

BULGARIAN NATIONAL BANK

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**Honorable Mr. Chairman
of the National Assembly!
Honorable members of Parliament!**

In accordance with the provisions of the Law on the Bulgarian National Bank, Article 1, paragraph 2, the Bulgarian National Bank reports its activities before the National Assembly. Pursuant to Article 53 of this Law, I have the honor to submit the semiannual report of the Bulgarian National Bank for the period ending 30 June 1996.

A handwritten signature in black ink, appearing to be 'Lubomir Filipov', written in a cursive style.

**Lubomir Filipov
Governor of the Bulgarian
National Bank**

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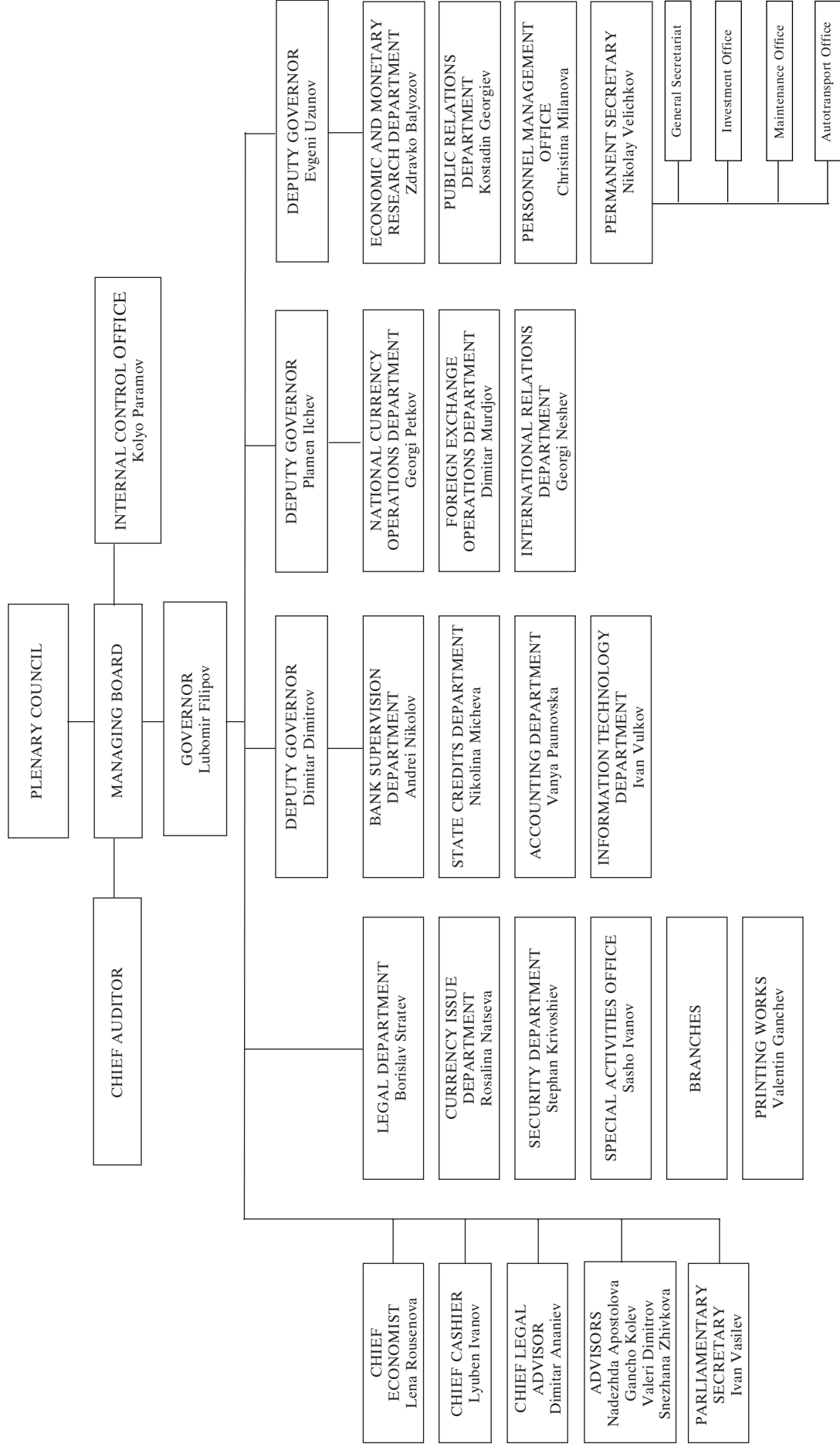
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Organizational Structure of the BNB

(as of September 1996)



Abbreviations

BGL (Lev)	<i>National Currency of the Republic of Bulgaria</i>
BISERA	<i>Banking Integrated System for Electronic Transfer</i>
BNB	<i>Bulgarian National Bank</i>
BORICA	<i>Banking Organization for Payments Initiated by Cards</i>
BUS	<i>Banking Unified Standard</i>
CGB	<i>Central Government Budget</i>
CM	<i>Council of Ministers</i>
COMECON	<i>Council for Mutual Economic Assistance</i>
CUBS	<i>Commission on Unified Banking Standards</i>
EBRD	<i>European Bank for Reconstruction and Development</i>
ECU	<i>European Currency Unit</i>
EFTA	<i>European Free Trade Association</i>
EIB	<i>European Investment Bank</i>
EU	<i>European Union</i>
GDP	<i>Gross Domestic Product</i>
IMF	<i>International Monetary Fund</i>
LBCA	<i>Law on Banks and Credit Activity</i>
LGB	<i>Long-term Government Bonds</i>
LSNC	<i>Law on Settlement of Nonperforming Credits Negotiated prior to 31 December 1990</i>
MF	<i>Ministry of Finance</i>
MLSS	<i>Ministry of Labor and Social Security</i>
MTIEC	<i>Ministry of Trade and International Economic Cooperation</i>
NSI	<i>National Statistical Institute</i>
OECD	<i>Organization for Economic Cooperation and Development</i>
SBL	<i>State Budget Law</i>
SDR	<i>Special Drawing Rights</i>
SII	<i>State Insurance Institute</i>
SSB	<i>State Savings Bank</i>

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I. Major Trends in the Development of the World Economy

No significant changes occurred in *global economic conditions* in the first half of 1996. Developments in some regions of the world, however, exhibited trends divergent to a greater or lesser extent from those of the global economy as a whole. The combined impact of these processes was reflected in a relative moderation of world output and trade growth in the second half of 1995 and the first half of 1996.

According to data released by international bodies which observe and analyze developments in the world economy¹, the gross product growth during the first half of 1996 was insufficient to offset the slowdown already started in 1995. Compared with a 4% average growth in 1970 – 1995, world output growth in 1995 is estimated at 3.5%² and no significant changes evolved in the first half of 1996. The slowdown in growth is basically due to unusually low economic activity in several leading world economies, particularly Germany and France. However, expectations for the second half of 1996 and the whole of 1997 are for a gradual increase in world gross product growth to a level exceeding the average for the last quarter century. World output forecasts estimate a 3.8% growth in 1996 and 4.3% in 1997.³ These assumptions are based on signals of overcoming recessionary impulses by the two biggest western European economies; Japan's emergence from deep stagnation; sustained noninflationary growth of the US economy; high economic growth rates (but still lower than in 1995) in eastern European countries in transition and developing countries, notably the dynamic economies of the Far East.

A modest slowdown in world trade growth also occurred in 1995 while a more sizable contraction is projected for this year. Such dynamics does not contradict sound reasoning, in the face of a record high growth (9%) set in 1994 over a period of nearly two decades. Goods and services exchanged worldwide rose by 8.7% in 1995, and are estimated to grow 6.4% and 7%⁴ in 1996 and 1997 respectively: that is at more moderate rates but still above the average for 1970 – 1995 (5.5%).

Against this background of emerging favorable trends in global terms, there emerge some contrary *regional factors* which affect the Bulgarian economy. These relate primarily to positive changes in the economic environment.

Macroeconomic conditions in Bulgaria's major western European partners (Germany and Italy) reveal diverging trends. This is attributable mainly to the desynchronised economic cycle of industrial countries, their differing approaches to foreign exchange policy, as well as to domestic economy differences in structural and macroeconomic developments.

Germany suffered an unexpected decline in output in the last quarter of 1995 which continued in the first half of 1996. Subdued economic activity is attributable to reduced investment, particularly in construction. Inflation stood low (some 1.5% in 1996) but employment fell and unemployment is expected to exceed the 10% threshold of the country's labor force. No significant changes are expected to occur by the end of this year, yet some improvement in business conditions is possible by the end of the period. Economic activity is predicted to accelerate slightly (consistent with revived investment and higher exports) as early as 1997.

Growth in *Italy* has slowed insignificantly. The slowdown appears temporary and may be reversed in the second half of 1996. Favorable economic conditions (in comparison with other western European economies) can be ascribed to rising net exports in the last few years (despite a slowdown in growth in 1994 and 1995) due to the depreciation of the Italian lira following its withdrawal from the EU exchange rate mechanism, as well as to a confidence effect reflecting an improvement in government finances. Inflation stood at an unusually low level (little over 4% in 1996)

¹ According to IMF, EBRD, etc.

^{2, 3, 4} According to IMF.

and despite the economic growth high unemployment persisted for the third year in succession (some 12% in 1995 and 1996). Economic activity is expected to moderately accelerate in 1997 (gross product growth is estimated at some 2 – 2.5%), reflecting increased personal consumption and investment coupled with insignificant, even slightly negative, net exports as a result of a stronger lira.

Macroeconomic conditions prevailing in the next group of Bulgaria's major western European trading partners – *France, Austria and Switzerland* – are similar to those in Germany, and macroeconomic conditions in another group, including the *Netherlands and Belgium*, are similar to those in Italy. *Great Britain* is the only country where prerequisites for a stable economic environment and moderate growth in output (within 2 – 3%), hence import demand, are in place.

The economies of *Russia and Ukraine*, Bulgaria's major eastern European partners, have not yet emerged from the postsocialist structural depression. The other former Soviet republics (with diverse macroeconomic indicators and advancement toward market reforms) have a negligible share in Bulgaria's foreign trade.

A number of factors give reasons to assume that Russia has prepared the ground for resumption of economic growth which may even occur this year. Annual inflation is measured in double digits, privatization has been completed to a large extent, and business conditions are close to normal.

Even though Ukraine's reforms have been slow and faltering so far, the country's macroeconomic indicators for the current year may outperform those of Bulgaria.

Projected 1996's macroeconomic indicators for the *former socialist countries from central and eastern Europe* reveal a delay in market reforms and economic stabilization in Bulgaria. Real gross product growth of some 5% is projected for the Czech Republic, Poland, Slovakia, Slovenia, Albania and Romania, and some 2% for Hungary. The average annual rate of inflation in the Czech Republic, Slovakia, Slovenia and Albania is below 10%, and some 20 – 25% in Poland, Hungary and Romania. Poland is the only country with unemployment higher (at 14% of the country's labor force) than that in Bulgaria. Albania is probably the only country projected to have a larger budget deficit than Bulgaria while budget deficits in the rest of the countries from the region are estimated at below 3% of GDP (with the exception of Hungary with an estimated deficit of some 4%). The currencies of eastern European countries are relatively stable and have not suffered dramatic devaluations in recent years.

The region of conflict on the *Balkan Peninsula* appears to have settled down. Economic prospects for the Balkan countries look generally optimistic for the first time in the 1990s.

Military actions on the territory of certain *former Yugoslav republics* are over. Under new peaceful conditions, these states have started restoring their economies and international economic relationships. These processes can be credited with contributing to the intensification of imports of goods, services and investment projects from neighboring countries and the restoration of the transport corridor to western European markets, which is of great significance to Bulgaria.

Bulgaria's southern neighbor countries, also ranking among its major trading partners, saw improved macroeconomic conditions.

After strenuous efforts in fighting inflation, in 1995 *Greece* succeeded in reducing its annual rate of inflation to one digit. Interest rates were further reduced, providing an additional stimulus for a sustained 2% economic growth per year and contributing to the pursuit of fiscal consolidation. High unemployment (over 10% in 1995) remains a concern and is unlikely to be reduced. Growth rates achieved hitherto are not expected to slow, hence the demand for imported goods and services.

Turkey continues being an arena of divergent economic trends and economic policy measures. Following a relative stabilization in 1995, macroeconomic indicators have been deteriorating since the beginning of 1996, reflecting accelerated inflation and transition to a deficit on the balance of payments current account. In 1996 and 1997 the high growth rate typical of that country is expected to slow down to 4.5 – 5%, combined with subsiding but still high inflation (within the range of

60 – 70%) and steady, moderate rate of unemployment (some 7.5%).

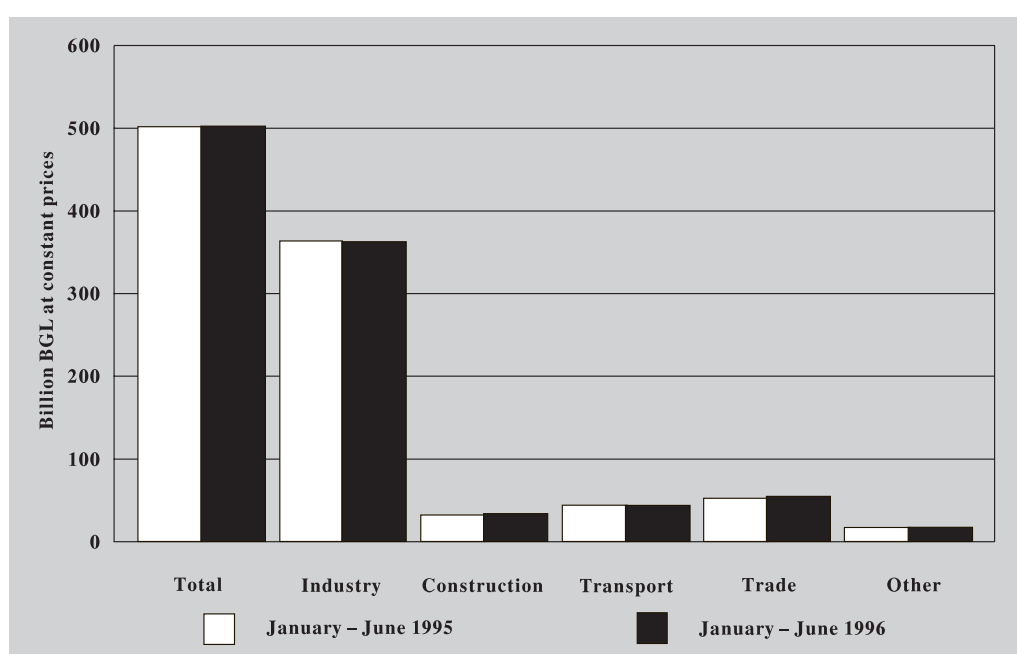
Assessment of global and regional economic conditions in the short- and medium-run suggests that *external demand* for Bulgarian goods and services could have a generally positive impact, providing incentives for output in Bulgaria. By the end of this year, however, owing to the slowdown in western European growth, Bulgaria's net exports will remain depressed to a large extent (as in the first half of the year), with prospects for sustained improvement after 1997. It is worrying that, on the basis of *comparative analyses* of macroeconomic indicators of the countries in transition to a market economy Bulgaria ranks unequivocally at the bottom of eastern European countries. Bulgaria is the only eastern European country recording a drop in output over the reporting period, as well as very high annual inflation, persistently high unemployment (despite a slightly downward trend), double depreciation of the currency unit, unusually high nominal (but strongly negative real) interest rates, chronically low level of foreign exchange reserves and a slump in gross investment with long-term effects on economic growth.

II. General Characteristics of the Economy

1. Output

During January – June 1996⁵ the real sector of the economy gave the first signals that the steady growth rates of the previous year would be difficult to sustain. Developments in the real sector of the economy reflected continued lack of fixed capital investment over recent years, combined with reduced credit to this sector in the end of the previous year due to challenges faced by the banking system. Output in the state, cooperative and private sectors totaled over BGL 689 billion. At constant prices, output remained at the level of the first half of 1995.

OUTPUT – TOTAL AND BY BRANCH OF ECONOMY



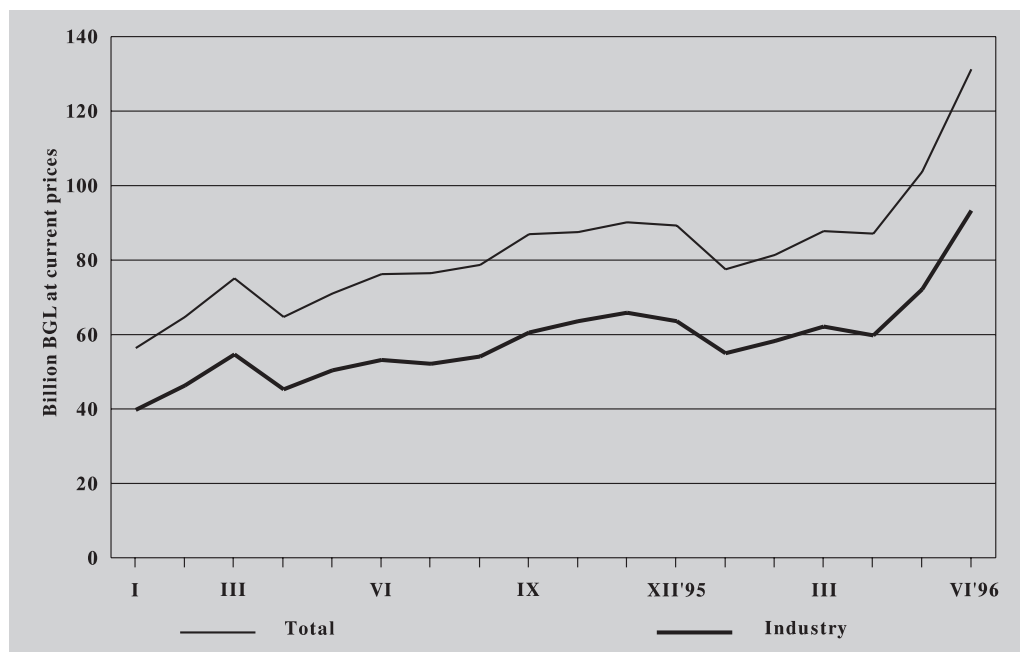
Source: NSI, BNB.

The private sector played a major role in preserving the level of output in real terms unchanged from last year's corresponding period. During the first half of 1996, private companies' output totaled BGL 177 billion at current prices. At constant prices the private sector output grew at a rate of over 16%, and all non-agricultural industries recorded a positive growth. Private companies, as in 1995, produced over 25% of nonagricultural output. In several sectors (trade – 80%, construction – 65%) private companies contributed more than half of the total output over the reporting period. However, private sector share in industry remained low at 14%.

Output and sales revenue in the state and cooperative sectors started to fall in real terms after January. Production in state and cooperative enterprises over the first six months of this year totaled BGL 512 billion and receipts from the sale of goods and services amounted to BGL 571 billion. Compared to the same period a year earlier (at constant prices), both output and sales revenue have decreased by 4%.

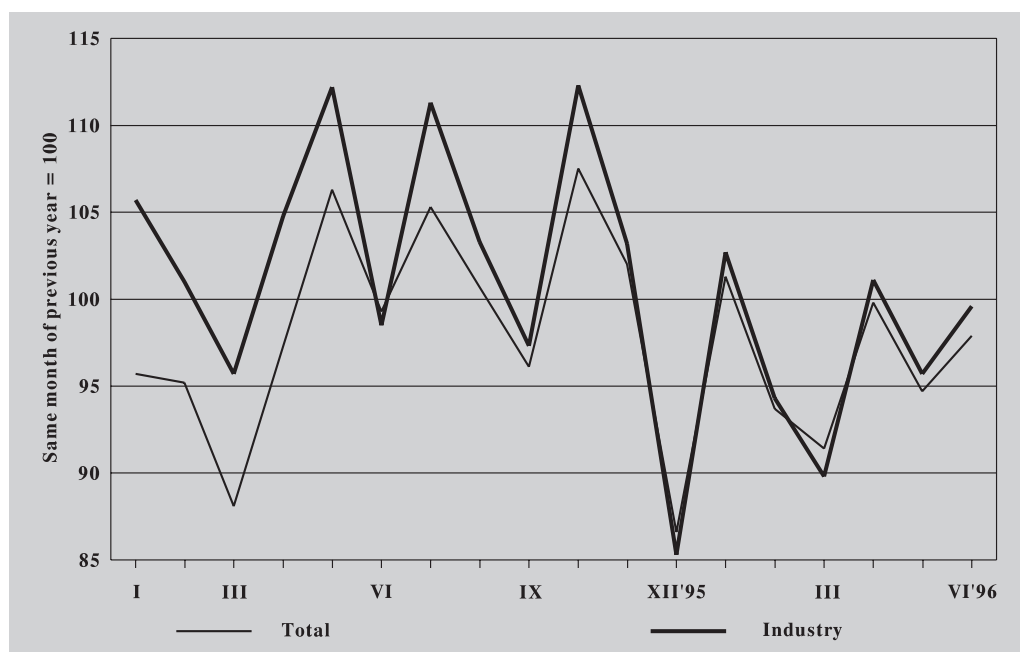
⁵ According to NSI data on current economic conditions. Data does not include agriculture.

RECEIPTS FROM SALES OF OUTPUT IN PUBLIC SECTOR



Source: NSI.

RATE OF RECEIPTS FROM SALES OF OUTPUT IN PUBLIC SECTOR



Source: NSI.

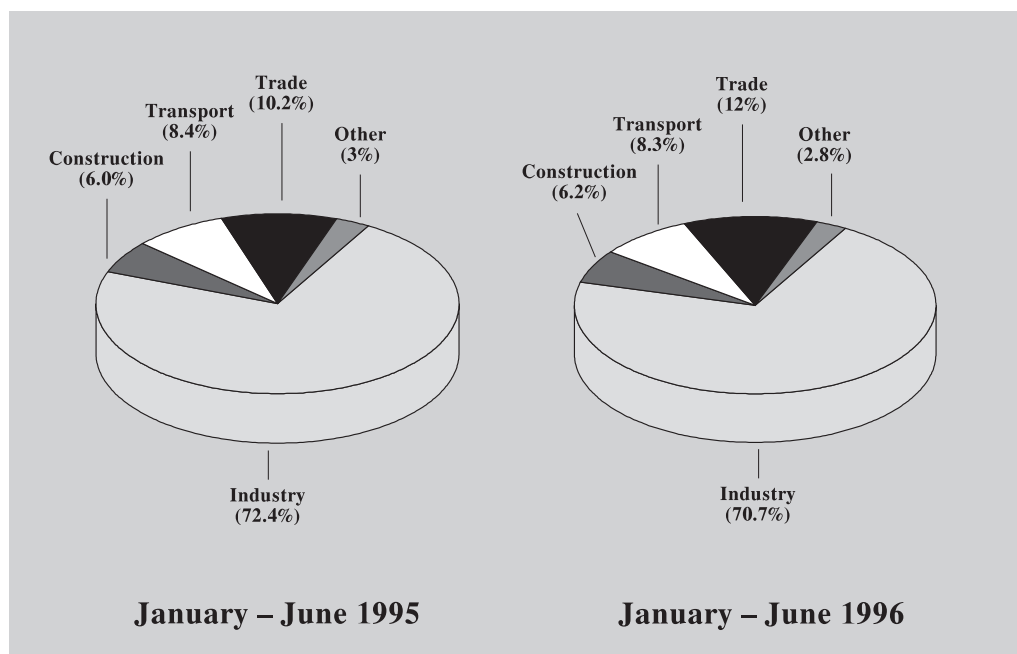
No significant changes occurred in the sectoral structure of output during the period under review. Industry continued to play a key role in the Bulgarian economy with over 70% in total output.

Increased domestic demand may be credited with contributing to a sustained level of output in real terms during the first half of 1996. Retail turnover in the state, cooperative and private sectors accounted for BGL 239 billion, an increase of 4.2% over last year's level.⁶ In June however, retail turnover fell in real terms (2.7%) from

⁶ Since the NSI has not yet released data on GDP for the first half of 1996, estimates of components by final demand should be interpreted as conditional.

the level recorded in the same period last year for the first time since the beginning of 1996, which suggests that domestic demand in the second half of the year would hardly generate the same stimulating effect on output. External demand for goods and noninterest services was lower than that in the same period a year before. In the face of rather poor performance on the revenue side of the state budget in the first half of this year, government spending on goods and services would not probably stimulate output growth.

STRUCTURE OF OUTPUT BY BRANCH OF ECONOMY



Source: NSI, BNB.

Managers' views expressed in NSI polls about economic conditions in the second half of 1996 do not give grounds for optimism. In their opinion, domestic and international markets may experience a reduction in demand. According to their estimates, over the coming twelve months the number of orders is going to decline causing further capacity underutilization. The tendency toward a closer convergence between the rates that measure the extent of capacity utilization for private and public sectors, observed in the second quarter of 1996, is expected to continue in the second half of this year.

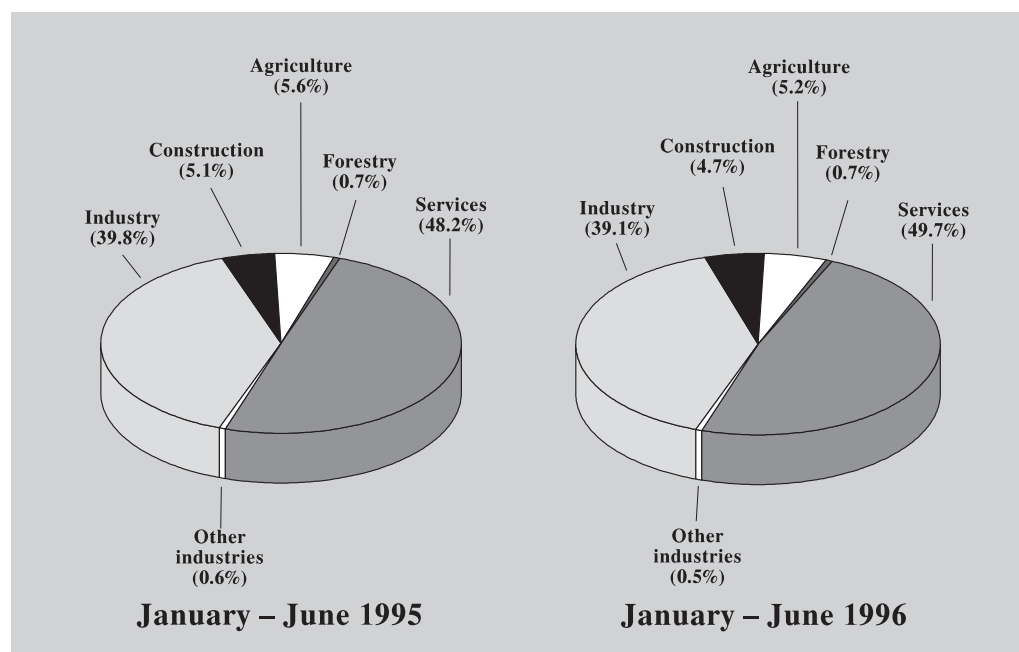
2. Employment

The labor market reinforced the conclusion about economic activity based on data of current economic conditions. The decline in employment in the public sector (state and cooperative) continued in the first half of 1996. According to NSI data the number of employees in this sector fell from 1,851,000 in the corresponding period of 1995, to 1,808,000. Employment in the public sector declined 2.3% on average: a smaller decline compared to previous years. The downward trend in unemployment evolving after January 1996 suggests that employment in the private sector has continued to rise this year. Even though these estimates may be broadly changeable, the number employed in this sector surpassed 1 million. The majority of employees in the private sector, however, is not employed under permanent contract⁷. The trend of a faster decline in employment in industry, agriculture, construc-

⁷ As information on the sectoral structure of employment in the private sector is unavailable, analysis and conclusions on the structural changes in employment refer only to the public (state and cooperative) sector. There is no reason to assume that the sectoral structure and developments in private sector employment are similar to those in the public sector.

tion, the trade sector and transport, typical of the previous year, continued, while management and public utilities saw a rising level of employment. This led to changes in the sectoral structure of employment. Compared with the same period a year earlier, the share of those employed in industry fell by 0.7 percentage points, and 0.4 percentage points in construction and agriculture. Conversely, the share of those employed in services has increased by 1.5 percentage points with the exception of transport and trade services.

STRUCTURE OF EMPLOYMENT IN THE PUBLIC SECTOR



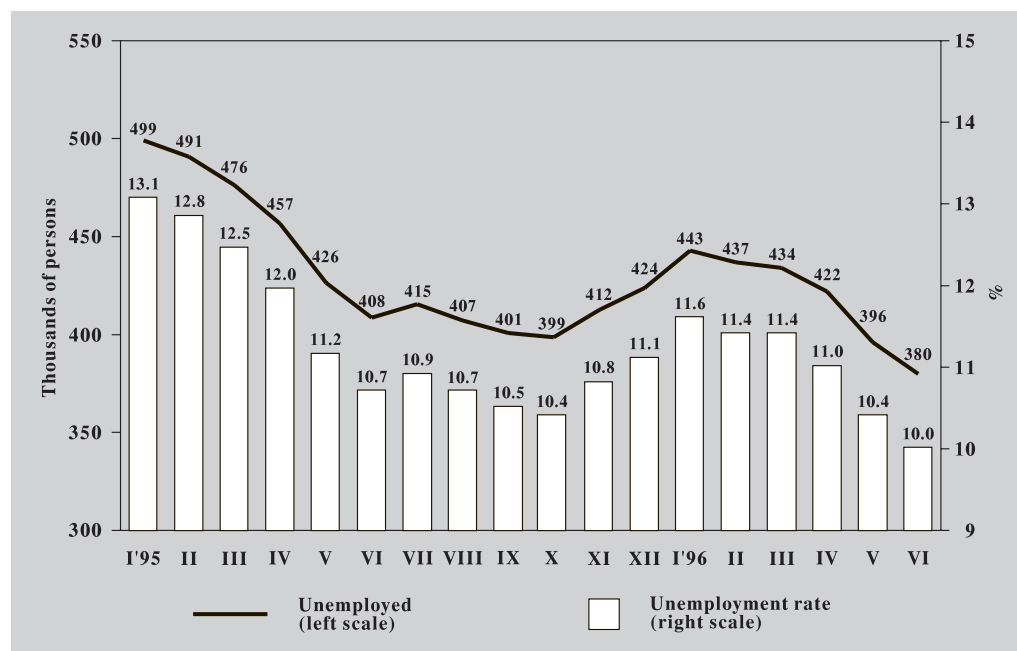
Source: NSI, BNB.

The number of average payroll employment in industry dropped by 29,500, or 4%, compared to the same period a year ago. The rate of decline in employment almost paralleled that of industrial receipts over the first half of the reporting year. With the exception of several industries such as ferrous metallurgy and the chemical and oil processing industry, where employment increased in line with the fall in receipts from sale, the above indicators exhibited converging trends. This suggests that no significant changes have occurred in labor productivity by industrial sector. The number of persons employed in agriculture declined by 10,500 during the first half of 1996, or 10.2% over the corresponding period last year. As in previous years, employment reduction in agriculture remained high. The number of those employed in construction fell by 8,600, or 9.2% compared to the same period a year ago. Weakened activity in major sectors went hand in hand with similar reductions in employment in some major service activities. The number of employees in the transport sector fell by 6,800, or 5.1% compared to the first six months of 1995, and 8,900, or 9.1% in trade. Several other service activities also experienced considerable reduction in employment. The number of persons employed in the services sector of public utilities increased by 9,700, or 18.8% compared to the same period a year earlier, 9,300 or 16.4% in management, and 1,900 or 6.7% in the finance, credit and insurance system. In addition, an increase in employment was recorded in the sectors of education and health care, social security, sports, and tourism.

Unemployment declined in the first half of 1996 following a rise in the second half of 1995. After reaching a peak of 442,700 persons in January, unemployment began to gradually decline and reached 380,300 persons by end-June. Unemployment as a proportion of the country's labor force fell from 11.6% in January to 10% by the end of the half-year period. A major factor contributing to reduced unemployment may be the ever increasing employment in the private sector. Deletion

from labor-office registration lists of a significant number of jobless persons due to insufficient provision of jobs and the expiration of unemployment benefits may be cited as another major factor for the reduction in the number of registered unemployed. The contingent of jobless persons deleted from labor-office registration lists was considerably larger than that of newly registered unemployed in January and in the last two months of the half-year.

UNEMPLOYMENT



Source: Ministry of Labor and Social Security (MLSS).

Reduction in unemployment after January encompassed all age and professional groups. Unemployment by age group is distributed in the following way: a decline of 13.5% compared to 1995 year-end among those aged 30 and under, and a decline in unemployment among those aged 30 – 50 and 50 and over within the range of 8% and 8.5% respectively. Within the structure of unemployment by professional group, the largest decline in unemployment occurred among manual workers, a decrease of 16% at end-June compared to 1995 year-end; a reduction in unemployed university graduates of 14.8%, and 6.5% among those with no set occupation.

NUMBER OF UNEMPLOYED AND COMPENSATION, BENEFIT AND RETRAINING EXPENDITURE

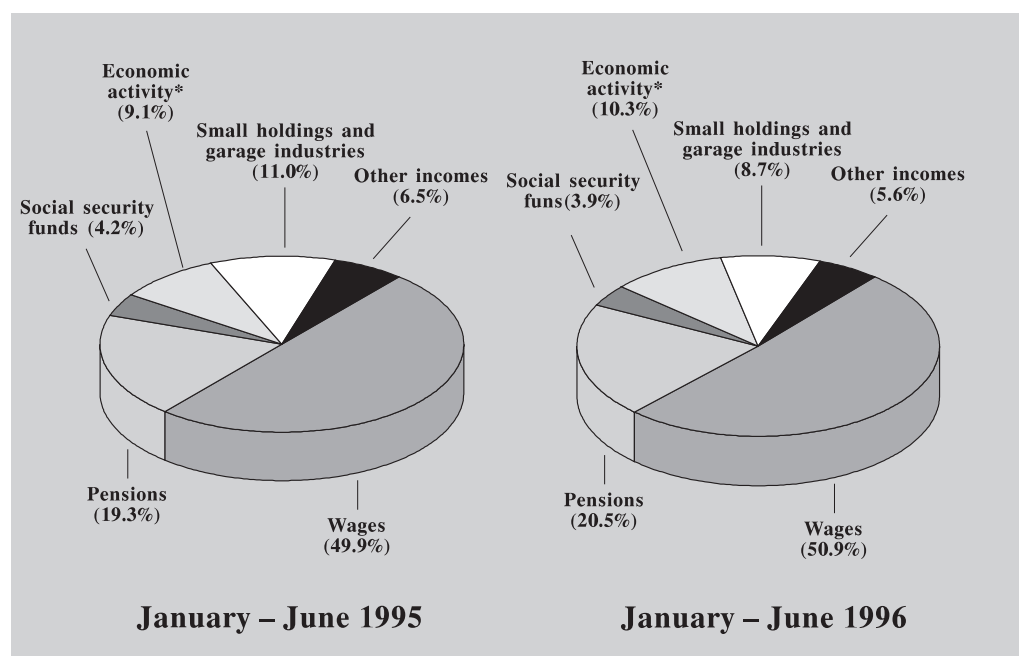
Indicators	June 1995	June 1996
Unemployed (thousands of persons)	408.5	380.3
Unemployed receiving compensation (thousands of persons)	109.5	102.2
Share of unemployed receiving compensation (%)	26.8	26.9
Average amount of compensation per one unemployed (BGL)	2399	3420
Retraining expenditure per one unemployed (BGL)	24.0	29.9

Source: MLSS, BNB.

3. Income and Consumption

During the first six months of 1996, gross income of the population⁸ (monetary and natural) grew by 36.3% in nominal terms over the previous year. However, real income declined significantly (19.9%) due to the faster rate of growth in consumer prices after March 1996 compared to the same period a year earlier. Income structure showed that wages continued to be the most significant source of household income. The share of wages in gross household income accounted for 50.8%, a 0.9 percentage point increase from the same period last year. The share of income from pensions and economic activity rose by 1.2 percentage each. At the same time, the share of income from small holdings and garage industries decreased significantly, by 2.3 percentage points.

STRUCTURE OF GROSS INCOME OF THE POPULATION



* This group includes income from small businesses, rent and dividend, income from sale of property, and income from economic activity other than wages.

Source: NSI, BNB.

During the first half of 1996, average monthly pay in the public (state and co-operative) sector⁹ reached BGL 9,450¹⁰ compared to BGL 6,659 a year earlier. In nominal terms, average monthly wages increased by 41.9%; compared to the first six months of 1995, however, they lost 16.6% of their purchasing power. The main factor responsible for this drop in real terms was the government's policy of tightened constraints on incomes, particularly in the second quarter. The March and April price jumps also contributed to the fall in real pay.

During the period under consideration, the differentials in nominal average wages among sectors were retained. The wages of workers employed in industry, transport and several services sectors such as finance, credit and insurance were considerably higher than the average public sector wage. As wages in construction, and equipment sales and purchasing grew at a faster rate than the average between January and June 1995, these sectors' pay bills exceeded the average in the public sector. As in previous years wages paid in agriculture, forestry and areas relying

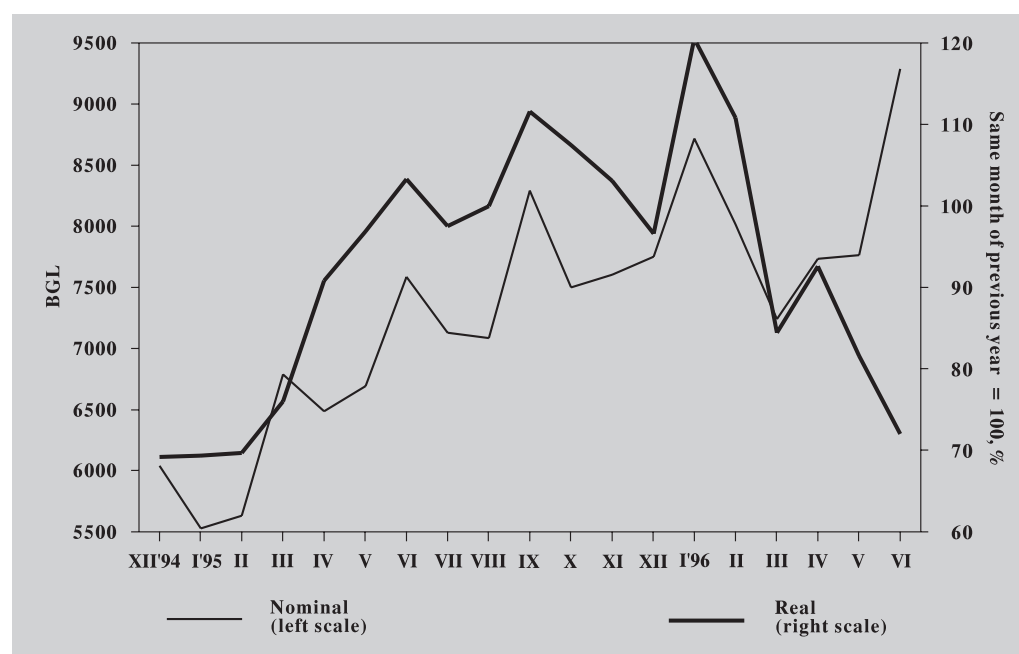
⁸ NSI monthly survey of household incomes is used.

⁹ Since data about private sector wages is missing, the analysis and conclusions refer to public (state and co-operative) sector wages only.

¹⁰ Women on maternity leave excluded.

heavily on budget support such as science and scientific research, education, the arts, health care, social security, sports and tourism, were significantly below the average in the public sector.

AVERAGE WAGE IN THE PUBLIC SECTOR



Source: NSI, BNB.

Data on household expenditures (obtained from the NSI monthly survey of household budgets) showed no significant changes from the same period a year earlier. Expenditures on food remained traditionally high (43.9%). Compared with the same period a year earlier, the share of expenditures on food in total household spend has fallen by 2.2 percentage points. The reduced share of food in total household expenditure relates primarily to a slower average rise in food prices relative to price increases in other consumer goods and services. A more significant increase (by two percentage points) in the share of expenditure on energy for households occurred compared with the same period a year earlier. This results from the policy to sharply increase the price of this commodity, thus reducing the losses of state-owned energy producing companies.

STRUCTURE OF GROSS HOUSEHOLD EXPENDITURE

(%)

Indicators	January – June 1995	January – June 1996
Total expenditure	100	100
Food	46.1	43.9
Drink	1.3	1.5
Tobacco products	2.2	2.4
Housing	3.1	3.6
Electricity for households	4.9	6.9
Home furniture	3.8	4.0
Clothing, footwear and haberdashery	7.3	7.0
Personal hygiene and health care	4.0	4.4
Education and leisure	2.7	3.9
Transport and communications	7.3	7.8
Small holdings and garage industries	5.2	4.4
Other expenditure	12.1	11.3

Source: NSI.

4. Prices

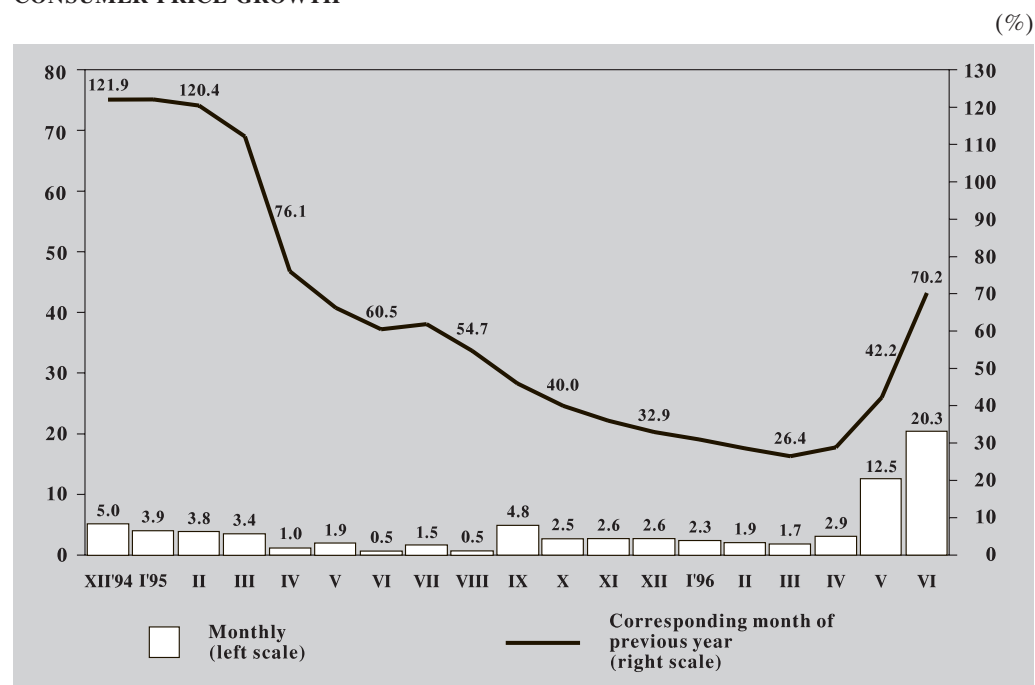
Significant price increases characterize the first six months of 1996. This occurred as a result of accumulated price tensions from previous periods and the lack of efficient means to contain them through economic policy. Price tensions accumulated first because measures in place for a controlled price liberalization were postponed in the previous two years and delayed in the first half of 1996, and second because structural reforms in the economy were delayed. Moreover, given the underdeveloped domestic financial markets, the liquidity squeeze in the banking system also contributed to higher inflationary expectations.

Monetary policy measures aimed at curbing inflationary expectations did not receive government support through rapid restructuring of the real economy and the banking sector. As a result, short-term monetary policy objectives in respect to some indicators such as the exchange rate, which have a key significance on inflationary expectations and inflation, were not achieved. The government centered its efforts on a shock increase in the fixed prices of major, commonly used goods and services (energy and thermal power, fuels, telecommunications services), which led to a dramatic contraction in enduser demand, while changes in relative prices have not managed to surface so far. At this point, the effects of the shock price rise have resulted only in highly volatile market conditions. This explains why no significant changes (consistent with the extent of fixed prices increases) have occurred in the behavior of producers, particularly those from the private sector.

Consumer Prices¹¹

In June 1996, the major indicator of inflation – the consumer price index – was 47.5% higher than in December 1995. This has been the highest increase in consumer prices for a six-month period since 1991 and 1994. Inflation between January and June 1996 surpassed its equivalent for the same 1995 period by 32.3 percentage points.

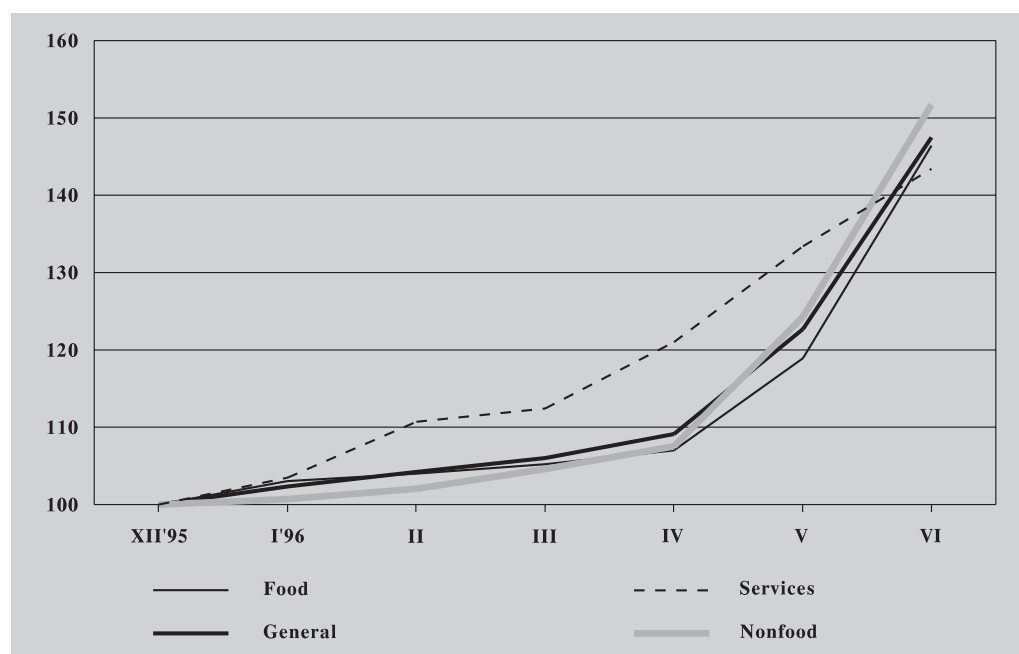
CONSUMER PRICE GROWTH



Source: NSI, BNB.

¹¹ In 1996, the NSI continued calculating the consumer price index using the methods adopted in early 1993. Some insignificant changes in the structure of the consumer price basket were made, reflecting the need to make it consistent with the quality of the various consumer goods offered in the domestic market.

CONSUMER PRICE INDICES
(December 1995 = 100)



Source: NSI, BNB.

The amplitude of monthly price fluctuations also widened. The highest monthly growth rate of consumer prices, 20.3%, occurred in June; March witnessed a monthly low of 1.7%. Consumer price dynamics differed significantly from those reported during the same periods of previous reform years. As seasonal factors did not play a role, developments in consumer prices related primarily to the sudden and dramatic lev devaluation in the second quarter and the price regulation policy.

During the first six months of 1996, movements within the group indices diverged less significantly from movements in the general consumer price index. Compared with 1995 year-end, food prices rose by 46.4%, nonfood prices by 51.7%, and services by 43.4%. This price behavior of group indices is typical of periods when government relies heavily on price regulation. Nonfood prices rose most significantly; since imported goods have a large share in this group, nonfood price dynamics was extremely sensitive to the depreciation of the national currency. Developments in food prices in the first half of 1996 nearly mirrored those in the general consumer price index as foodstuffs have a large share in the consumer basket. The government's efforts to slow price rises in foodstuffs through more comprehensive government price regulation again proved ineffective, which additionally impeded the process of price adjustment and contributed to expectations of higher inflation. Price movements in services were less than those experienced one year earlier and thus helped moderate the increase in the general consumer price index. This moderate price behavior is a result mainly of the large share occupied by state-controlled services in the notional consumer basket. Their shock increase was postponed for the second half of the year.

Producer Price Index¹²

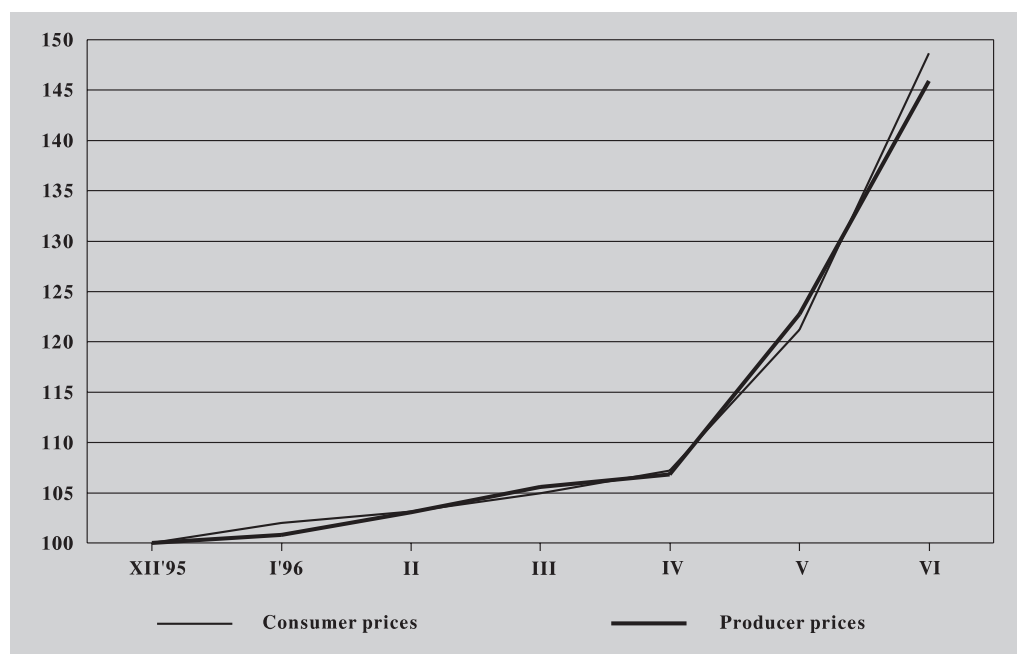
During the first half of 1996 monthly industrial producer price indices approached the level of consumer price indices¹³ as they had in the previous year. Since early 1996, industrial producer prices have increased by 45.9%, or 1.6 per-

¹² During the first half of 1996, the NSI did not change the methods of calculation of industrial output producer price indices. This index is a narrow and not very reliable source of information on processes in the real sector.

¹³ It should be noted that commodity industrial output producer price indices do not reflect changes in production services prices. Comparing, though conditionally, commodity industrial output producer price indices with consumer price indices is relevant, since the latter are determined to a large extent by price indices of goods in the consumer basket.

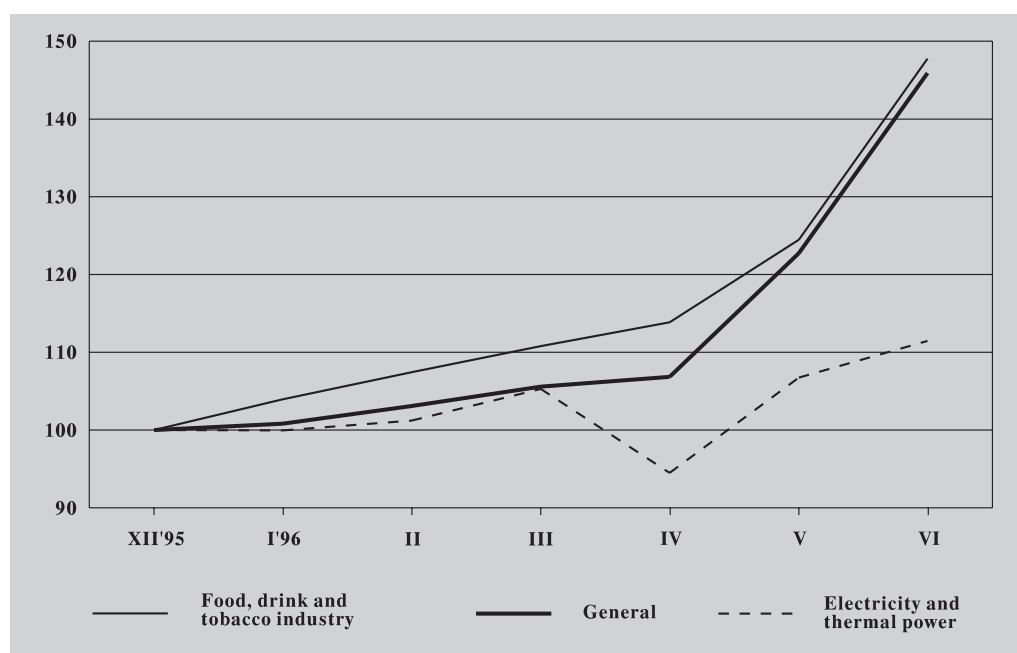
centage points less than consumer prices. Movements in the exchange rate were the major factor responsible for the developments in industrial producer prices. Depreciation of the lev contributed not only to the short-term rise in competitiveness of domestic output and higher lev equivalent of exports due to higher prices of imported raw materials, but also to an increase in producer prices. By the end of the period under review, the government's active policy on regulated prices also contributed to considerable producer price fluctuations.

**INDICES OF INDUSTRIAL OUTPUT PRODUCER PRICES
AND INDICES OF CONSUMER PRICES
(December 1995 = 100)**



Source: NSI, BNB.

INDICES OF INDUSTRIAL OUTPUT PRODUCER PRICES



Source: NSI, BNB.

Various producer price indices moved close to the average producer price index but in almost all months stayed higher than in the corresponding months of 1995. Significant departures in the monthly producer price indices of various industrial branches from the general index suggest the following: on the one hand, industrial companies have not established permanent foreign trade relations and foreign exchange movements may lead only to a temporary rise in competitiveness in the international markets; on the other hand industrial companies rely to a great extent on imported materials. Consequently, higher prices than the average producer price index were registered in the chemical and oil-processing industry (approximately 30 percentage points), and engineering and metallurgy (over 16 percentage points). Producer prices in sectors subject to government regulation indicated a smaller growth: electricity and thermal power generation by 11.4%, and coal mining by 27.8%.

5. Foreign Trade

According to preliminary data the trade balance in the first half of 1996 ran a surplus of USD 155.8 million¹⁴ with the bulk of it (USD 131.8 million) accumulated during the first quarter of 1996. Foreign trade turnover declined by 17.5% (from USD 5,002.2 million to USD 4,130.4 million) compared with the corresponding period of 1995. The decline in exports by 15% (from USD 2,521.2 million to USD 2,143.1 million) and imports by 19.9% (from USD 2,481 million to USD 1,987.3 million) reflects the increase in the positive trade balance¹⁵.

The decline in exports (according to preliminary data) despite the dramatic nominal devaluation of the lev (119.9% compared with 1995 year-end) affected adversely Bulgaria's economy. Revenues from exports are of great importance for imports, regular foreign debt servicing and replenishment of forex reserves. Significant real depreciation of the lev against convertible currencies created additional stimuli for exporters, while a number of factors contributed to the decrease in exports.

Lower external demand. Slower growth rates in the EU countries (40.2% of exports in the first half of 1996) reflected in a lower demand for Bulgarian goods. The expected GDP growth of the EU in 1996 is 1.5% versus 2.5% in 1995. Lower external demand led to a decline in exports of important commodity groups: base metals and chemical industry products.

Decreased credit supply. Bulgaria's economy is strongly dependent on bank lending, current output included. Any greater decrease in credit supply (an element of the policy aimed at reducing expenditure in the economy and tightening budget constraints) has an adverse effect on output, hence exports. The real decrease in credit indebtedness of nonfinancial public and private enterprises (75.8%) in the first half of 1996 compared with the end of 1995 is likely to have affected output, hence exports. High interest rates and expected structural changes in the real sector have adversely impacted the volume of output and consequently exports. These conclusions have been proved by the decreased output in the branches with traditionally big shares in exports, i.e. ferrous metallurgy, food industry, etc.

While analyzing the expected effects of the nominal and real depreciation of the lev on exports during the first half of 1996, the following should be taken into account:

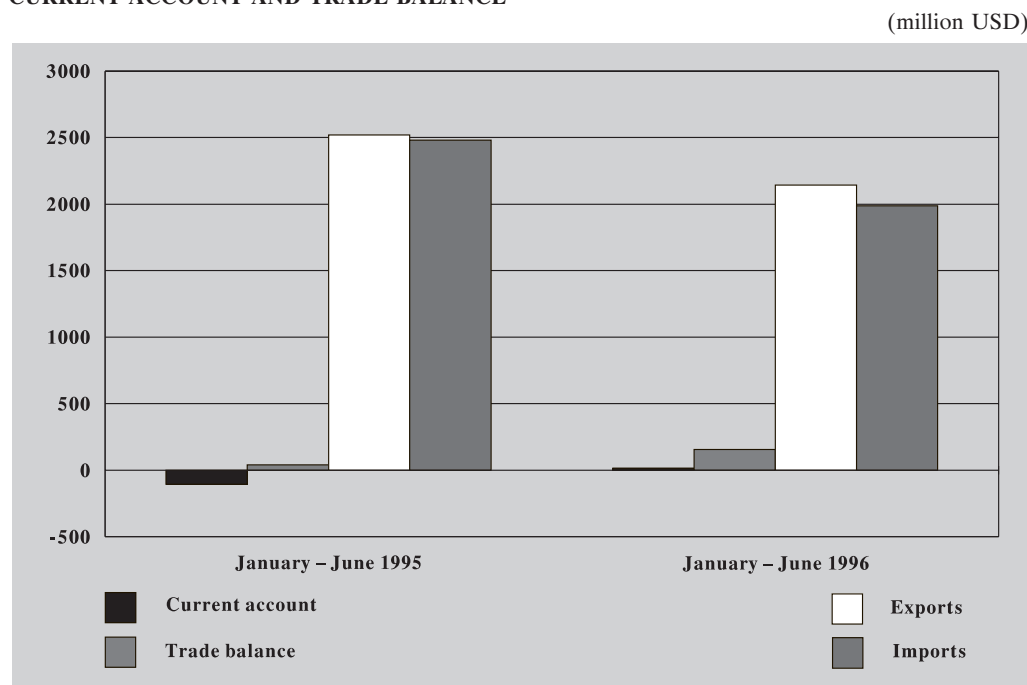
First, Bulgaria's economy has a high *imports/GDP ratio* (39.8% in 1995) due to its scale and its production and technological structure. As a result production prices and hence export competitiveness depend to a great extent on import prices. Other conditions being equal, the significant devaluation of the national currency results in higher import prices and a rise in output price, respectively exports. Un-

¹⁴ Due to delayed release of the NSI data, the balance of payments is based on preliminary data on imports and exports obtained from customs declarations and processed by the MF Computing Center. To obtain the complete values of foreign trade, this data has been additionally processed by the BNB.

¹⁵ Smaller values in exports and imports, particularly in the second quarter of 1996, are likely to be a result of unprocessed customs declarations.

der current conditions the share of the import component in the price of goods may be decreased by changes in technology, which requires significant investment. This could be hardly expected in the short run. Consequently, depreciation of the lev should not be considered only as a factor to raise competitiveness of exports and increase export volume.

CURRENT ACCOUNT AND TRADE BALANCE



Source: NSI, BNB.

Second, real depreciation of the lev should not be assumed as a constant. A higher inflation rate results in an overvaluation of the lev thus discouraging exports and leading to a decline in exports, and an increase in imports, a depletion of forex reserves which builds pressure for a further devaluation of the national currency. Consequently, preservation of export incentives as well as avoidance of this vicious circle in the economy pose certain requirements to the BNB monetary (foreign exchange) policy and require the pursuit of a consistent and coordinated macro-economic policy by all institutions.

Third, the bulk of the country's receipts come from exports of energy-intensive goods (e.g. metallurgy and chemical industry products). As a result, the effect of the exchange rate coupled with increased energy prices, all other conditions being equal, would also seriously impact the competitiveness and exports of these goods.

A decrease in real consumption due to depreciation of the lev and inflation led to a decline in *imports*. Domestic demand for imported goods has decreased due to contracted lending to nonfinancial enterprises in real terms.

Export Competitiveness

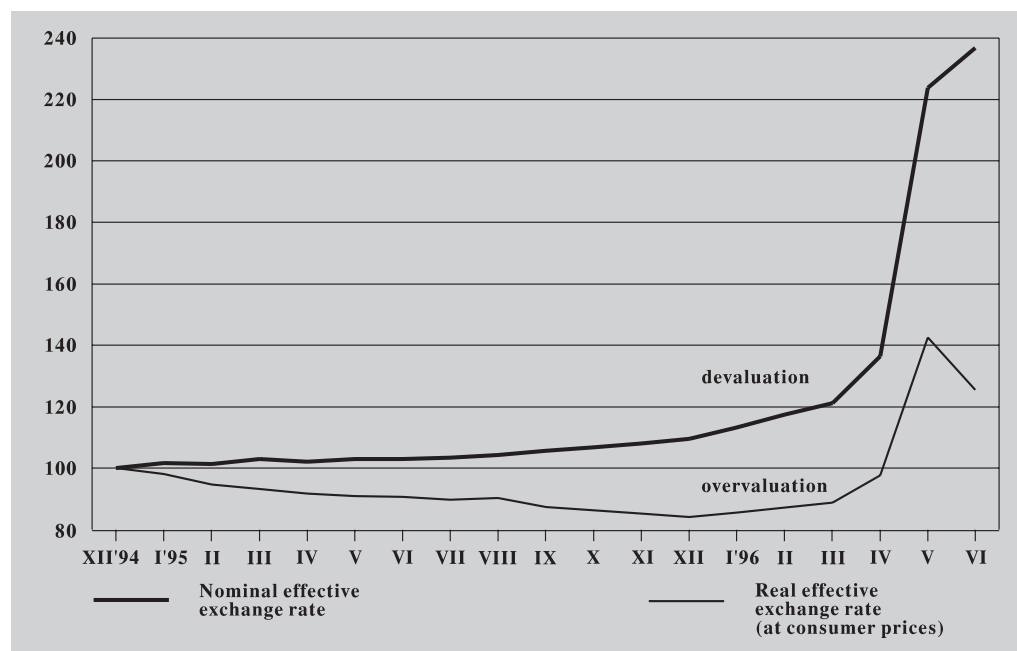
In 1995 and in early 1996, the lev appreciated in real terms. Between December 1994 and December 1995, the index of the real effective exchange rate was 84.1¹⁶. The lev devalued in real terms reaching 142.5 by end-May, mainly a result of its nominal devaluation (by 119% since end-1995). Due to the subsequent price jump, by end-June the index of the real effective exchange rate fell to 125.5. A faster price increase than the rate of lev devaluation may further reduce the advantages of export competitiveness as a result of lev devaluation.¹⁷

¹⁶ The index of the real effective exchange rate is calculated by major currencies, used in international settlements, distributed as follows: USD 75%; DEM 20%; CHF 5%. The consumer price index for the respective country is used.

¹⁷ As per preliminary data, the index of the real effective exchange rate by end-August (1994 = 100) fell to 114.5.

The real depreciation of the lev indicates improved competitiveness, and everything else being equal, it should have encouraged exports and repressed imports. However due to reduced external demand, combined with some internal factors including incomplete coverage of all customs declarations in the second quarter of 1996, no export growth was registered.

EXCHANGE RATE INDICES (1994 = 100)



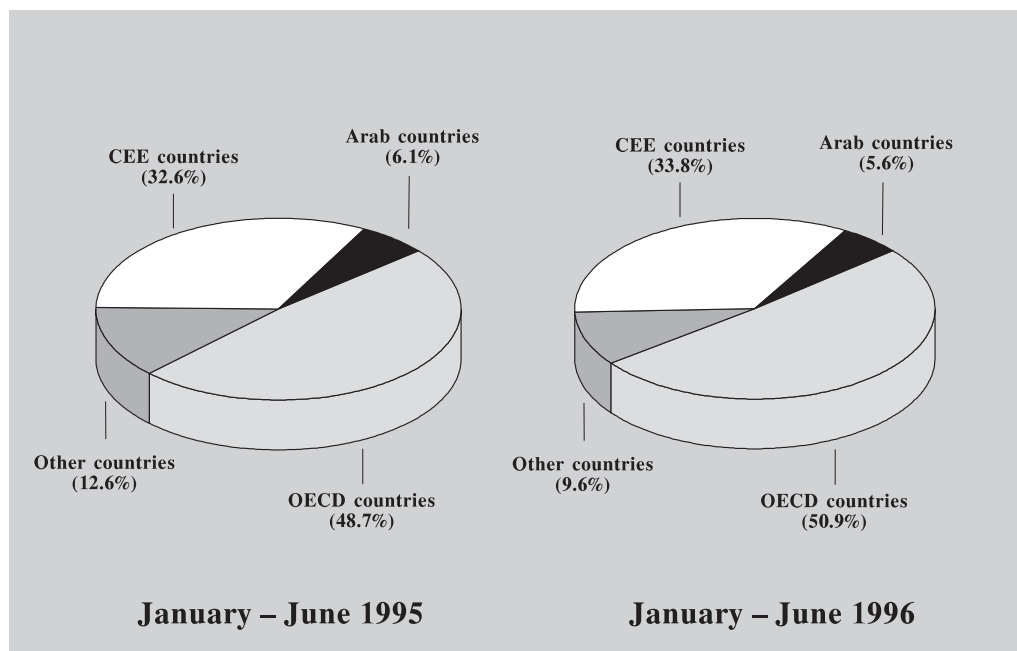
Source: BNB, NSI, International Financial Statistics.

Geographic Structure of Foreign Trade

The geographic structure of exports remained generally stable. During the first half of 1996, the shares of exports to OECD countries and central and eastern European (CEE) countries accounted for 50.9% and 33.8% respectively, against 48.7% and 32.6% in the first half of 1995. The share of exports to EU countries rose from 38.7% to 40.2%. However, the change in the structure of exports resulted in a 8.5% decrease in value in the first half of 1996. The share of exports to the former Soviet republics increased from 15.5% to 19.7%, and the value of exports by 12.2%. The share of exports to the Balkan countries decreased from 15.7% to 12.4%. Exports to the Arab countries remained within the 5 – 6% band.

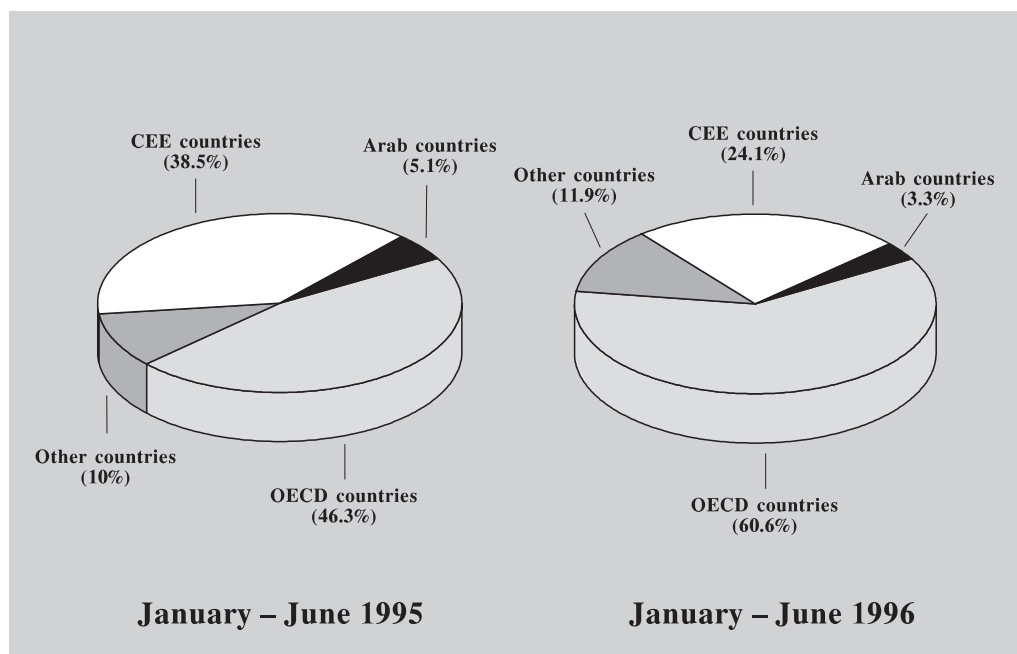
Significant changes occurred in the geographic structure of imports. The share of imports from OECD countries increased from 46.3% to 60.6%, with the value of imports increasing by 3.8%. This reflects dramatically contracted imports from the CEE countries (from USD 926.2 million to USD 460.5 million), a decrease by more than 14 percentage points (from 38.5% to 24.1%). The share of imports from EU countries increased from 39.9% to 52.4% (a 4.1% growth in the value of imports) while the share of imports from the former Soviet republics fell from 30.2% to 15.3% (a 60% decrease in the value of imports). Imports of mineral products and fuels from these countries indicated the strongest decline, from USD 462.8 million to USD 113.8 million.

GEOGRAPHIC STRUCTURE OF EXPORTS



Source: NSI, BNB.

GEOGRAPHIC STRUCTURE OF IMPORTS

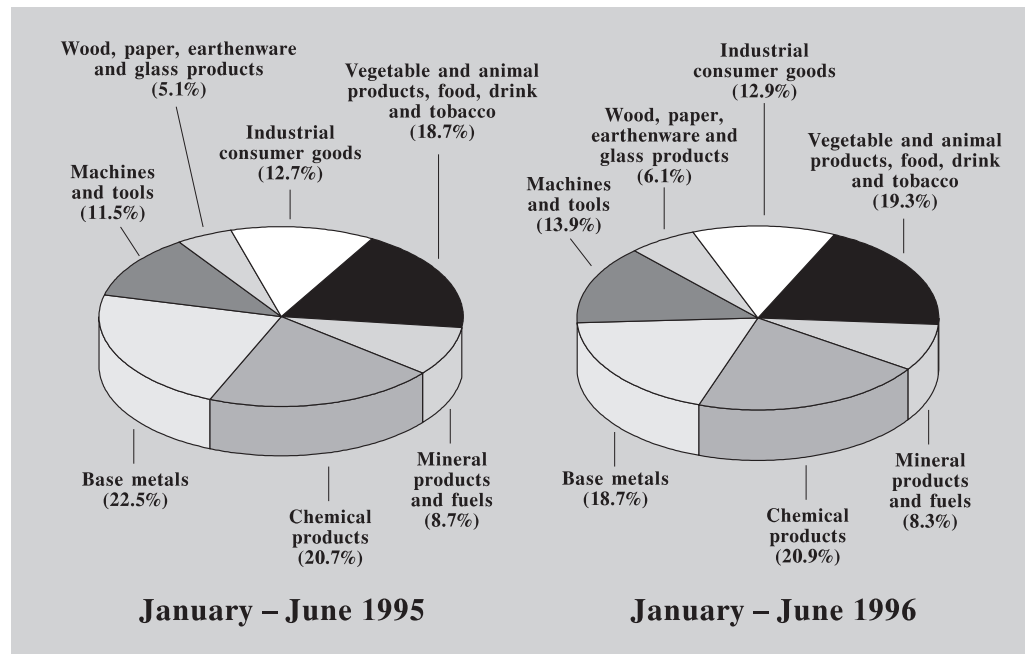


Source: NSI, BNB.

Commodity Structure of Foreign Trade

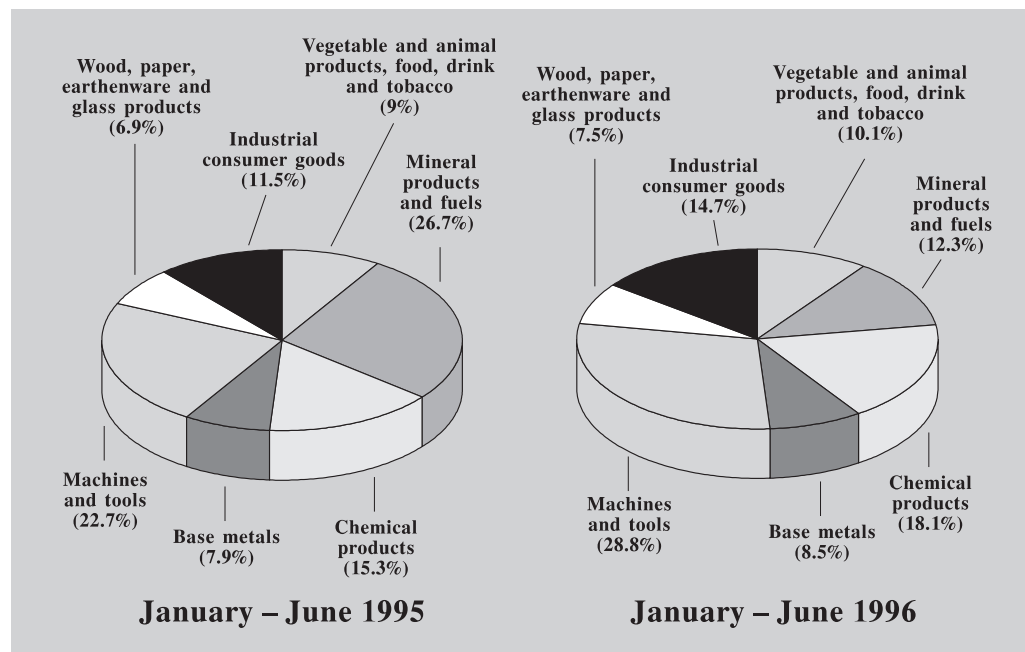
No significant changes occurred in the commodity structure of exports. The value of base metals dropped more significantly. Exported base metals during the first half of 1996 amounted to USD 400.8 million against USD 548.3 million a year ago. Exports of base metals to OECD countries decreased most dramatically, from USD 371.4 million to USD 275.7 million, a decrease of 25.8%. The major reason behind this fall is decreased demand in these countries. Exports of chemical products have dropped by 11%. The machines and equipment group alone indicated an increase of 5.9%. The other commodity groups sustained their shares in general with some decreases in their absolute values.

COMMODITY STRUCTURE OF EXPORTS



Source: NSI, BNB.

COMMODITY STRUCTURE OF IMPORTS



Source: NSI, BNB.

More significant changes occurred in the commodity structure of imports. The share of imported mineral products and fuels decreased from 26.7% to 12.3% with the absolute value declining 2.7 times (from USD 642 million to USD 234 million). There are several reasons behind this decline: a decline in output and lower demand for energy resources respectively; increased prices of fuels due to the dramatic lev depreciation; limited possibilities for processing and reexport of oil products. As in exports, a certain growth in value (0.8%) in imports of machines and equipment was registered. Imported industrial consumer goods increased by 1.1%.

6. Balance of Payments

The balance of payments data reflects the complicated environment under which the Bulgarian economy was functioning in the first half of 1996. While developments in the current account were impacted by internal and external factors, the developments in the capital and financial account, particularly the capital flight, were prompted by internal factors.

Current Account

The current account balance ended in surplus (USD 15.3 million) during the reporting period, a better result than the same period of 1995 when the account was in deficit (USD -106.7 million). The improvement (USD 122 million) can be accounted for in large measure by the trade balance.

The balance of the services account ended in surplus (USD 14.2 million) and remained almost unchanged from the level attained in the first half of 1995, at USD 16.3 million. The balances of travel services (USD 45 million) and transportation (USD 15.1 million) were also positive. The balance of interest was in deficit (USD -230.8 million) reflecting the reduced amount of interest due to the decrease both in the BNB forex reserves and commercial banks' foreign currency deposits since the beginning of 1996, and the interest paid on the country's foreign debt.

The balance of current transfers ended in surplus (USD 76.1 million), an increase of USD 22.1 million compared with the same period last year. Revenues from transfers totaled USD 127.8 million, an increase of USD 9.2 million. Expenditures accounted for USD 51.7 million, a decline of USD 12.9 million.

Capital and Financial Account¹⁸

The capital and financial account during the first half of 1996 saw a considerable capital flight and a severe fall in BNB forex reserves. The balance of the capital and financial account generated deficit (USD 71.9 million). By way of comparison, during the first six months of 1995 the capital and financial account was also in deficit, totaling USD 22.3 million.¹⁹

*Financial Account*²⁰. Foreign direct investment in the country totaled USD 49 million²¹, a decrease of USD 27.6 million compared with the same period last year. The countries with the greatest share in direct investment are: the Netherlands (20.7%), Russia (19.1%), Luxembourg (9.3%), Great Britain (8.1%), and Germany (4.5%).

Portfolio investment (net) amounted to USD -30.6 million. Of the total amount, USD 44.1 million was due to an increase in investment (assets) abroad by Bulgarian commercial banks in shares, bonds and government securities. Foreign liabilities of the government increased by USD 13.5 million due to a decrease in assets of residents in Bulgarian Brady bonds (USD 7.5 million), and purchase of government securities by nonresidents (USD 4.1 million).

Long- and short-term credits extended to nonresidents, the change in commercial banks' foreign exchange deposits and some other financial claims have been reported in assets in the other investment item. Assets in the other investment item rose by USD 666.6 million mainly due to capital flight, whereas during the same period of 1995 they diminished by USD 299.4 million.

Repayments of long-term loans previously extended by Bulgaria totaled USD 174.9 million (USD 135.9 million in the first half of 1995). Much of these comprise repayments (deliveries in natural gas) from Russia under the Yamburg

¹⁸ For assets, a negative sign shows an increase and a positive figure shows a decrease. For liabilities, a positive sign shows an increase and a negative figure a decrease.

¹⁹ In accordance with the methodology introduced by the fifth edition of the Balance of Payments Manual (Balance of Payments Manual, Fifth Edition, 1993, International Monetary Fund) the financial account now includes changes in BNB forex reserves. From this point of view, the decrease in forex reserves tends to increase the surplus on the financial account. Capital flight, including an increase in residents' foreign exchange assets outside Bulgarian banks, is shown as a negative figure.

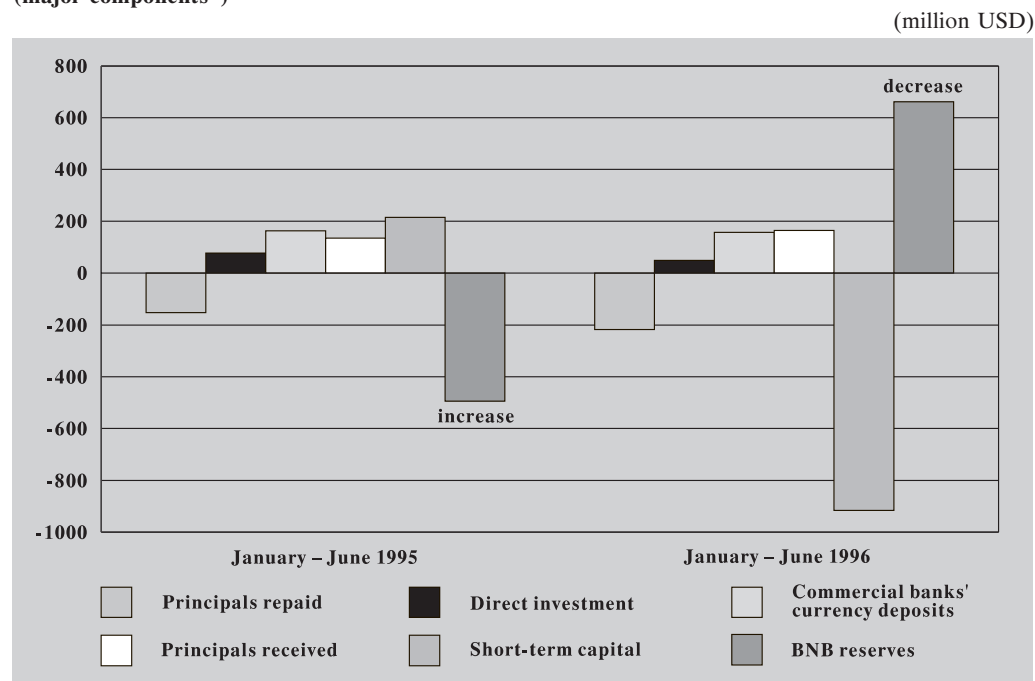
²⁰ No capital transfers were made in the first half of 1996.

²¹ As per MF data.

Agreement. During the period under review, repayments of USD 33 million from several developing countries were made.

Commercial banks' deposits abroad fell by USD 157.2 million, or USD 6.3 million less than the decrease in the first half of 1995 (USD 163.5 million).

BALANCE OF PAYMENTS FINANCIAL ACCOUNT
(major components*)



* For assets, a negative sign shows an increase and a positive figure shows a decrease. For liabilities, a positive sign shows an increase and a negative figure a decrease.

Source: BNB.

The period January – June 1996 is characterized by a capital flight which was remarkably high for the scale of the Bulgarian economy and the country's reserves. The major factors behind this outflow are: dramatically shaken confidence in the banking system; expectations of a drastic nominal devaluation of the lev (a negative interest rate differential). The largest negative interest rate differential occurred in January, April and May accompanied by the strongest expected and actual devaluation of the lev²². Dramatically shaken confidence in the banking system in April and May prompted a significantly negative interest rate differential.

During the period under review, two major forms of capital flight occurred: resident capital outflow and capital outflow abroad. For the first time after the start of economic reform in 1991, *resident capital outflow* occurred (a massive withdrawal of cash from individuals' forex deposits), which caused a fall in forex reserves at commercial banks and the BNB. Between January and June 1996, individuals and private companies' deposits declined by USD 512.4 million. As a result, banks had to buy foreign currency in the market which put additional pressure on the lev. Further devaluation of the lev enhanced the so-called "cash foreign exchange substitution", i.e. individuals withdraw their lev deposits and buy foreign exchange which they do not deposit into banks. Individuals follow the same pattern with the incomes they have allocated for savings.

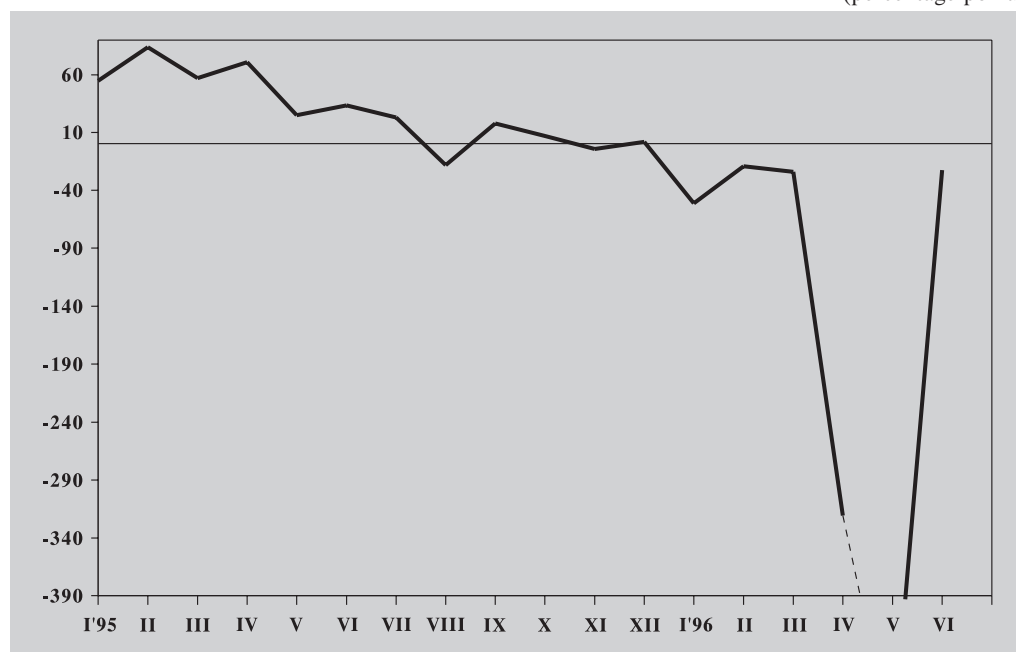
The capital flight which occurred in the first half of 1996 can be attributed primarily to expectations about a significant nominal devaluation of the lev. These expectations were based on the real overvaluation of the lev in 1995, the substantial amount of foreign capital brought from abroad to increase BNB reserves in 1995

²² The nominal devaluation of the lev to the US dollar in January 1996 was 9.7%, whereas in the whole 1995 it was 7.1%

and large pending payments to service the country's foreign debt. The process was further intensified by existing problems in the banking system. As per estimates, in the first six months of 1996 alone, capital of approximately USD 250 – 300 million either left or failed to flow into the country.²³

INTEREST RATE DIFFERENTIAL*

(percentage points)



* Interest rate on one-month deposits (in BGL) minus interest rate on one-month deposits (in USD) of commercial banks minus monthly percentage of devaluation of the lev to the US dollar (on an annual basis).
Source: BNB.

Changes in liabilities on long- and short-term credits extended to nonresidents (including from the IMF) have been reported in the *other investment* liabilities item. Changes in liabilities on commercial banks' foreign exchange and lev funds attracted from nonresidents have been also reported.

The country's liabilities under *other investment* decreased by USD 106.1 million whereas in the first half of 1995 they rose by USD 126.2 million.

Principal repayments to foreign creditors totaled USD 224.5 million (USD 146.2 million in the first half of 1995), an increase of USD 78.3 million.

During the first half of 1996, BNB forex reserves sharply fell, by USD 645.6 million (the biggest fall took place in the first quarter – USD 567.7 million).

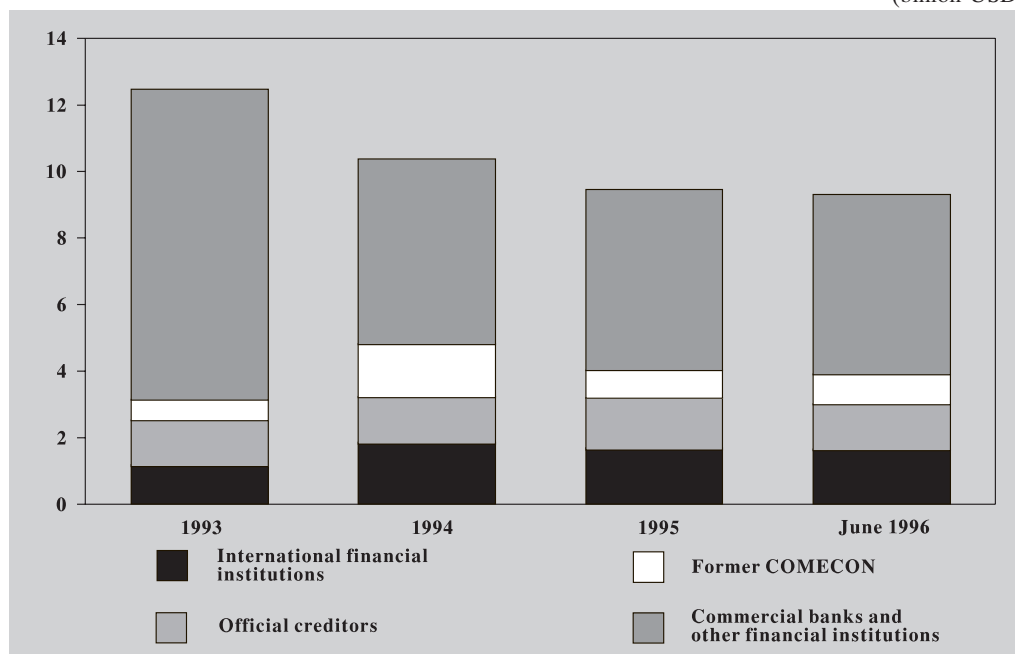
Foreign Debt

According to preliminary data the country's official foreign debt totaled USD 9,306.5 million by end-June 1996. Due to regular repayments and movements in the exchange rates it decreased by USD 139.5 million from the end of 1995.

²³ Traditional forms of capital flight are undervaluation of exports and overvaluation of imports.

OFFICIAL FOREIGN DEBT

(billion USD)



Source: BNB.

OFFICIAL FOREIGN DEBT

(million USD)

Indicators	1993	1994	1995	June 1996
Official debt, total	12472	10363	9446	9306.5
incl. to:				
international financial institutions ¹	1157	1825	1656.5	1621.6
official creditors ²	1368	1408	1528.3	1390.9
former COMECON creditors ³	611	1591	846.1	891.1
commercial banks and other private creditors ⁴	9336	5539	5415.1	5402.9

¹ IMF, World Bank, European Union, EIB, and EBRD.

² On bilateral basis. Including official credits received prior to 1989 and new official credits.

³ Debt in convertible currency to the IBEC, IIB, and the National Bank of Poland. For 1993, obligations to Russian banks are included in the debt to commercial banks and other private creditors.

⁴ Including obligations on Brady bonds.

Source: BNB.

III. Fiscal Policy

Deteriorated macroeconomic conditions in the country during the first half of 1996 entailed a pursuit of strongly restrictive fiscal policy. Delayed structural reform in the real and banking sectors, accumulated sizable losses in recent years and employed mechanisms for their conversion into government debt burdened substantially the expenditure side of the budget. Institution of insolvency proceedings for a number of banks coupled with the assumption of a portion of expenditures connected with the service of guaranty government securities by the budget intensified additionally the existing problems. Growing inflation and devaluation of the lev required additional constraints both in fiscal and monetary policies. Notwithstanding, dramatically increasing domestic government debt and its servicing causes serious concern.

1. Consolidated State Budget

The consolidated state budget includes the general government budget²⁴, legal system budget, social security budget, local budgets, some extrabudgetary accounts and funds²⁵. The 1996 State Budget Law (SBL) adopted the general government budget, social security budget, legal system budget, budget account of the National Audit Chamber and the relationships between the general government budget and municipal budget.

By the end of June 1996 net revenue on the consolidated state budget (obtained after the deduction of intrabudgetary transfers and funds for budget deficit financing) totaled BGL 183,813.8 million, 16% of GDP projected²⁶. Net expenditures on the consolidated state budget totaled BGL 223,496.1 million, 19.4% of GDP projected. Compared with 1995's same period, net revenues and expenditures in reported GDP²⁷ were 16.2% and 19% respectively.

Revenues and expenditures in the general government budget accounted for the largest share in the consolidated state budget. Compared with the first half of 1995, the share of revenues and expenditures in the general government budget declined in the total amount of revenues and expenditures in the consolidated state budget: revenues from 58.2% in 1995 to 57.5% in 1996, and expenditures from 57.6% to 57.3%. The structure and amount of revenues and expenditures of the general government budget directly reflected the structure and amount of the central government budget revenues and expenditures. As of 30 June 1996, revenue in the central government budget (CGB) totaled BGL 105,767.5 million, 42.3% of SBL projections, and 9.2% of GDP. In the same period of 1995, central government budget revenues as projected by SBL were 38.2%, and their share of GDP reported was 9.6%. Value added tax was the major source of central government budget revenues. As of 30 June 1996, these revenues totaled BGL 32,006.4 million, 38.6% of SBL projections. In the first half of 1995, revenues from VAT comprised 32.2% of SBL estimated.

As of 30 June 1996 the CGB expenditures totaled BGL 145,922.1 million, 46.3% of SBL projections and 12.7% of GDP estimated. By the end of June 1995, expenditure on the CGB comprised 41.6% of SBL projections and 13.1% of GDP. Current expenditures accounted for the largest share in CGB expenditures. The share of current expenditures in total expenditures significantly increased, from 56%

²⁴ The general government budget includes the central government budget, budget of ministries and government agencies, regional administration budgets, and the budget account of the National Audit Chamber.

²⁵ Extrabudgetary accounts and funds included in the consolidated state budget are as follows: "Professional Retraining and Unemployment Fund" and "Land Tenure and Improvement Fund," and the extrabudgetary accounts opened as per CM Decree No. 27 of 1992 and the Law on Protection of Arable Land and Pastures.

²⁶ Estimated GDP is BGL 1,150 billion.

²⁷ Reported GDP by the end of 1995 totaled BGL 871.4 billion.

in the first half of 1995 to 59.7%, a result of dramatically increased interest payments. Expenditures on interest payments comprised 52.65% of total expenditures, against 50.36% in the corresponding period of 1995. The increase in interest payments reflected both the amount and structure of domestic government debt and comparatively high level of the basic interest rate. As of 30 June 1996 interest payments amounted to BGL 75,252.8 million, or 52.65% of total expenditures. This comprised 61.8% of expenditures on interest payments as projected by SBL and 6.5% of projected GDP. By the end of June 1995 the amount of interest paid was BGL 57,310.6 million, i.e. 46.7% of SBL projections and 5% of GDP reported. Much of the increase in interest payments was attributable to internal interest payments, totaling BGL 61,864.2 million by the end of the first half-year, 69.8% of SBL projections. In the first half of 1995 they were BGL 46,116.9 million. Total amount of transfers to cover deficits on other budgets amounted to BGL 149,731.7 million. By end-June 1996 only 38.1% of this amount was transferred.

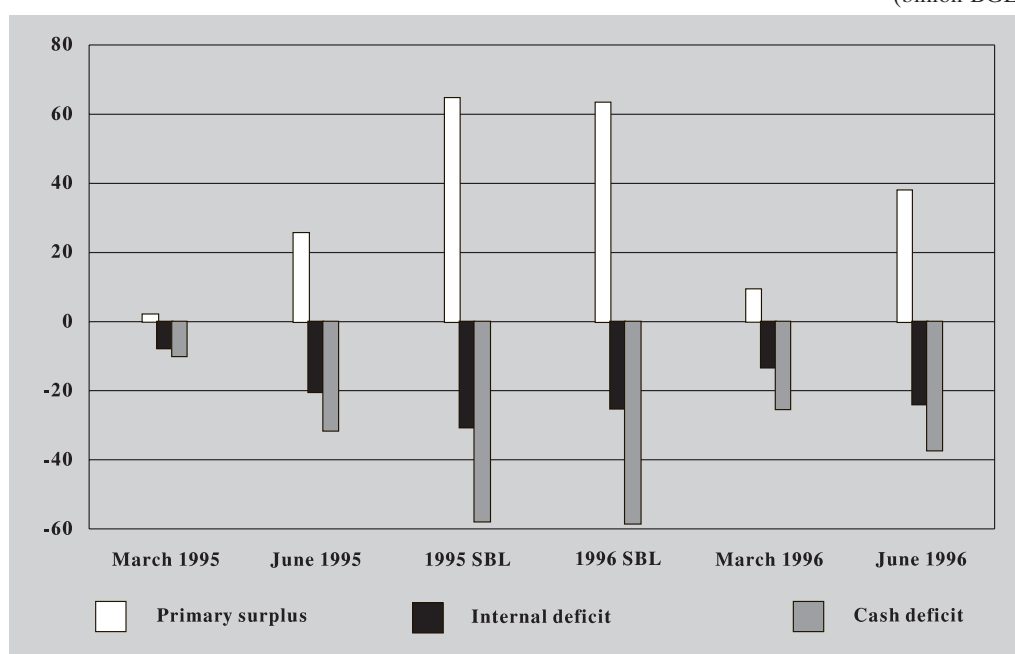
2. Budget Deficit

As a result of the restrictive fiscal policy and the MF method of reporting temporary noninterest-bearing loans from extrabudgetary accounts and funds as transfers, a primary surplus of BGL 38,098.2 million was reported on CGB by 30 June 1996. This comprised 60% of SBL projections and exceeded significantly the surplus reported in the same period of 1995 (BGL 25,788.4 million). The primary surplus accounted for 3.3% of GDP in 1996, against 3% in 1995.

Despite the relatively large primary surplus on CGB, it proved to be insufficient to cover expenditures on debt service. After reporting the relationships of the budget and domestic creditors, a deficit of BGL 23,766 million was reported, 94.6% of SBL projections and 2.1% of GDP. By the end of June 1996 the internal deficit accounted for 66.4% of the revised SBL and 2.3% of GDP.

DEFICIT OF THE GENERAL GOVERNMENT BUDGET

(billion BGL)



Source: BNB.

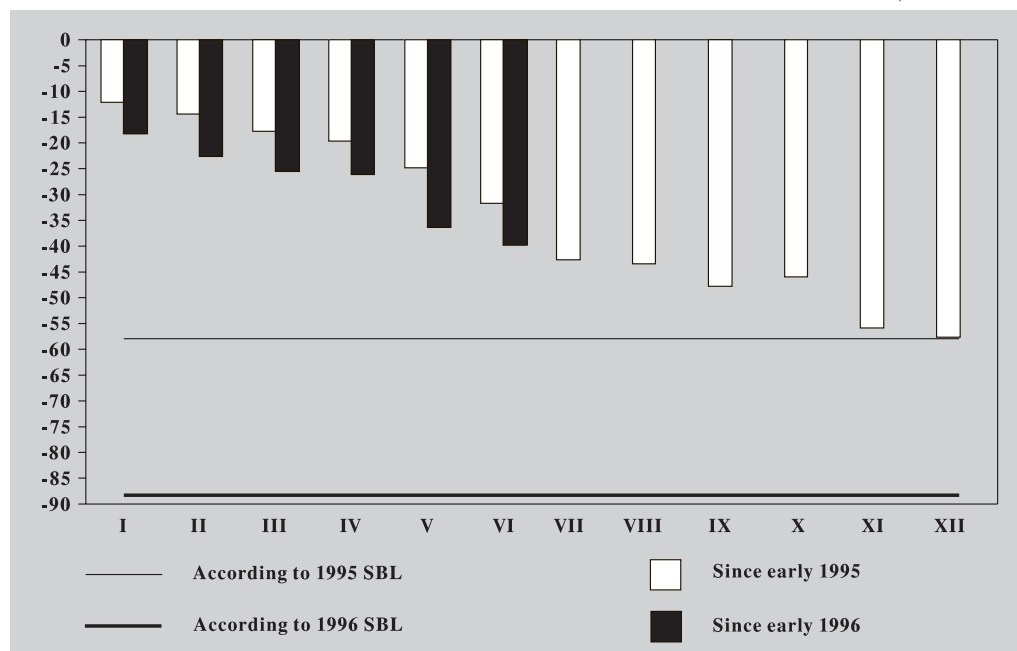
As of 30 June 1996 the cash deficit on CGB reached BGL 37,154.7 million, 63.7% of SBL projections and 3.2% of GDP. In the same period of 1995, the cash deficit made up 54.4% of the revised SBL and 3.6% of GDP reported.

The cash deficit on the consolidated state budget by the end of the first half-year of 1996 totaled BGL 39,682.4 million, or 3.4% of projected GDP. In the same

period of 1995 the share of cash deficit on the consolidated state budget was a mere 2.8% of reported GDP.

CASH DEFICIT OF THE GENERAL GOVERNMENT BUDGET

(billion BGL)



Source: BNB.

Dramatically increased credit indebtedness of the budget to internal creditors coupled with the maturity structure of the debt reflected a substantial growth in general borrowing requirements. As of 30 June 1996 general borrowing needs reached BGL 148,374.9 million, an increase of 69.3% compared with the same period of 1995. The trend of increasingly growing general borrowing requirements further intensified the problems relating to the provision of resources to service government debt and employment of effective mechanisms to subdue inflationary pressures on the budget deficit.

3. Budget Deficit Financing

By the end of June 1996 a negative net foreign financing had been reported, totaling BGL 6,858.5 million, or 23.3% of SBL estimates. Repayments of negative balances to the former COMECON member countries accounted for the smallest share of GDP projections, 5.2%. In the same period of 1995, the deficit on operations abroad totaled BGL 4,778 million, or 41.1% of GDP estimates.

As of 30 June 1996 net domestic financing of the CGB totaled BGL 44,013.2 million, resulting primarily from government securities operations. By the end of the first half-year of 1996 government securities operations totaled BGL 42,464.8 million, or 46.5% of SBL estimates.

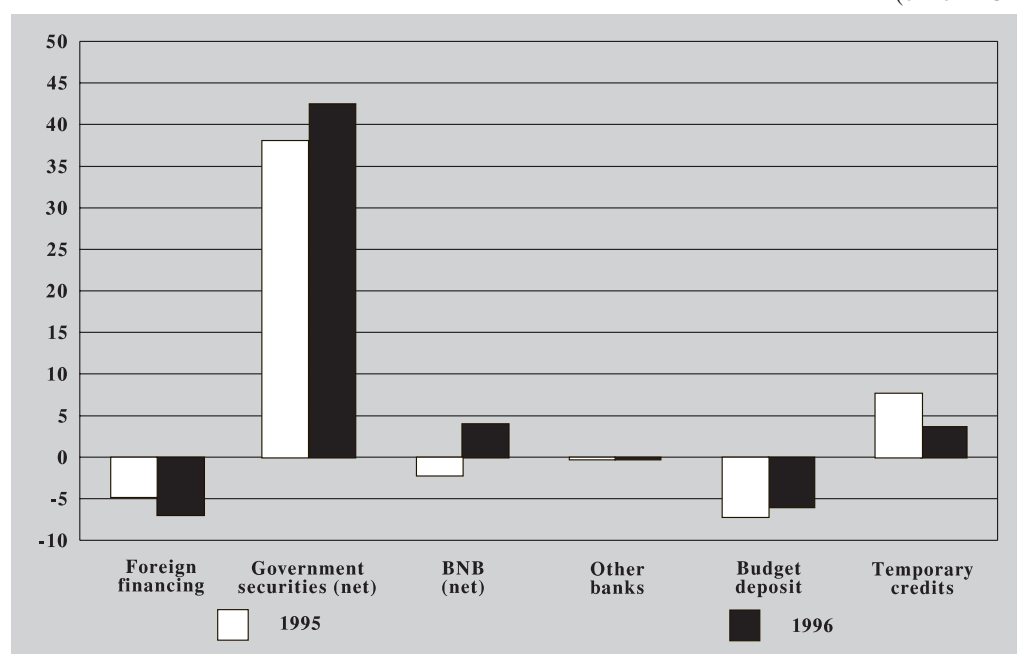
The crisis in the financial system limited the possibilities of the primary market to realize the government securities issued. This entails the use of other sources to cover temporary cash deficiencies of the budget. Short-term temporary credits (advances) under Article 46 of the Law on the BNB were one of these sources. Between January and June 1996, credits (advances) of BGL 34,000 million were extended to the MF. By 30 June 1996, BGL 28,500 million had been repaid. In addition, BGL 1,731.8 million was repaid by the budget in regular installments on the debt to financial institutions accumulated in recent years. Consequently, direct bank financing (net) of the government budget totaled BGL 3,768.2 million.

Transitional balances on CGB from 1995, worth BGL 3,712.7 million, and

loans repaid by municipal councils from previous years, worth BGL 35.2 million, were other sources to finance the budget deficit. By the end of June, the budget deposit totaled BGL 5,967.7 million, reducing net domestic financing by that amount.

CASH DEFICIT FINANCING OF THE GENERAL GOVERNMENT BUDGET

(billion BGL)



Source: BNB.

The structure of sources used to finance the government budget was as follows: government securities operations, 74.52%; temporary credits (advances), 22.91%; budget balances from previous years, 2.5%; loans repaid by municipal councils from previous years, 0.02%.

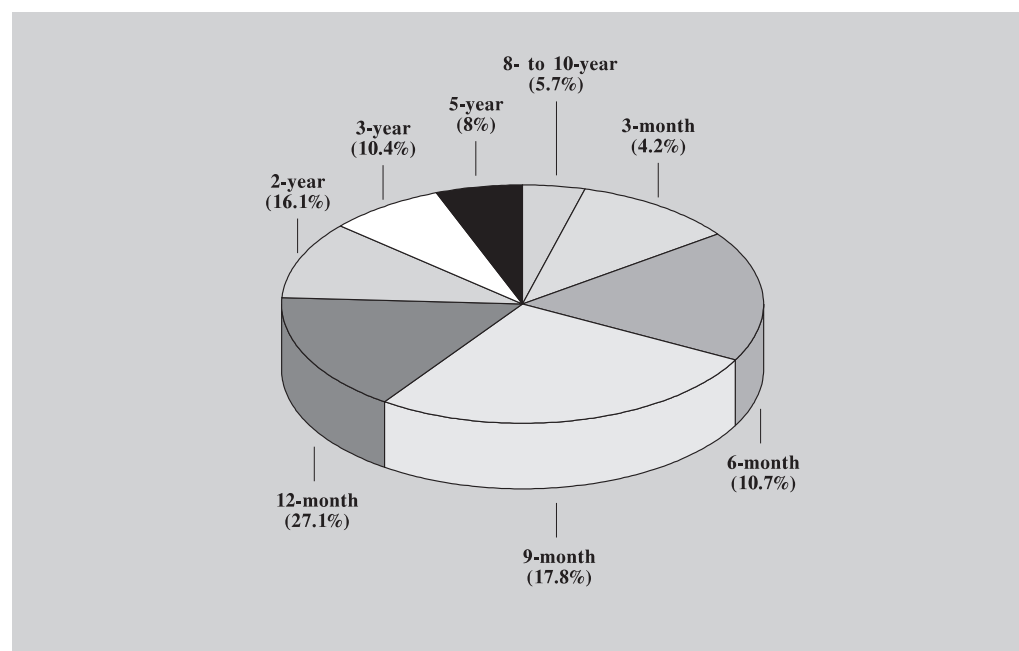
Actual state budget revenue in CGB from the issue of government securities (as per Regulations No. 5 and target issues for companies and individuals) totaled BGL 110,567 million, a 1.5 times increase compared with the same period of 1995. Maturing government securities of BGL 68,102.2 million were redeemed, including BGL 60,435.2 million from government securities issued in previous years.

The bulk of government securities was sold through auctions. During the period under review, 50 issues of book-entry government securities with a total nominal value of BGL 107,238.37 million were sold through the BNB to finance the budget deficit, including seven issues of discount treasury bills, 28 issues of interest-bearing treasury bills, and 15 issues of treasury bonds. As of 30 June 1996, 117 issues were in circulation (47 issues of treasury bills and 70 issues of treasury bonds) with a total nominal value of BGL 181,784.4 million.

Auctions for the sale of government securities during the first three months of the year were held under the terms of Regulations No. 5 of 1993 on the issuance of book-entry government securities and the procedure for their acquisition and redemption. Expansion of the government securities market required that the rules for participation in the auctions to be amplified and upgraded. Since April 1996, government securities transactions had been effected under Regulations No. 5 of 1996 on the terms and procedure for the issuance, acquisition and redemption of book-entry government securities. The new Regulations determine the rules and criteria for the selection of primary dealers that are eligible for participation in the auctions held by the BNB. These Regulations also set the procedure for the transfer by individuals and legal entities to other persons of government securities prior to the maturity date as well as the manner and rules for the conduct of auctions for the reverse repurchase of government securities prior to their maturity date and their re-

placement by a new government securities issue or by redemption of the nominal value and the interest on them.

STRUCTURE OF OUTSTANDING GOVERNMENT SECURITIES ISSUED FOR BUDGET DEFICIT FINANCING AS OF 30 JUNE 1996



Source: BNB.

The aggregate nominal value of government securities offered by the MF during the first half of 1996 totaled BGL 131,077 million.

Financial institutions' bids tendered at the auctions totaled BGL 119,377.8 million. As the MF did not announce in advance minimum acceptable prices for participation in the auctions, financial institutions' bids were approved upon attainment of a price set by the MF at the auction day with the exception of several issues sold under the terms of Article 3, para. 4 of Regulations No. 5 of 1996.

During the reporting period, commercial banks continued the tendency, typical of previous periods, towards increased investment in treasury bills in the primary market while the SSB remained a major investor in treasury bonds. Nevertheless, the SSB portfolio of government securities was reduced, while those of the BNB, the State Insurance Institute and commercial banks increased.

The bulk of the issues ensured average annual yield equal to or higher than the basic interest rate operative in the respective period. The only exception were issues Nos. 113 and 130 of treasury bills sold at a discount from their nominal value, and issue No. 311 of treasury bonds sold under the terms of Article 3, para. 4 of Regulations No. 5 of 1996.

Pursuant to Article 8 and Article 9, para. 1, item 1 of the Law on state protection of deposits and accounts with commercial banks in respect whereof the BNB has petitioned the institution of bankruptcy proceedings, the central bank registered two issues of seven-year guaranty government bonds (Nos. 402 and 403) in favor of the SSB with a total nominal value of BGL 12,338.967 million, and two public issues of three-year guaranty government bonds (Nos. 314 and 315) with a total nominal value of USD 61.2 million.

Government securities transactions in the secondary interbank market increased 2.4 times compared with those in the same 1995 period. During the first half of 1996, 9,942 transactions in government securities were concluded in the secondary market, totaling BGL 1,221,034.4 million. The BNB continued to be a major participant in the secondary market (7,332 transactions of BGL 1,116,391.3 million). Nevertheless, the share of transactions without BNB participation rose 1.7 times.

According to the BNB register containing information obtained from financial

institutions under Article 18 of Regulations No. 5 of 1996, the amount of government securities acquired by nonbank financial institutions, companies and individuals totaled BGL 47,255 million as of 30 June 1996 (including government securities of BGL 5,260.7 million bought with noncompetitive bids by companies and individuals), or 26% of all outstanding issues by 30 June 1996. By way of comparison, in the same 1995 period government securities sold to nonbank financial institutions, companies and individuals totaled BGL 16,517 million. The largest portion of government securities sales to nonfinancial enterprises was effected by the SSB.

The MF continued the established practice of weekly offering for sale government securities targeted at nonfinancial institutions – individuals and legal entities. Target issues were sold through financial institutions appointed to act as agents, from Monday to Friday, at prices set by the MF. Until enforcement of the new Regulations No. 5, agents for the target issues, which had contracts with the MF, were 26 financial institutions; after the new Regulations came into force their number was reduced to those selected to act as primary dealers (17). During the reporting period, the MF offered for sale treasury bills from the target issues with maturity of three, six and 12 months. Initially the three-month target issues were sold at a discount from their nominal value but after the sharp rise in the basic interest rate the MF had to replace them by three-month interest-bearing treasury bills. The effective annual yield on the target issues was higher than the basic interest rate and the interest rate applied by commercial banks on time deposits in levs. As of 30 June 1996 the aggregate nominal value of target government securities sold to nonfinancial institutions totaled BGL 5,835 million.

4. Domestic Government Debt

Unfavorable developments in macroeconomic conditions in the first half of 1996 combined with increased general borrowing needs brought about significant changes in the amount and structure of domestic government debt and additionally hampered its service.

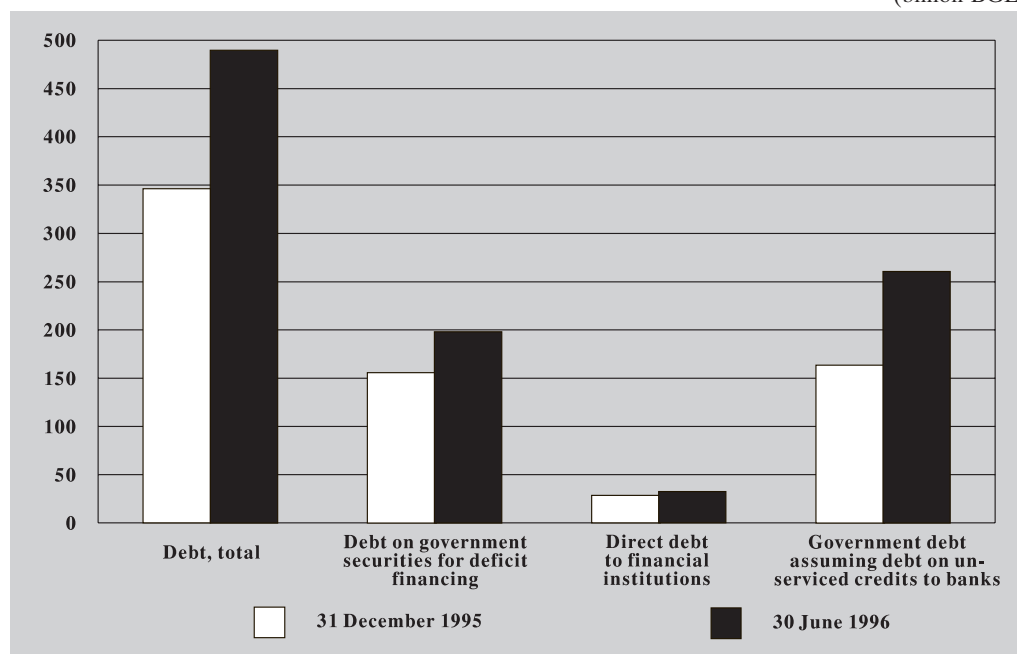
As of 30 June 1996 domestic government debt totaled BGL 488,836.5 million, including debt on government securities issued under Regulations No. 5 and target issues of BGL 197,258.9 million; BGL 31,557.6 million direct debt to financial institutions, and debt of BGL 260,020 million on government securities issued to replace unserviced credits and as per other decrees and laws. Compared to the debt as of 31 December 1995, domestic government debt has risen by 41.53% (at 1995 year-end it was BGL 345,395.2 million).

The MF debt to the BNB totaled BGL 30,056.2 million at the end of the reporting period, up 15.4% on 1995 year-end. During the first half of 1996 the total amount of direct debt to financial institutions rose by 13.6% compared with 31 December 1995, and debt on government securities issued under Regulations No. 5 and the target issues for individuals increased by 27.5%. As a result of the government securities issued under the Law on state protection of deposits, domestic debt increased by BGL 16,388.9 million (3.35% of the total amount of debt), including debt of BGL 5,456.6 million on government securities denominated in US dollars and recalculated in levs at the exchange rate for the particular day. Debt on government securities issued to settle nonperforming credits of state-owned enterprises to banks (LSNC) rose from BGL 101,929.1 million at 1995 year-end to BGL 182,716.4 million by 30 June 1996, or 79.26%. The share of this debt in total domestic government debt rose from 29.51% to 37.38%.

In structural terms, direct debt to financial institutions decreased from 8.05% in total domestic debt at the beginning of this year to 6.46% by the end of the first half-year, and debt on government securities issued for budget deficit financing dropped from 44.81% to 40.35%.

STRUCTURE OF DOMESTIC GOVERNMENT DEBT

(billion BGL)



Source: BNB.

In terms of maturity of outstanding government securities issued for budget deficit financing, those issued with a term of up to one year prevailed, with a share of 59.75%; government securities with a term of from five to ten years accounted for 5.71% of total amount, constituting mostly securitized debt to the BNB. Government securities with a term of up to five years comprised 8%, those with a term of up to three years 10.4%, and those with a term of up to two years 16.15%. In order to restructure domestic government debt, and on a motion by the MF, government securities of BGL 3,238.2 million were repurchased prior to maturity. Worsened maturity structure of the government securities issued for budget deficit financing reflected adverse developments in the economy and investors' unwillingness to make long-term investments.

If macroeconomic indicators continue to worsen through year-end, reflecting further devaluation of the national currency, high basic interest rate, contraction of the primary market and a reduction in the volume of government securities sales, as well as a reduction in the volume of purchases by companies and individuals as a result of the downward trend in incomes, and subsequent withdrawal of savings and deposits, it would be more difficult to finance the budget deficit and provide the necessary funds for domestic government debt service.