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The Bulgarian National Bank and the New Bulgaria

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By Warren Coats[1]

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Introduction

The Bulgarian National Bank (BNB) has seen many changes over its 126 years of operation. Among the most important were the "sovietisation" of the banking system in late 1947, the return to a two tier banking system in 1991, the privatization of the banks over the rest of the 1990s, the banking crisis of 1996-97 and the introduction of currency board arrangements on July 1, 1997. Each of these episodes had profound impacts on economic life in Bulgaria. As an institution, while always proud, the BNB has had its ups and downs as well. Bulgaria's march toward a market economy and democracy following the collapse of the Soviet Union started slowly. It suffered a major set back with the banking crisis of 1996 and 7 and the related hyperinflation. Only with the introduction of currency board arrangements in mid 1997, did the BNB's contribution to Bulgaria's economic growth take deep roots.

I was involved in the BNB's early efforts to rebuild its capacity to conduct monetary policy and supervise banks in a market economy environment, in its efforts to manage the banking crisis of 1996-7 and its establishment of currency board arrangements. I also lead the IMF teams that established the Central Bank of Bosnia and Herzegovina at almost the same time, which operates a very strict currency board regime with great success. I was one of those at the IMF who strongly supported the adoption of currency board rules in Bulgaria.

The establishment of credible currency board rules for the BNB was a watershed for Bulgaria in its slow quest to develop a modern market economy. While the behavior and performance of an economy is the result of many factors, and this is a proposition I wish to stress in this presentation, a sharp improvement occurred with the introduction of currency board rules in Bulgaria.

Over the six years preceding the crisis year of 1997 (1991-1996), the year in which currency board rules were adopted, inflation, measured by the consumer price index (CPI), averaged 130 percent per year. Over the six years following 1997 (1998-

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2003) the CPI averaged under 8 percent per year. That average was pulled up by the 19 percent inflation in 1998 and had dropped to under 3 percent in 2003.

Over the same six years preceding 1997, real income, measured by Gross Domestic Product (GDP) adjusted for inflation, fell by 3.6 percent per year on average. Over the six years following 1997 real GDP grew by 4.2 percent per year on average. Preliminary estimates for 2004 are that real GDP grew by another 5 percent. Per capita GDP rose from 1,240 US dollars in 1996 to 2,546 dollars in 2003.

Between these two periods employment actual fell slightly from an average of 3.3 million before 1997 and 3.0 million after 1997. However, there was a dramatic shift from employment in the public sector to the private sector. In 1993 72 percent of those employed worked in the public sector while in 2002 that ratio had fallen to 25 percent. Thus over the same period, private sector employment rose from 28 percent of the total to 75 percent. The large increase in productivity resulting from this shift, and from other factors, helps explain how per capital income doubled over this period while employ fell slightly.

Currency board arrangements have been extensively discussed in Bulgaria and elsewhere. An excellent account of such arrangements in Bulgaria is given by my IMF colleague Ann-Marie Gulde in several places.[2] In my remarks today I wish to put Bulgaria's currency board regime in its broader context, in order to highlight what currency board can do and what they cannot do, and to update the economic results for Bulgaria of its currency board arrangements.

Background

Clearly, economic performance before and after 1997 were very different. The adoption of currency board rules in 1997 made a very profound difference. It would be a mistake, however, to assume that the currency board was the only difference that really mattered. You cannot eat money, even stable money. Bulgaria's willingness to adopt currency board rules, and its determination to make the arrangement credible, signaled an important change in attitude more broadly.

Maintaining a stable currency is a necessary but not sufficient condition for a healthy economy. It provides reasonable predictability of the value of the unit in which contracts and obligations of all sorts will be denominated. It is one element, but a very important element, of the rule of law. Bulgaria's adoption of a credible currency board arrangement signaled its intention to establish and deepen the rule of law.

It is useful to review the limited and ultimately ineffective reforms that preceded the crisis of 1996 and 97. All CEEC countries had undertaken stabilization and reform

[2] Ann-Marie Gulde, "The Role of the Currency Board in Bulgaria's Stabilization" *Finance and Development,* September 1999; and "The Role of the Currency Board in Bulgaria's Stabilization," *IMF Policy Discussion Paper,* April 1999.

programs by 1994. Hungary and Poland started in 1990. All of the others started in 1991 or 92 except for Croatia, which started with a currency reform in 1994. Over the three year from 1994 three 1996, growth in real income in Bulgaria, which averaged [] was the lowest among all CEEC countries, which averaged []. Over the six years after introducing currency board rules, from 1998 through 2003, real income growth in Bulgaria averaged [], while all CEED countries averaged [].

Table 5: Selected Performance Indicators
(P = year in which stabilization program began)

	Real GDP			Inflation		Broad Money/GDP
	1998/1989	Average	Average	Average	Average	
	percent	2 years before P	3 years after P	2 years before P	3 years after P	1998/1993
Albania	87	-17.6	9.1	170.3	17.6	149.0
Bulgaria	66	-10.5	0.8	205.8	88.4	34.7
Croatia	79	-1.1	5.1	573.4	3.6	301.1
Czech Rep	97	-7.2	3.4	35.2	14.5	110.9
Estonia	77	-12.6	2.1	628.8	35.4	109.0
Hungary	95	-1.4	-0.3	23.0	26.8	84.7
Latvia	58	-22.7	1.0	561.7	56.7	78.7
Lithuania	63	-13.5	-0.6	772.7	89.8	75.3
Macedonia	59	-16.6	-0.7	1020.1	98.1	46.5
Poland	118	-5.7	3.9	444.4	47.5	130.6
Romania	78	-9.3	4.2	130.4	185.5	147.1
Slovak Rep	100	-7.7	2.7	38.2	15.3	97.3
Slovenia	103	-6.8	4.1	173.1	45.6	187.8
Average	83.1	-10.2	2.7	367.4	55.7	119.4

What was wrong with Bulgaria's stabilization efforts before 1997 and what was right, or at least better, after that?

"We [Bulgaria] had the worst political, economic and social position one can imagine: week and archaic state institutions, unstable political system with a frequent change of governments, economic downfall and hyperinflation, two-digit budget deficit and an economy with a huge portion of non-competitive state-owned companies. We were dramatically lagging behind others. In late 1996 and early 1997 we were hit by a grave crisis. The progress we made is to be attributed to the steady hard work of a new generation of Bulgarians who desire to build a modern country that holds a place of its own in the globalizing world."[3]

Bulgaria's reforms were launched rather dramatically in February 1991 after the creation of the coalition government of Dimitar Popov. Most prices and import and

[3] Ivan Kostov, [Then] Prime Minister of the Republic of Bulgaria, Economic Reform and Progress in Bulgaria, a statement in Washington DC, April 23, 2001.

export controls were dramatically liberalized. The lev exchange rate was unified and floated on a newly established interbank currency market. Debt reduction and stabilization were financed and reforms were supported by a one-year “Standby” loan from the IMF.

My IMF colleagues who had visited Sofia in February 1991 had found shivering sales clerk standing next to empty shelves in what was then still a large state department store across from the Sheraton Hotel. It was a very cold February in Sofia and heat was scarce. The sales clerks had come to work knowing that they had nothing to sell, but did not know what else to do. Sofia was a drab, very Soviet, and sad place. I visited Bulgaria for the first time in February and March 1992. The launch of Bulgaria’s market reforms was already a year old. Some of the initial responses were dramatic and positive. The same state department store again had some goods on its shelves.

However, transforming centrally planned economic and political systems into democratic, market ones requires much more that liberalizing markets. Many elements of the much broader reform blue print prepared by the U.S. Chamber of Commerce Foundation, led by Richard Rahn, where ignored or postponed. But even if they had all been pursued vigorously, the task was bigger and more complex than most of us had realized. The model of the post World War II German Wirtshafts Wunder, which had so influenced many of us, was just not applicable to the newly independent states of the former Soviet Union or even of Central and Eastern Europe. New institutions—the institutions of capitalism—new rules, new knowledge, new attitudes would take a long time to develop even if there were unwavering public and political support for them. And where was such support to come from? Much of it came, of course, from the wave of history Bulgaria was part of in the 1990, but it was unsteady and uneven.

Dr. Ognian Pishev summarized important aspects of the difficulties Bulgaria faced: “Despite the emergence of a strong and independent Central bank capable of carrying out strict monetary policies and combating inflation, brought down from almost 300 % in 1991 to less than 80 % in 1992, banking and financial sector reform were further delayed. Moreover, the commercial banks, most of them state-owned, were the first to realize their particular interest in channeling credit for spontaneous privatization. A demonstration of this well-organized spontaneity is the establishment of a new circular pattern of economic behavior. For instance, a public enterprise guarantees a sizable bank loan to a private company set up by the next of kin of the public enterprise's managers. The private company's management in turn buys shares of the commercial bank that gave the loan. Because financial sector profits are the most reliable source of tax revenue, the Ministry of Finance was ready to tolerate such practices, even though they ran against the logic of economic reform. Instead, the government opted for more immediate control over the real economy through demonopolization and transformation of public enterprises into joint-stock companies with the state as the sole shareholder.

“Such policies cannot eliminate CMEA-inherited dependence and structural rigidities. The pace of reform is quite uneven across sectors - the external sector is responding to market incentives and signals - price and trade liberalization, domestic convertibility of the lev, and administrative reform - quite well, though only after a significant decline in the volume of trade - with the ensuing drastic decline in output and GDP. Agriculture is also ready to take off again, now that the lengthy process of land restitution is gaining momentum. Service industries, tourism in particular, are adopting rational, free market behavior, but their revival depends on attracting customers from abroad - a task not made easier by the war in Bosnia. The closing down of uranium mining was the first serious step of industrial rationalization, but manufacturing in general is still a largely ossified system of huge sunk costs, immobilized labor, and few incentives to change."[4]

On top of these challenges, which were faced by all transition economies to one degree or another, Bulgaria had always been particularly unlucky in its choices. It had joined with and fought with the losing side in both World Wars, its largest external claims were on Iraq, its closest post World War II allies and trading partners were the USSR and the Communist block countries. That dismal track record was compound by bad luck wholly beyond its control. During its reforms it withstood external shocks coming from the collapse of COMECON—its primary market, the Persian Gulf war, and the wars in Bosnia and Herzegovina and Kosovo. The trade sanctions against Serbia, through whose territory most of its trade with the west passed, were a further blow, which had the additional consequence of significantly enlarging and already series public corruption problem.

Use of banks for social policy thus undermining them—banking crisis.

Public acceptance and credibility

Early concern that banks were not lending—now concern over very rapid credit growth

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"The severe financial crisis from which Bulgaria is emerging was rooted in the slow pace of structural reform and financial indiscipline in the enterprise and banking sectors. After a promising start in 1991-92 when prices, the exchange rate, and interest rates were liberalized, structural reforms stalled and left most of industrial production and the banking system in state hands, allowing loss making enterprises to be kept afloat by bank credit. Public indebtedness grew as the losses in state enterprises and banks spilled onto the budget, compounding an already heavy external debt burden and leaving the economy vulnerable to currency crises. Periodic attempts to stabilize the economy succeeded temporarily but were eventually undone by the failure to follow through with structural reforms.

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[4] Dr. Ognian Pishev, Bulgaria: "The Political Economy of Political Reform" Institute for International Economics, Washington DC January 1993.

The 1996 crisis hit Bulgaria with unexpected virulence as confidence in the banking system and the currency collapsed. By late 1995, the public had become increasingly aware of the ill health of banks and began to withdraw deposits and shift into foreign currency. Pressures for depreciation were initially resisted and foreign exchange reserves fell rapidly. This raised doubts about Bulgaria's ability to service its large external debt and triggered large withdrawals of foreign exchange deposits, further weakening the liquidity of banks.

A stabilization and reform program adopted in mid-1996 failed to restore confidence owing to policy slippages, particularly in the implementation of structural reforms. As a result, real GDP fell by 11 percent; the lev depreciated from 71 per U.S. dollar at end-1995 to 487 per U.S. dollar at end 1996; 12-month inflation accelerated sharply to 311 percent; and foreign exchange reserves fell to US$0.5 billion, equivalent to less than one month of imports (Table 1). Nonetheless, the sharp compression of non-interest expenditures in the budget enabled Bulgaria to remain current on its external debt service obligations, and by end-year the worst banks, representing almost one-third of total deposits, had been closed."