absolutely legally.

The Zhan Videnov's government made some amendments to the regulations:

- Only 50% of the price of the deal could be paid in Brady bonds. The other half might be paid in cash or ZUNK bonds (bonds issued by the government to settle the non-performing loans of state-owned enterprises extended before 1990)

- Non-paid interest on Brady bonds are accepted for payment, despite the fact that there is no explicit condition for cash payment.

- Profits may not be repatriated for 4 years after the privatization deal is being signed, and capital - for 10 years.

Without any doubts, the restriction implied in the new regulations⁶ did not cheer the foreign investors, especially those with speculative intentions.

The introduction of the currency board and the signs of financial stabilization, as well as the agreements with the IMF and the World Bank changed the investment climate in the country. Confidence is coming back, though very slowly. From that point of view, amendments in the regulations for privatization through foreign debt bonds are absolutely necessary.

The basic provisional changes are as follows:

- increase (from 50% to 75%) in the share of payment through FLIRBs.;
- clarifying whether the second half can be paid in ZUNKs, or not;
- abolishment of any restrictions on repatriation of profit and capital.

These amendment aim at attracting more investors. The increased percentage (from 50% to 75%) provides better opportunities for those, owning FLIRBs. They would be able to buy more property for the same price, other things being equal. Given the overall appreciation of the Bulgarian Brady Bonds, this amendment is quite necessary. Moreover, the still remaining country risk and the further increase in prices will make investment less profitable. As for the restrictions on repatriation of profit and capital, the problems are more “tricky”. The grounds for them lie in the very essence of the Bulgarian Brady deal: according to the agreement with the London Club Bulgaria received 7 year gratis period for the FLIRBs and 30 year gratis period for the DISCs for the principle repayment. They make no sense if the investor can immediately repatriate the capital - i.e. the principle.⁷ The outflow of capital will by all means affect negatively the balance of payments of the country. the question here is whether it will be compensated by higher increase in the foreign direct investment (FDI), which usually follow any privatization deal. If the restrictions were amended this should be followed by strict regulations

⁶ In Council of Ministries' Decree (CMD) N278 of 25 November, 1994 new regulations for debt-equity swaps through foreign debt bonds were adopted, amended later on with CMD 41 of 20 February, 1995.

⁷ The Brady Bonds can be bought at a lower than the face value, while in privatization they are accepted for payment at par. Therefore the repatriation of capital will also be at par value.

providing that the enterprise is not immediately liquidated and the capital - repatriated. Otherwise, it will only facilitate speculative operations without relative restructuring in the real sector. The prolongation negotiated with the London Club should by all means be used. Moreover, there are reasons to believe that a lot of local entrepreneurs are interested in privatization through Brady Bonds, which make all restrictions on repatriation meaningless. As for the foreign investors, these restriction can hardly repel them, if they come with long-term intentions. From that point of view, it is reasonable that only the restriction on repatriation of profit is abolished, and the restriction on repatriation of capital is decreased to 5 years.

Debt-equity swaps, however, are not panacea for economies in debt crises. They cannot, and should not be used instead of other stabilization instruments, but rather in addition to them. A national program is needed for their successful execution, and not a chaotic sale. The elements of that program should at least answer the following questions:

1. Which debt category is applicable for debt-equity swaps?
2. Which category of investors will be attracted?
3. In which sectors the program should be directed?
4. What share of the payment will be accepted in bonds?
5. Should there be any restrictions on repatriation of profit and capital?
6. Should there be a specific tax treatment of investment through debt-equity swaps?

Of what was said, one can conclude that the execution of a balanced debt-equity swaps program will affect positively the economy for quite a long time, without threatening its political and economic independence.

1.4. Some Conclusions

Resolving the foreign debt problem is long and complicated process. It is only a part, though significant, of the revival of the whole Bulgarian economy. It is obvious that without real GDP growth, and especially export growth, without curbing inflation, without reasonable state budget, the country will hardly be able to meet its debt obligations without new loans. The idea of new borrowing to cover old debt payments always ends in a vicious circle.

The analysis so far proves that the Bulgarian Brady deal had to be signed, but only as a part of a larger agreement for.

The most important grounds of the necessity for reduction and restructuring the debt with official creditors lies in the currency board regulations in the country and the real possibility for Bulgaria to achieve not only a financial stabilization, but sustainable economic growth as well. The chance of exiting the vicious circle “high debt - new loans - higher debt”

should not be missed once again. This is the only way of partial compensation for the losses stemming from Gulf War and the UN embargo on Yugoslavia.

2. Fisc Influence

Changing macroeconomic environment in the country, after introducing a Currency Board vitally influenced the cash performance of the state budget in 1997. The process of financial stabilization that started, restoring confidence in the banking system, accompanied by increased liquidity, presenting the macro-frame and the draft budget for the next year on time, had a positive influence on performing the 1997 budget. This way the efforts in the fiscal sector are concentrated on finding an optimal solution guarantying government securities development (through carrying out an adequate issuing policy that by this moment became a major instrument of regulating banking system liquidity), at the same time ensuring the obligatory for the country fiscal reserve indices, included into the IMF Memorandum, and not to allow unjustified increasing.

The radical change of inflation index during the present year influences state budget monthly incomes dynamics. Analyzing data, not taking into consideration this factor shows, that the budget returns are more significant in 1997 compared to previous years. Also, it is to be mentioned that taxes are collected more effectively as a result of measures undertaken by the government. The monthly incomes in the second half of this year (around 289 bln. BGL) remained comparatively steady, despite the rapid decrease of inflation. Keeping inflation at a low level was marked with fluctuating and decreasing monthly incomes (monthly average 132 bln. BGL) during the same period. The conclusions drawn were confirmed by successfully performing the state budget.

At the same time, if there are no additional expenses, the budget year will end with retrenchment of expenses calculated in the 1997 state budget. By 30th of June 1997, Bulgaria's expenses in comparison with the calculated are 39%, by 17th of November — 78.2%, as of the expected by 31st December — 95.3%.

These comparatively low expenses were as a result of both, the government guided restrictive fiscal policy and decreasing interest payments of the budget. Introducing Currency Board and measures undertaken by BNB towards stabilizing banking sector, accompanied with closing non-vigor banks, as well as low regulations envisaged for sanctioning and licensing bank manager and leaders, led to clenching banking activity. In this environment investments in state securities, that are guaranteed by the government and carry minimum risk became a

preferred form of utilizing free sources. The big demand of state securities and the low supply led to decreasing their profitability, respectively (by the methodology of defining basic interest rate) — to decreasing the basic interest rate. This mirrored directly to the size of budget expenses for interests, thus decreasing their share of the general expenses consequently decreased to 61.1% by 30th of June 1997, and 53.8% by 30th of September, as by the end of this year it is expected to reach 40.1%.

After introducing Currency Board a steady trend of increasing general credit demand can be observed. For the purposes of this analysis we consider excluding budget deposit from credit demand as appropriate, because it has big share in it, for unlike other elements it can be used as a financing resource. The data compiled after eliminating this influence shows, that credit demand increase is a result mainly of the fact that most of the payment dates of state securities come at first half of the years, whereas state securities were 7-days issues, that were rolled.

2.1. Budget Deficit Financing

The Law of the State Budget for 1997, unlike previous years, envisaged positive net external financing amounting 133,247.8 mln. BGL. The real size of external financing by 30th of June is negative, amounting -59,593.5 mln. BGL, and by 17th of November -165,601.4 mln. BGL. In case the expected \$100 mln. on FESAL loan are received during the first week of December, and 140 mln. ECU during the period 15-19 of December — by the end of the year the net external financing will reach -52,576 mln. BGL.

Central government budget net internal financing by 30th of June amounts 506,184.7 mln. BGL, by 30th of September — 648,245.1 mln. BGL, by 17th of November — 504,735.7 mln. BGL, as the expectations of its size by the end of the year are to amount 541,819.3 mln. BGL.

Main sources for cash deficit internal financing are state securities operations and credits according to Act. 45 of Central Bank Law. Issuing state securities is considered more dynamic element, which the Ministry of Finance can use to implement its policy and more effectively regulate the fiscal reserve, because credits under Act. 45 of Central Bank Law depend on IMF Agreements and are of defined in advance size and dates of receipt. The net financing with state securities by 30th of June amounts 579,154.8 mln. BGL, by 30th of September - 566,661.1 mln. BGL, and by 17th of November - 558,040.4 mln. BGL. Taking into consideration the issuing policy introduced by the Ministry of Finance, it is expected by 31st of December this year net financing to reach 550,039.7 mln. BGL.

In view of issuing state securities regulatory role, we consider necessary to submit to the market a bigger variety of state securities, both as of maturity and profitability. Realizing different issues can indicate investors' expectations both, in short-term and long-term. Being familiar with these will allow taking optimal motivated managing decisions regarding issuing policy and budget deficit financing. We think that the third quarter of the current year could have realized a bigger size of long-term state securities, if they were issued with a profitability matching better market conditions. Increasing its share in the general size of issuing subverts extension of the loan in time and bring relief in servicing, thus decreasing credit necessities in short-term.

Surveying state securities market shows, that it is still unstable and any rumor of changing macroeconomic indicators can influence it. By our judgment it is evident that after announcing publicly average basic interest rate for 1998 - 10% (that is now considerably lower), a supply increase of state treasury bonds profitability, formed on sell auctions, is observed. The bonds with validity of two years offered in the period have not been realized, in spite of their small size. Additional conclusions on the market can be drawn by the results of sell auctions of the announced two-year state securities on 20th of November with interest payments of six months, whose profitability is formed on the profitability reached at the auction of six-month state securities, prior to the respective interest period + 1 point. From the 5 bln. BGL nominal value securities issued by Ministry of Finance, some 1.35 bln. BGL were sold. Obviously, investors are not inclined to make long-term investment not being clear about the possible profit they can receive from it.

The above confirms our view of a necessary developing and publicly announcing an issuing calendar, that will support effectiveness of management and regulation of banks system liquidity and stabilization of the financial market, as well as investors' confidence because based upon these, they will make grounded decisions regarding managing assets.

In order to limit inflationary bank financing of the budget deficit, we consider government's measures should lead to creating incentives for increasing non-bank financing. Through supporting a proper state securities issuing policy, the government can compensate depreciation of individuals' savings, due to low interest rates that commercial banks render to loans. This is basically because of their weak credit activities (except for state securities issued as a guarantee for consumer loans, thus promoting banks render them).

The dynamics of expident issues sales aimed at individuals and non-financial institutions for now have no steady trend, which can be explained with the investors' confidence

in the banking system. We consider important the fact that for the last quarter a decrease in state securities sales is evident. We think this is due to lowering their profitability in comparison to profitability during inflational periods. The restriction imposed by the Ministry of Finance, in September, on buying-back these securities influenced also. Taking into consideration that the purchases of state securities are made mainly by small investors in dispose of limited assets, in addition they will probably need cash any time, and so they prefer to invest money in time deposits in commercial banks with lower interest rate but bigger liquidity. Other reason for decreasing sales of these specific securities is insufficient advertising after implementing the Currency Board. Practice shows that public needs to be precisely informed of the advantages and disadvantages of every investment. Besides, the individuals willing to invest, before actually buying, want to know the exact size of profitability to be received.

Another main source budget deficit financing are direct credits from BNB, corrected with expenses for servicing old debt. Taking into consideration the process of restructuring government debt according to BNB balance sheet, into debt denominated in Special Drawing Rights, direct bank financing - net by 30th of June amounts 65,304.7 mln. BGL, by 30th of September - 29,659.6 mln. BGL, and by 17 November amounts 256,876.3 mln. BGL. By the end of 1997 it is expected to reach 494,293.9 mln. BGL, including credit already granted amounting 62.2 mln. SDR for November, as well as provided transfer for December amounting 62.2 mln. SDR.

As sources for financing cash deficit, in 1997, a 1996 surplus is used amounting 20,864.6 mln. BGL, plus incomes from privatization that are by 30th of June amount 295,142.0 mln. BGL, by 30th of September - 337,644.8 mln. BGL, and by 17th of November - 435,402.0 mln. BGL, as it is expected size to remain the same at the end of the year.

With realization of expectancies so far, the budget will end the year with comparatively big budget deposit (previous surplus) amounting 830 bln. BGL. In view of the big size of payments in the first days of next year, the existence of this deposit itself creates safety of real execution. At the same time, the problem with negative interest rate differential, that means losses for the budget because a vast amount of it consists of loans.

2.2. Fiscal Reserve

Favorable development of macroeconomic environment during the second half of 1997, allowed forming and supporting comparatively big fiscal reserve which remained more IMF-agreed limit during the whole period. By 30th of June the fiscal reserve amounted 1,113,783.5 mln. BGL, by 30th of September - 1,050,870.0 mln. BGL, by 17th of November - 1,503,372.0

mln. BGL, and by the end of the year it is expected to reach 1,696,000 mln. BGL, while the limit is 1,191,600.0 mln. BGL.

The availability of a big fiscal reserve during this period layed the effective management problem pending. The big share of loans in it requires control both over budget expenses on servicing these obligations, as well as interest rates proceedings that are received on relevant accounts.

The effective fiscal reserve management requires also limiting its wrongful increasing. This is achieved by developing exact recounts of expected budget incomes and an expenditures schedule, based on which to develop a strategy for providing financing sources, and respectively for issuing policy.

The question for an optimal time limits arises from the above, within which to buy all necessary SDR for the country. A conclusion arises that it would be more advantageous for the country is the schedule of IMF tranches recks with payments for servicing government debt. In case a change of this schedule is impossible, we think that it is expedient to decide first whether it will be more appropriate when buying new SDR, to direct them toward SFRD accounts, the same way CCFF. This will stimulate the government to manage reserves more effectively, at the same time BNB will not bear losses because of negative interest differential.

3. Monetary Aggregate and Interest Rates Dynamics

Under Currency Board

After introducing the Currency Board, Central Bank activities are limited to supporting national currency stability through full coverage of monetary reserves (BNB liabilities) with foreign currency on a fixed exchange rate to the DM. BNB potential of intervening in the banking system with monetary instruments is considerably limited to a single available instrument - minimal obligatory reserves (MOR) and is rather of a strategic importance. Referring to this, the main influence of BNB over commercial banks is performed through bank control. Responsibility for financial stabilization under Currency Board is directly connected to government fiscal and revenues policies.

3.1. Monetary Aggregates

Under Currency Board, BNB has no opportunity to control monetary supply. Financing budget deficit and re-financing commercial banks is no longer a source for increasing monetary reserves, as well as (through money multiplier) to broad money. From this viewpoint,

increasing monetary aggregate could only be related to raising real monetary demand due to recovering confidence in the banking system.

3.1.1. Prerequisites for Monetary Aggregate Dynamics

- **Money turnover pace** (GDP/broad money correlation) in 1998 will increase, which means that with an assigned value of GDP, necessary money for normal functioning of the economy will be less, in comparison with previous years. After the dramatic changes in 1997, money demand volume still cannot be restored. Real sector development, which is determining transaction motive in money demand, does not reason considerable money demand increase. Probably, after all shocks survived, economic agents have changed their attitudes toward money, therefore, new standards of inter-relations between GDP and money are introduced. This way, any comparison with previous years cannot be used as a start point, even less as a goal. Monetary turnover pace can be influenced by different factors: inflation (\uparrow), interest rates (\downarrow), informal economy share (\downarrow), payment system development (\uparrow). Forecasting this rate will be difficult, because of contradiction of factors influence. It can be assumed that after 1998 this rate will be stabilized with a slight trend of reduction, due to general economic and financial stabilization.

- **Money multiplier** is expected to increase. After introducing Currency Board, the share of money in turnover to attracted deposits is showing increase as well. In the previous four years this share was limited between 10-12%, and by the end of 1997 reached 28%. Basic reason for this can be found in decline of deposits amount as a whole, due to bank system confidence crisis, as well as rapid decrease of interest rates. Economic agents decide to keep most of their money in cash, thus increasing money in turnover, rather than deposits. This brings lowering of money multiplier, nevertheless this trend is opposed by decrease of bank reserves/attracted deposits correlation. The above can be expected mainly because of decline of commercial banks' reserves.

- **Net BNB foreign assets** will increase due to expected growth of international foreign currency reserves, pledged in the balance of payments. Because of the small real sector, this forecast includes an increase of commercial banks' assets for 1998. This means capital outflow and convulsion of domestic crediting capacity. Interest rates stabilization is expected, leading to stabilization of the real sector, which on its turn can stimulate commercial banks to allocate more credits toward domestic market and reduction of assets. It should be stressed upon, that every delay in structural reform will postpone in time retrieving Bulgarian capital

back to Bulgaria, as well as convulsion of domestic crediting capacity (especially for non-governmental sector), which finally leads to slower economic growth pace.

- **Low budget deficit** provided in the Law of the State Budget for 1998 (around 2% of GDP) and the possibility of financing to be carried out only by incomes from privatization and external financing, brings along an environment, where government claims will decline, thus re-allocating resources for crediting the non-governmental sector. This forecast includes out viewpoint, that the government will not only stop accumulating claims, but will decrease the domestic debt through issuing negative state securities. This way, it will help commercial banks liquidity. For 1999 and 2000, a well balanced budget is foreseen to accelerate the above process.

- No change in the **exchange rate BGL/DM** is to be expected, as all forecasts are based on fixed exchange rate BGL/USD.

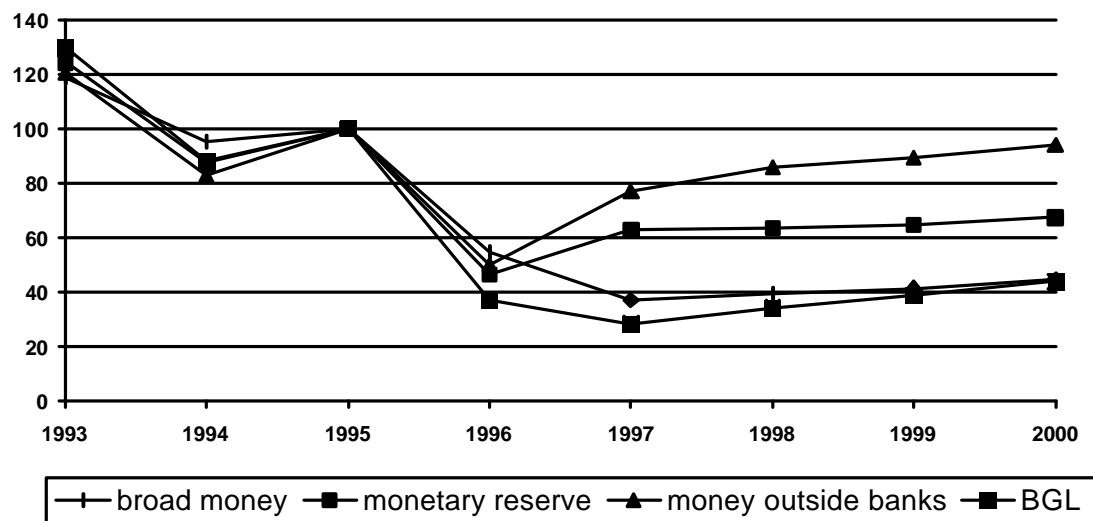
3.1.2. Basic parameters for year-2000 money report

- Nominal expression of broad money growth till year 2000 is foreseen to be more than the accumulated inflation for the years studied. This way, a real increase of money supply is ensured, which will catalyze process of re-monetarization of the economy that started after introducing the Currency Board. The process that was commenced is slow and steady - the real growth of broad money is at average 6% annually, and average annual share of broad money to GDP grows with 1 percentage point per year. By the end of period studied, this correlation will reach about 32%, while in 1993 and 1994 it was more than 60%, and by the end of 1997 - 25%⁸. The slow pace of re-monetarization is determined from both, money turnover trend, and BNB responsibility to cover all monetary obligations with gross foreign currency reserves, emanating from Act. 28 of Central Bank Law. The limited opportunities of BNB to increase monetary reserves through re-financing commercial banks and through lending direct credits for the government results in limiting monetary aggregate growth. Increasing monetary aggregate (the share of broad/reserve money) cannot compensate the above mentioned factors influence, hence, re-monetarization of the economy will probably slow down.

⁸ As it was stressed above, after the economic crisis and hyperinflation, money demand convulsed and brought a new balance point between money and production - i.e. neither money turnover can reach back values of 1.26 - 1.27 (as of 1993 and 1994 respectively), nor broad money can exceed 60% of GDP.

Graph 4.

Monetary Aggregates Dynamics 1995=100



- **Monetary reserve** growth is determined by the Currency Board rules. In real measurement, the growth is 1 to 4% per year, as the only source for that are foreign currency reserves, followed by balance of payments development. Government claims from BNB the will decrease both, in nominal and real terms, resulting from the introduced fiscal discipline and low budget deficit. Balancing budget is based on reduction of non-interest payment, as well as decline of interest payments on servicing domestic debt based on drastic decline of basic interest rate. No movement on commercial banks claims to BNB is calculated, which means no banking administration deposit is to be used for re-financing banks with liquidity problems. Nevertheless, it is possible to use this instrument in order to avoid any further financial crises.

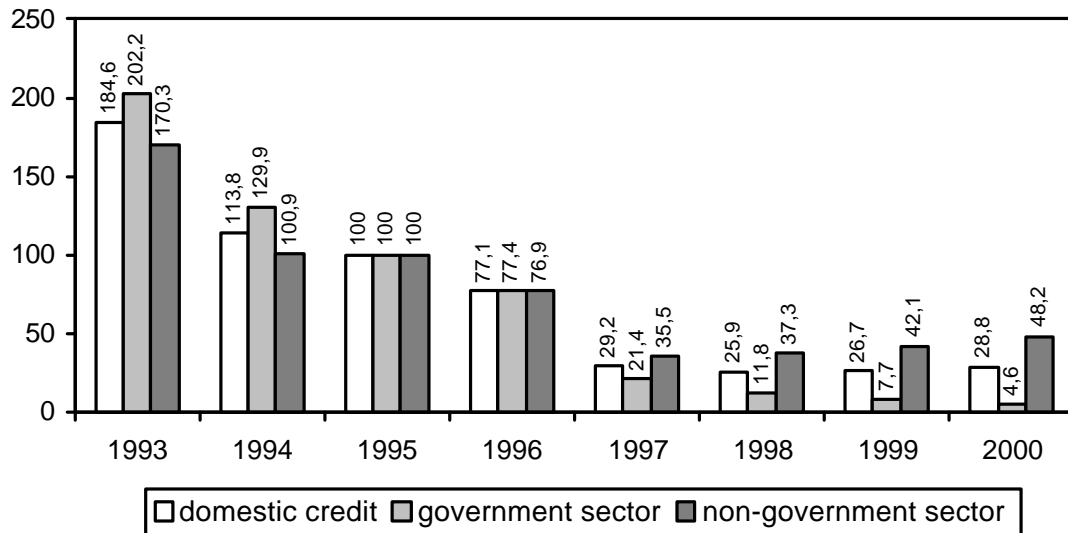
- Increasing **net foreign assets** is determined both, by balance of payments, and by commercial banks behavior. The expected development of balance of the payments for 1998 and commitments toward international financial institutions, gives ground to increase BNB foreign currency reserves by \$440 mln. Regarding the calculated current payments deficit, this increase will be totally due to the positive balance on the capital account, resulting from foreign investment (from privatization - around \$400-500 mln.), credits from international financial institutions - the IMF, World Bank, European Community - app. \$600 mln. The commercial banks behavior after introducing Currency Board and hyper-reserves accumulated, gives reason to assume that in 1998 they will increase their foreign deposits (with app. \$300 mln.), which will contribute to net foreign assets growth. In the following two years, along with real sector

stabilization, this trend will probably break, as commercial banks will allocate more resources for crediting production. With expected increase of BNB foreign currency reserves in 1999 and 2000 with about \$250 mln., net foreign assets will slow down their growth, and in real terms will even decline 1% per year.

- **Domestic credit** in 1997 showed radical decline of 60% in real terms. In 1998, this trend will even be harder to overcome, as it is expected to reach 11% reduction due to real decrease in government claims estimated to 45%. For the next years a growth of domestic credit is projected with resp. 3 and 8% annually. Along with changes in nominal real terms, a prompt restructuring process of domestic credit is assumed, as the bigger share of it will go to non-governmental sector. Just as a comparison: the credits aimed at government sector agents correlated to credits for non-government sector was, as follows: 1993 - 104%, 1994 - 96%, 1995 - 124%, 1996 - 123%, and 1997 - 49%. For 1998 this correlation is estimated to reach around 26%, and by the end of 2000 - 8%. Non-governmental credits increase is a prerequisite of vital importance for reviving the economy and sustaining steady paces of economic growth. Provided that a negative balance of current payments is calculated, the assumed GDP increase for 1998 is 3-4%, and could only be reached if investment rapidly grows, at the same time keeping slow and steady pace of domestic consumption growth. For the time being foreign investment is aimed mainly toward privatization, i.e. no new production capacities are created, there is an ongoing process of changing ownership. This means that a very important source for reviving the economy remains domestic investment, expressed in growth of credits for the non-governmental sector. The forecast includes real increase pace, resp. 5, 12 and 14% per year, that are sufficient for the calculated GDP growth. It should be mentioned, that during the last few years, credits for non-governmental sector have been steadily reducing in real terms, even during years with GDP increase (1994 and 1995). During these years, however, there is noted a process of accumulating inter-company liabilities, bad credits, which become an indirect form of financing. If this negative process ends, credits growth assumed for non-governmental sector will in real terms mean credit expansion, with all bared consequences. Commercial banks will face an ordeal. From one side, accumulated hyper-reserves and limited state securities emissions will urge them to grant new credits. From the other side, bad memories of recent financial crisis, limitations by Banks law, low capital adequacy and unwillingness to undertake risks will prevent them from lending more money. Related to the above, the responsibility not only of the commercial banks becomes enormous, but of BNB to control and monitor all transaction and limiting credit expansion before it turn into another financial disaster.

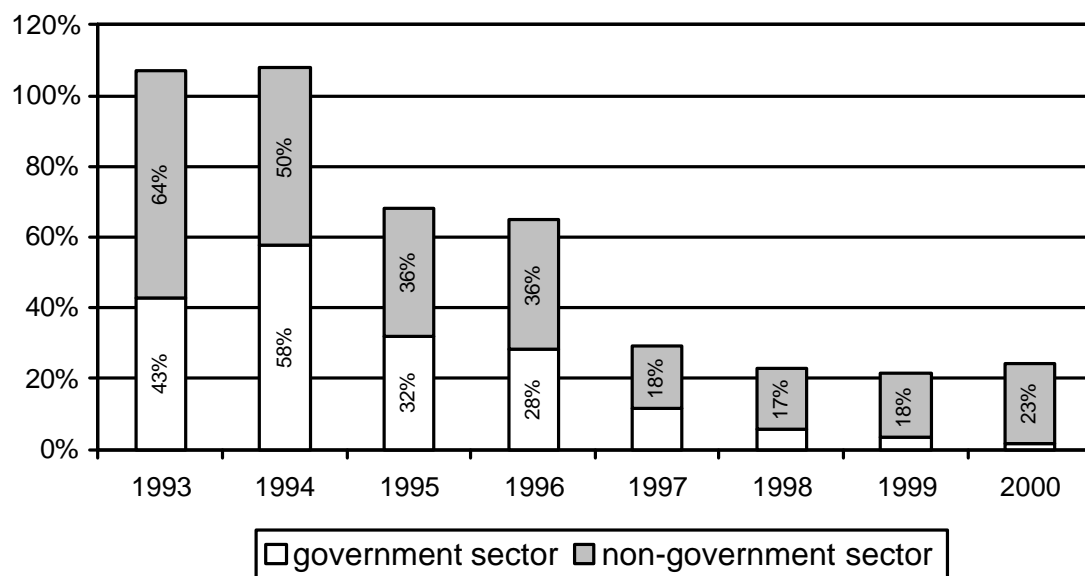
Graph 5

**Domestic credit - real changes
1995=100**



Graph 6

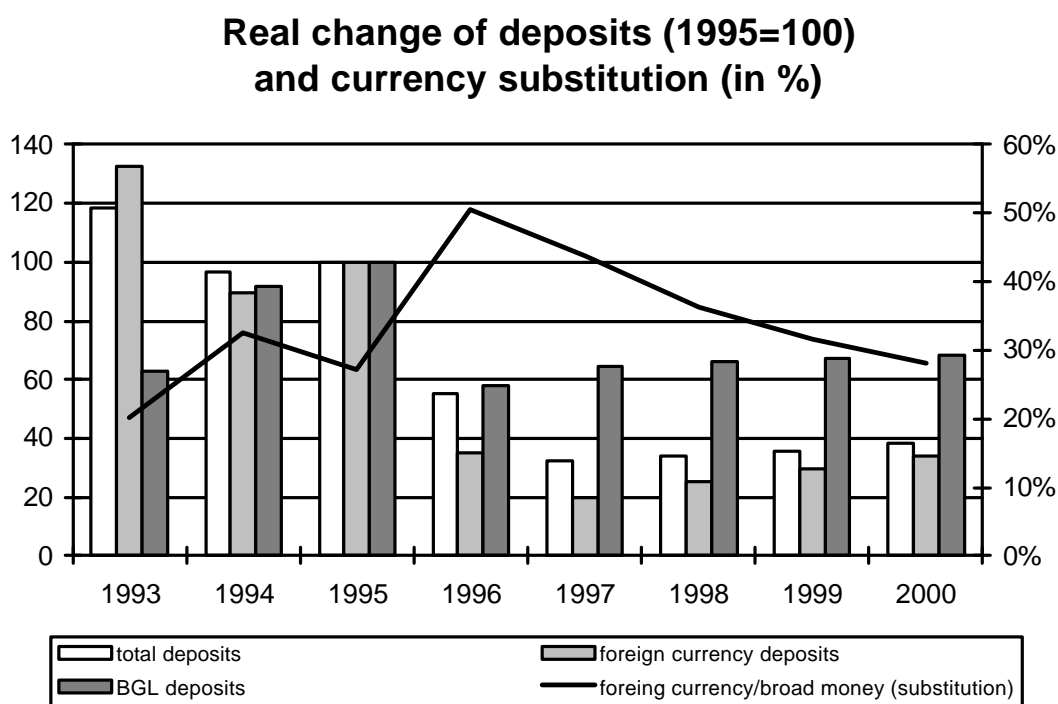
Domestic credit as a % of GDP



- Resulting from the financial crisis and radical reduction of confidence in the banking system in 1996 and 1997, **deposits** amount decreased in real term, resp. with 45 and 41%. The nation still keep a suspicion toward banks, public opinion polls show evidence that almost half of the interviewed (46%) have no confidence in the banking system. Apart from introducing the Currency Board, recovering this confidence will be a slow and difficult process,

which limits deposits amount growth. A limiting factor will be the income policy which assumes no sharp changes in view of supporting competitiveness of export under a fixed exchange rate. The real growth of deposits is estimated up to 57% per year, as BGL deposits will forestall foreign currency deposits both, by size and pace. The process of currency substitution will subside as foreign currency/broad money correlation will gradually decrease to 30%.

Graph 7



3.2. Interest Rates

The main goal of the Currency Board is to remove all negative expectations, accelerate investment activity, assure economic growth. With fixed exchange rate, the basic interest rate (BIR) is a single macroeconomic instrument to determine main economic agents' behavior. By forming and changing it, the real situation in the monetary sector, economy as a whole and investment, can be observed. *The only function of BIR, which is only announced by BNB, is to be an indicator of economic situation, improving economic agents' rationality.* Incompatible levels of interest rates, based on improper methodology for determining, as well as frequent fluctuation can turn to the crisis of the banking system, as it almost always lies in other countries' systematic crises. Under a currency Board such systematic crises are very hard to overcome, and this can badly compromise the future development of the country.

In countries with currency boards, there is no BIR. These are Argentina, Estonia and Lithuania. Art. 35 of Central Bank Law does not allow this in Bulgaria. A serious though on removing this article is worth.

In developed countries, the inter-bank market interest rate on money turned over is used as a base. In Bulgaria, this market is underdeveloped, albeit ending BNB re-financing policy. The slow development of inter-bank market is an indicator of the low confidence in the general economic environment. As a whole, money market is segmented, there is no correspondence between different segments and it is difficult to formulate profitability curve. This way an easy transfer from one asset to another is impeded, possibilities for prompt arbitrage and liquidity are limited. Developing and motivating the inter-bank money market is urgent; serious administrative and economic measures are of vital importance⁹.

The present determination of BIR, based on three-month auctions of state securities profitability shows the dynamics only of the money market segments, and cannot be used as a representative indicator of money price. Lack of BNB intervention instruments, used to adjust bank system liquidity, forces the Ministry of Finance to carry out some non-inherent money-related functions. Through state securities emissions, the Ministry is trying both, the solve budget, and liquidity problems. This brings contradiction, because if possible, the Ministry of Finance will aim (mostly with these emissions) at minimizing new state securities emissions profitability, thus solving future problems with dividends payments on emissions related to BIR. Looking at the issue from this point of view, ***BIR is not quite market oriented*** (if “market orientation” can be used here at all, because state securities supply is a monopoly of the state itself). BIR depends on cash budget deficit dynamics, which makes it fluctuate. It is obvious that with the present methodology, servicing domestic debt is relieved, but BIR does not display demand and supply of money, but demand and supply of state securities (only three-month emissions), that is only one segment of the money market. Even more, under Currency Board, the interest rate should ***fast and effectively react*** on inflow and outflow of foreign capitals in view of stabilizing liquidity. If not, Currency Board principles can easily be compromised.

After ending repo-operations of BNB, commercial banks’ hyper-reserves are curtly increased. Commercial banks in current environment with no re-financing will probably keep bigger reserves in BNB, because of liquidity problems hazard. Lack of data far enough back in time, however, does not allow to estimate hyper-reserves of banks under Currency Board and

⁹ The Association of Commercial Banks proposal that views possibilities for guaranteeing inter-bank money market with later’s reserves kept in BNB, is worth to consider.

possible indirect influence on determining BIR. Underdeveloped inter-bank market still does not determine BIR based on real interest rates.

All the above brings to a conclusion that the methodology for determining BIR will obviously not be changed soon, which also means that BIR will remain low and fluctuate in the limits of 6-8% on annual basis¹⁰. This actually proves that no earlier than year 2000 interest rates level can be expected to become positive. Real negative interest rates are profitable for investors, but savers must once again bear losses. It is obvious, though, that this abuse of ordinary savers' patience cannot carry on forever. In previous years, nominally high interest rates level on deposits in fact hide the truth about their real depreciation. After introducing the Currency Board and proclaimed financial stabilization, it will be even more difficult to explain why each BGL deposited in a bank is "losing", instead of "multiplied"¹¹. The commercial banks still form their interest rates policy, following BIR dynamics, without being forced, not administratively, nor economically for such a policy. Moreover, a trend for big banks to announce same interest on deposits can be observed, i.e. competition on attracting sources is omitted. Under these circumstances, competition should show up in banks' active operations, which in similar environment narrows interest spread.

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¹⁰ In view of expectations for low budget deficit and stable fiscal reserves, the reason for sharp growth of BIR could only be reduction in state securities demand, caused by increased commercial banks' investment abroad process.

¹¹ This can lead to deposit amount erosion. If money move toward stock exchange, i.e. direct to real sector, without commercial banks intermediate, there will be no negative effect on the economy.