Bulgaria '97 - The Last Try?

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The Starting Point

Bulgaria entered 1997 in the midst of a political, economic and confidence weightlessness. The country had already entered a hyperinflation spiral, with 1996 annual inflation of 311%, and currency depreciation of above 600%. The market was dollarized. The foreign exchange reserves fell to the dramatic level of $417 million, which was equivalent to one month's worth of imports to the country. The banking system was in collapse, with 18 banks put under special supervision by the BNB. The rescue plan, adopted by the socialist cabinet of Zhan Videnov and approved by the IMF, failed in its major objectives: the abandonment of money printing as government policy — to curb inflation — and the closure of loss-making enterprises. The population's loss of confidence caused a panic run on the banking system and currency substitution, thus increasing inflationary pressure. On December 28, 1996, Zhan Videnov resigned, leaving the country without a government and the ruling party in anarchy.

The Political Crisis of January-February: How It Was Resolved

Despite ruining the economy (the figures proved a 3,000% depreciation of the local currency compared to February 1996, drained foreign currency reserves and a 10.9% contraction in real GDP), despite failing to implement the structural prerequisites for the implementation of the July agreement with IMF, and despite recognizing these failures after the resignation of Zhan Videnov, the Socialist majority wanted to try again to run the country. The constitution gives the right to any parliamentary majority to attempt to assemble a new administration. The socialists interpreted their right as a duty, and claimed that anyone who disagreed was against the constitution. They even used violence to punish protesters in early January 1997. The public, however, disagreed. The reason was that this was already the second failure of the Socialist party to run the country. The opposition had no choice other than to lead the popular discontent. Under pressure from the street and the important political role of the newly-elected president, Petar Stoyanov, the BSP nominee returned the mandate. That opened the way for new general elections, and on April 19, the democrats gained an absolute majority for the first time in the transition era.

Macroeconomic Stabilization: How It Was Achieved

The caretaker cabinet, lead by Stefan Sofianski, stepped into power in a hyperinflationary environment, with a ruined banking sector and shortages of basic products, such as bread, milk, and gasoline. The budget deficit exceeded budget revenues in January and February. The country was on the threshold of defaulting on its Brady deal.

What made stabilization possible was the new administration's commitment to reform, and the population's regained confidence. President Stoyanov explicitly declared that the "illusion factory" should be closed down, and the democratic coalition, which was expected to win the upcoming elections and to stay in power for at least its first 4-year mandate, stood behind him. The cabinet managed to sign credit agreements with the IMF, the World Bank and the EU. The common belief that foreign financing had been negotiated stopped the hysterical currency substitution, and the Lev appreciated by 100%, from BGL 3,000/USD 1 in the beginning of February to BGL 1,500/USD 1 in March — even without using the IMF dollars.

Another reason for the exchange rate stabilization was the so-called "gentlemen's agreement" between the big importers (e.g., Neftochim oil refinery, National Electrical Company, etc.), and several state-owned banks for direct purchases of dollars, without putting the forex market under pressure. However, the role of the administration in that deal was never revealed, thus leaving room for doubts about government coercion on the market.

Also, the democrats declared that a currency board would be introduced in the summer of 1997, and that there would be no turning back. The general mood in favor of the new administration was so strong that people even started to sell their hard currency, inevitably contributing to the appreciation of the Lev. As in all open economies, the major determinant of inflation in Bulgaria is the exchange rate. Given the forex market stability in March-June, the inflation rate fell from 43% in January and 243% (!) in February to 12.5% in March, -0.7% in April, 5.6% in May and 0.8% in June.

Foreign portfolio investors were also optimistic, and a serious investment in Bulgarian T-Bills began, causing a fall in interest rates, from some 18-19% monthly in February to some 1.2-1.5% monthly on the eve of the currency board's introduction on July1.

Combined with the cash inflow from privatization (especially the Solvay-Sodi deal, which brought $160 million to the budget), all these factors combined to generate the positive energy needed for macroeconomic stabilization.

The Currency Board

On July 1, 1997, a the Bulgarian National Bank officially started to operate under a currency board regime. That meant, first, fixing the exchange rate at the level of BGL 1,000 to DEM 1 and an irreversible obligation on the part of the BNB to buy and sell Deutschemarks on request at that level. Second, that prevented the government from direct financing from the Central Bank. And last but not least, that put an end to BNB refinancing of commercial banks, except in the case of a systemic risk. The positive impact of that measure was partially effective before its very introduction Nevertheless, the period after July 1 marked an increase in foreign reserves, from DEM 2.8 billion to DEM 4.2 billion, and a fall in the basic interest rate to 5-6% on an annual basis. However, the inflation records were more disturbing. Q3 inflation was 15.1%, compared to 7.2% in Q2. Q4 figures are quite modest: 2.5%.

The major reason, as always, was the DEM depreciation of 8-10% against the USD. About 80% of the country's imports are denominated in USD, and import pushed inflation was induced. Another reason was the adjustment of some utility prices, which had lagged far behind international ones in previous periods. In the long run, the most significant source of concern would be the impact of the so-called "natural monopolies" (mainly in the energy sector). As such they do not allow competition to establish equilibrium prices, and by default they are not flexible. Also, the state uses a huge part of its (NEC, Neftochim, Bulgargas) profits to cover losses in the subsidized utility sector, and is therefore interested in maintaining high prices.

What Happened to the Commercial Banks?

The exchange rate crisis of 1996, and especially January-February 1997, wiped out a considerable part of the Lev-denominated liabilities of the commercial banks. Thus, most of them became profit-making just by virtue of keeping dollar assets. This, together with the closing of one-third of the banking system, made it possible for the remaining banks to stabilize — at least on paper. One of biggest state-owned banks, the United Bulgarian Bank, was sold to EBRD, Oppenheimer, and Bulbank, marking the start of bank privatization in the country.

The significant decline in interest rates, not accompanied by a respective decrease in risk, however, put most of the banks in a very tricky situation. They still maintain a huge nominal level of fixed and administrative costs. On the other hand, the nominal margin between interest rates on the asset versus the liabilities side shrank. The long-run problem now faced by Bulgarian banks seems to be making an adequate profit from their assets. Part of the banks' assets (bad loans, buildings, etc.) generate no income. In addition, the banks are very conservative in their lending activities. Banks still consider lending as very risky activity, because the business environment has not improved significantly, as well as the fact

that the execution of creditors' rights is low and banks face problems with collection on non-performing loans.

Furthermore, according to Banking Act banks are restricted from extending a "big loan," exceeding 25% of the bank's shareholder equity, which is now set by the Law at BGL 10 billion. That makes a loan of DEM 2.5 million "big," and therefore subject to special requirements, e.g., collateral in gold or foreign currency. On the other hand, most of the banks do not consider loan applications below $200,000-250,000 (such as Raiffeisenbank, for example), because of the high level of administrative costs of the contract.

At the same time, the inflation rate is still high and real interest rates are negative. The negative real interest rates threaten the incentives for saving and the deposit base. Clear evidence for this is found in the fact that for September 1997 the currency outside banks exceeded the total amount of time and saving deposits.

The lack of sufficient opportunities for placement of banks' resources is resulting in an orientation towards keeping mainly high-liquidity assets — cash, assets on banks accounts and government securities.

The Real Sector

No matter how successful a macroeconomic stabilization is, the real source of growth is the profitability and efficiency of every single enterprise. Though almost all of the 64 state-owned enterprises (SOEs) on the "liquidation" list are closed, things still do not look bright. Inter-firm indebtedness is growing. The major creditors — the gas supplier "Bulgargas" and the National Electrical Company — declare claims on enterprises amounting BGL 300 billion and BGL 118 billion, respectively. Most of the big SOEs still survive on credit. Utility sector restructuring is still a good intention rather than a reality. The major problem for most of the SOEs now and in the future is how to be profitable without counting on currency depreciation. This means increasing labor productivity and closing non-productive activities.

Apart from that, there are still a number of impediments to the growth of the private sector:

1. The new set of taxation laws that was adopted in October-December 1997 imposed comparatively high tax levels and sophisticated time- and money-consuming reporting requirements. This leads to the registration of phantom entities in order to avoid taxation. Moreover, social insurance costs will be increased by some 12% in 1999 (divided equally between the employer and the employee), imposing an additional 48 lev cost on every 100 Levs spent on salaries by the entrepreneurs.

2. Archaic accounting regulations. Revenues are to be recorded at the moment the service or good is delivered, no matter whether a payment is made or not. Investment expenses are not recognized by the tax administration. Instead, a conservative depreciation method is applied by the tax authorities, based on the "historical price" of long-term assets. Thus, a very small and insignificant part of the value of the asset is relieved by corporate profit. Given the fact that access to long-term bank loans is almost unavailable to the broad range of small enterprises, the main source of capital is family savings or loans from friends. The cost of that capital is not to be deducted from taxable profit, and is therefore taxed. The only to avoid its being taxed is to underdeclare incomes.

3. Administrative impediments. Other important sources of informal action and corruption in Bulgaria have always been price controls and quasi-fiscal subsidies. Given the currency board regime, the latter have practically no place. Price controls on consumer goods were abandoned, thanks to high inflation in 1996 and early 1997. At the same time, the new administration re-established price controls in the form of controls over trading contracts. It issued Decree 269 of June 1997, requiring producers and wholesale merchants to determine the final "contractual" (in fact, retail) price of a product. The intention is to eliminate wholesale intermediaries. City police, under the joint leadership of the trade and interior ministers, have flooded commodity markets asking merchants to "prove" that their contracts are "correct." This regulation deals with "contractual prices" of only fifteen consumer

products, mostly foodstuffs, and it is hardly possible to implement. But the actual damage it does is that it both induces populist expectations in the public at large and creates a widespread source of *petite* corruption. Commodity exchanges and wholesale markets have already existed for six-seven years. Last year, the socialists adopted a law creating the Government Commodity Exchanges and Wholesale Markets Commission, comprised of nominees of the Council of Ministers, but with no merchants, and no self-regulatory procedure. The democrats did not amend the regulations, but appointed commissioners and required commodity traders to apply for a license.

4. Control over domestic commodity markets motivates merchants to try to export goods, if they can find a better price for them in neighboring countries. "Fighting smugglers" has been the government's excuse for sticking to complicated customs procedures and delaying the abolishment of tariff barriers.

In all of the above cases there is common denominator: a general e*tatist* philosophy of the new administration.

In addition, the privatization process is still neither transparent nor fast enough. Despite several huge deals, like the sale of Sodi-Devnya, MDK-Pirdop, United Bulgarian Bank, and Sheraton Sofia, small- and medium-scale privatization is lagging behind. Moreover, the precedent set by some deals, such as the UBB-EBRD deal, in which neither the price nor the additional obligations were revealed, marked a very dangerous trend of non-transparency. That is why only 18% of state-owned assets have been privatized so far. The whole idea of privatization through "sale to a potential buyer" without a public tender, which is to be tolerated even further in sale of the "blue chips," fundamentally contradicts the market principles embraced by the new administration. If not abandoned soon, it will cause a significant shrink in privatization revenues, so strongly needed by the government in the transition period.

The Emergence of the Bulgarian Stock Exchange

At last, Bulgaria has an official stock exchange market. On October 9, it was licensed by the Securities and Stock Exchange Commission. On October 21 it opened for "block" trade. On November 24 it opened for so-called "regular" trade.

However, it is still too early to talk about a capital market in Bulgaria. The restrictive regulations that are applied in Bulgaria would rather befit a country with at least a 200-year history in Stock Exchanges.

1997: Can Bulgaria "dig" any deeper?

The statistics for 1997 are quite self-sufficient: accumulated inflation of 578 %, an average interest rate of 75-76%, and a GDP decline of 7.4%. In any other country, these figures would sound like a disaster. In the case of Bulgaria, they signify (or should do) the year of the Great Revival. After the partial macroeconomic stabilizations of 1991 and 1994, the year of 1997 was the third attempt to pull the country up from the bottom. If Bulgaria "succeeds" in sinking again, there will be no "*fourth try*" to "*fight the evil*."

As in the fairy tales, everyone has only three tries.