The Art of Central Banking in Eastern Europe in the 90s

BULGARIAN NATIONAL BANK

1879

120 YEARS

BULGARIAN NATIONAL BANK

The Art of Central Banking in Eastern Europe in the 90s

Presentations delivered at the conference
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the 120th anniversary of the Bulgarian National Bank

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Preface

On 25 January 1999, the Bulgarian National Bank celebrated its 120th anniversary. This placed the Bank among the world's ten oldest central banks. A variety of events marked the occasion. They drew on the illustrious past of the Bank and put its modern mission into clear perspective. The distilled message to today's public came across in the jubilee conference: The Art of Central Banking in Eastern Europe in the 90s.

The Conference sought to underscore and clarify the radical change the BNB underwent after the launch of a currency board in Bulgaria. The board is one of the deepest institutional evolutions in the BNB's 120 years of existence. At the same time — and being less apparent, this deserves emphasis — the board is Bulgaria's optimum starting point for future accession to the European Monetary Union.

The Conference's second major accent was to give monetary policy a regional perspective. As a basis for research here, one can hardly better the varied experiences of Central Banks invited to present papers. These papers cover practically the entire range of contemporary monetary policy options: from relatively free floating exchange rates, through the specific circumstances of European Union candidates aiming for EMU, to monetary policy under a currency board.

A scientific conference rewards personal participation: it is a forum for debate and networking among delegates. The Art of Central Banking in Eastern Europe in the 90s richly repaid expectations, with much shared experience and vivid discussion.

Most papers delivered at Conference plenary sessions are included in this compendium. Regrettably, despite the organisers' efforts, not all speakers submitted final and authorised written contributions. This explains both the delays in publishing the compendium, and its incompleteness. However, even in this form it gives a clear record of a major scientific event, which gathered leading Bulgarian and foreign economists and representatives of the influential fraternity of European central bankers.

The Present-day Central Banking in Bulgaria

by Svetoslav Gavriiski

Svetoslav Gavriiski is Governor of the Bulgarian National Bank.

The occasion of this conference is the 120th anniversary of the Bulgarian National Bank. However, we have gathered here not only to mark this anniversary, but also to share views and experience with central bank activities on the eve of the new century. It is not by chance that the topic of today's conference is **The Art of Central Banking.** The position and role of central banks as an element of economic policy cannot be overestimated. This applies to an even greater extent to Eastern Europe where most of the economies have accepted the challenge for transition to market economy. I also believe, that after the reports and discussions, we will be enriched with new knowledge and experience to be used in our everyday activities as central bankers.

I would like to focus your attention on the activities of the Bulgarian National Bank in particular. The anniversary that we celebrate today provides a good opportunity to look back on its history, and become aware of the efforts of several generations of Bulgarian bankers. You will have the opportunity to listen to a report on this subject. I will try to focus on the current activities and objectives of the central bank.

As you might be aware, more than a year and a half now the Bulgarian National Bank has been functioning as a currency board arrangement. It was not easy to take a decision for a deep institutional change and this is understandable. It is very difficult for a central bank, all the more that it has a century-old history, to give up its basic function of money supply management. Even today, in spite of the obvious financial stability following the introduction of the currency board arrangement, there are critical opinions against it. There are appeals still to be heard for a return to discretionary monetary policy. As to the reasons that brought about the introduction of the currency board arrangement, I will discuss them later in my report. Now, I would like to share some views on the principal differences between a central bank and a currency board arrangement, and to discuss the pros and cons of various currency board arrangements, based on the experience in Bulgaria and some other countries.

In 1999, at a conference in Kansas city which had as its topic the problems of central banks in emerging market economies, **Paul Walker,** a former chairman of the Board of Governors of the Federal Reserve System, said the following:

"For all the glories of my banking friends, I have to tell you they are not very big on the role of central banking in emerging market economies."

Is that really so? Is a central bank and discretionary monetary policy really possible (**and agreeable**) for transition economies? The introduction of a currency board arrangement in Bulgaria contains some elements of the answer. However, is the currency board arrangement a step back to more primitive forms of monetary policy, or a natural development in the management of the monetary system? How does a currency board arrangement fit into modern central banking?

I will try to answer these questions, all the more that I have accepted to be Governor of a currency board arrangement, not of a discretionary central bank.

Firstly, I will state my underlying thesis: *the criterion for the efficiency of a monetary institution is its ability to maintain a constant purchasing power of money in the course of time, i. e. to minimise inflationary expectations. Everything else is a result of real economy.*

I am going to consider the currency board arrangement in the light of three discussions: *rules versus discretion, covered versus uncovered money, and exchange-rate-based stabilisation versus monetary-aggregate-based stabilisation.* The first two represent a symbolic continuation of the classical discussion about the organisation of money starting in 18th and 19th centuries, whereas the third one is a product of the more recent history of credit money and national currencies stabilisation which began at the end of 19th and went throughout 20th century.

1. Rules Versus Discretion

As we know, there are two ways of conducting central bank monetary policy:

– **discretionary** – based on the current judgement of the money market condition and the macroeconomic situation; and

– monetary policy **based on predefined rules**.

Discretionary policy corresponds to the view that the State should be fine-tuning the economy, and that policy was predominant in the period after the Great Depression until the late 70s. Discretionary monetary policy could be defined as a continuous manipulation of two main sides of the money market: direct or indirect influence over money *supply* and indirect influence over money *demand*. A whole series of targets and intermediate objectives are determined making attempts to achieve them by various instruments. The Bulgarian National Bank, for instance, had set broad money growth targets using to that end the intermediate target for reserve money growth which presupposed stability of the multiplier. The money supply formed in that way collided with the money demand formed by the real economy. It was also assumed that the velocity of the currency circulation was more or less constant. Later direct reserve money management was introduced assuming that the Bulgarian National Bank would be in a position to control the sources of reserve money growth by the whole range of instruments, such as open market operations, discount and Lombard refinancing, direct lending, interventions in the forex market, sterilisations, etc. In terms of its instruments, the Bulgarian National Bank was in no way inferior to modern western banks and was ahead of most central banks in transition economies.

This way of managing money, however, proved inappropriate for Bulgaria. Apparently monetary policy instruments were introduced much earlier than the central bank's capabilities to use them. This and impaired central bank independence in taking managerial decisions brought about a financial crisis. Bulgaria's bitter experience, however, brings to the fore much more important issues. What are the abilities of a small and very open economy to pursue a completely independent monetary policy? How a central bank can combine the functions of maintaining the stability of the currency, ensuring the stability of prices and the exchange rate, ensuring the balance between money supply and demand, ensuring the stability of the whole banking system in the conditions of shrinking economic activity, growing fiscal and quasi-fiscal deficits, difficulties in servicing the foreign debt, low and unstable foreign currency reserves? If we add to these the desire, so typical of politicians, to exert pressure upon monetary authorities, all that proves difficult, even impossible, for a central bank without the necessary experience and reputation in society. In such a case a cardinal solution is sought, a possibility for a radical change.

The reasons for the unsuccessful attempt to conduct discretionary monetary policy may be looked for in other directions as well.

Firstly, in order for a central bank to be able to control the liquidity in the economy, it should have a clear idea of and exact data on the money demand and the multiplier, and full control over the reserve money sources – mostly net domestic assets. As you have large experience in central banking there is no need to convince you that this is hard to achieve. Hypothetically economic and behavioural correlations are assumed, most of which cannot be checked or are simply untrue. The Nobel Prize winner Friedrich Hayek aptly likens discretionary monetary policy to a driver who, having run over the pedestrian, believes that by driving back over him, he would bring him back to life again.

Secondly, the use of central bank instruments is often purely subjective and is not based on a definite logic, not rarely done under political pressure. From such pressure have suffered not only the Bulgarian National Bank but also far bigger and more reputed central banks. The impulses for reserve money growth in similar conditions are created externally and the central bank becomes a transmitting mechanism for assets and liabilities of other economic agents. In spite of their legal autonomy, central banks are often forced to pursue the economic policy of governments, sacrificing (voluntarily or not) their own principles.

An alternative to discretionary policy is monetary policy **based on explicit rules.** The supremacy of rules over discretion has been proved many times in theoretical debates and in the practice of central banks. This is the monetary policy model which the central banks of all developed countries chose in the late 70s. The explicit rules help to overcome the inherent inconsistency in a central bank's policy. The main weakness of discretionary policy is the possibility of divergent expectations of economic agents regarding the inflation rate which leads to higher seigniorage for the central bank and higher revenues for the government. This inconsistency in a central bank's actions causes higher inflation rates than those optimal for social development. The adoption of simple and clearly-defined rules which the central bank is obliged to observe in its policy eliminates the inconsistency problem and leads to optimal results. It is sufficient to mention Bundesbank's current monetary rules based on a monetary aggregate targeting, or the monetary rule for inflation targeting that became very popular in the early 90s. The countries from Central Europe, such as Poland, the Czech Republic and Hungary, also began to use the rule for inflation targeting.

The currency board arrangement is a specific type of monetary rule based on exchange rate targeting. This type of exchange rate targeting has been brought to the extreme by linking the reserve money supply with the dynamics of the balance of payments and the foreign currency reserves of the country. In this case the money supply mechanism comes maximally close to the classical form of money supply under the gold standard. It is a historically indisputable fact that the periods when central banks pursued discretionary policy are the periods of highest inflation rates in human history. On the other hand, the periods when money supply was managed by monetary institutions under the gold standard are the periods of greatest price level stability. Given these facts, we may conclude that the Bulgarian National Bank's transition from a discretionary central bank to a currency board arrangement is not a return to more primitive forms of monetary policy but a natural step forward in the evolution of the monetary system. Another ground for that conclusion is the fact that observing the CBA monetary rule helps to achieve greater price level stability. This is the criterion for efficiency of a monetary institution which I mentioned at the beginning of my report.

2. Covered Versus Uncovered Money

If we look at the history of monetary systems, we will see that the whole history of money is marked by searching for an invariable measure of value. By definition, money should have a constant value, an unchanging purchasing power. Quoting Friedman, “having inflation money means that you prefer driving a car with square tyres.”

Well known are the discussions amongst proponents of the currency school, who believe that money has to be fully covered, and those of the banking school who adhere to the idea that paper money should only partially be covered to boost lending and economic growth. In the context of this discussion, the currency board arrangement is more or less a return to David Ricardo’s currency principle, according to which currency circulation should be covered by some goods or a metal the value of which does not vary in time.

In the case of a currency board arrangement, the role of such goods is taken on by a stable convertible currency or a basket of currencies.

3. Exchange-Rate-Based Stabilisation Versus Monetary-Aggregate-Based Stabilisation

The third discussion is more contemporary and relates to the choice of a nominal stabilisation anchor. The stabilisation programmes used both for the recovery of West European economies after World War II, and for the countries in transition during the 90s, fall mainly into two types: money-based and exchange-rate-based.

The idea of a choice of a type of stabilisation is quite simple: an anchor should be such a variable which is a major pole of the expectations of economic agents, and which is able to break their inflationary behaviour. Money-based stabilisations are more difficult to achieve for small and open economies for two basic reasons:

- **Firstly**, due to the lack of a strong and stable link between the ultimate goal of central bank monetary policy and the targeted monetary aggregate. The unstable money velocity in such economies predetermines the weak link between the ultimate and the interim monetary policy goal.

- **Secondly**, the central banks in these countries are not in a position to completely control monetary aggregates. In such a case the dynamics of these aggregates do not provide a clear signal of monetary authorities' intentions, which undermines confidence in them, and makes their policy inefficient.

For small and open economies the exchange rate is a basic balancing variable, which makes stabilisation programmes based on a fixed exchange rate the only alternative for these countries. Stabilisation programmes based on such an approach show their advantages very quickly, which are expressed in:

1. Foreign exchange targeting is a very efficient instrument for reducing chronically high inflation rates;
2. The fixed exchange rate nominal anchor fixes the inflation rate for internationally traded goods, which, coupled with the high level of openness of such economies, helps to control inflation;
3. Foreign exchange targeting provides an automatic rule for conducting monetary policy by the central bank, which helps to prevent the problem of time inconsistency in its policy.

In support of this view it would be quite appropriate to give as an example some small but prosperous West European economies, which had *de facto* fixed their exchange rates to the Deutschemark and accorded their monetary policy with a view to maintaining such an exchange rate. The monetary policy model chosen by them and the results achieved speak for themselves.

A currency board arrangement is an exchange-rate-based stabilisation. It is a transparent and strict commitment to maintaining a fixed exchange rate which precludes any discretion in the policy of a central bank. By tying the rate of reserve money growth to the rate of international reserve growth, this mechanism overcomes the basic weakness of the regimes based only on a fixed exchange rate – the possibility for speculation with the national currency. The fixed exchange rate is especially appropriate for a small country which starts from low levels of economy production and efficiency. It is then slowly overestimated and allows for business restructuring.

* * *

Before proceeding to the reasons and implications related to the introduction of the currency board arrangement in Bulgaria, which brought about deep structural and functional changes in Bulgarian National Bank's activities, I would like to focus on two other trends in the development of contemporary economy, which expose central banking to new trials, and diminish the possibilities for control over liquidity in the economy. These are the emergence of the **new information society** and the overwhelming growth of **financial innovations**.

Rapid decentralisation of information, especially the wide expansion of Internet services, create a possibility for a great portion of settlements through the so-called 'electronic money' to be effected beyond the awareness and control of the central bank. On the other hand, central banks' liabilities will get shorter as electronic money is cheaper than paper money, and a bank's seigniorage therefore will trend downwards. The most developed countries and central bankers have reasons for concern.

The great number of financial innovations and monetary substitutes shorten the segment of liquidity, which could be monitored and controlled by central banks. These two phenomena shrink reserve money demand; commercial banks reduce their reserves, and the velocity of currency circulation shows a consistent upward trend. To be able to meet such challenges, as well as to prevent an increase in inflationary expectations, central banks will have to reduce reserve money, which will lead to less proceeds from seigniorage, thus diminishing the role of central banks in the economy.

*From this point of view we can definitely say that modern central banking is firstly, a **minimum banking**, and secondly, a **market central banking.*** This allows commercial banks and economic entities to optimise their resources and assume the responsibility for the outcome of their decisions.

The currency board arrangement fits completely into modern trends in monetary relationships. It can be viewed not as a return to colonial methods in monetary policy, as many argue, but only as a revived institutional form of monetary policy, which fits into the very essence and evolution of money. We should not forget that while market economy and money have existed for more than two thousand years, central banks and central banking are the outcome of the recent history of monetary relations.

* * *

Hoping that I have succeeded in pursuading you of the advantage of monetary rules applied by small and open economies over a purely discretionary monetary policy, allow me to make a brief outline of the reasons for the introduction of the currency board arrangement in Bulgaria, as well as for the changes introduced in the Bulgarian National Bank's structure and activities, and the implications of such changes.

On 1 July 1997, a currency board arrangement was introduced in Bulgaria which put an end to the failed attempt to conduct monetary policy without real economic reforms. The Bulgarian National Bank underwent one of the deepest institutional changes since its establishment in 1879.

What were the roots of this radical measure?

At the end of 1996 and the beginning of 1997 Bulgaria witnessed a financial crisis of a scale unseen before. The country was driven into a disastrous hyperinflation and sharp depreciation of the national currency. Only in February 1997 price growth exceeded 200%, while the national currency depreciated almost three times. The economy was naturalized and dollarised. The forex reserves of the country fell to critical levels. There was a real danger of a moratorium on internal and external debt service. The public was seized with banking panic. One fourth of the banking sector was subject to liquidation. In this situation the central bank completely lost control over money supply and the foreign exchange. The major instruments of conducting monetary policy had no effect on the banking and monetary system, and were practically ineffective.

In the beginning of 1997 the economic crisis evolved into a **political** crisis. In December the government resigned from office. The newly elected president appointed a caretaker government. The first steps of the new government were directed at bringing the exchange rate and inflation under control, and ensuring budget deficit financing by securities at the shortest end (7 and 28-day). The pre-term parliamentary elections in the spring of 1997 were won by the opposition which formed a cabinet determined to carry out quick and radical economic reforms.

The underlying motive in the government programme and the stand-by agreement with the IMF was the introduction of the currency board arrangement. The political forces reached a *consensus* on the need for a currency board arrangement and radical changes with a view to stabilising the financial system, which made possible its painless introduction. Practically, *even before* the currency board arrangement was legally established, most national institutions, including the Bulgarian National Bank, started operating under its rules.

What were the roots of the financial collapse in the country?

They could be found in the pace of economic reforms in the early 90s, and in the last government's management. In this period stabilisation measures periodically failed and had to be taken repeatedly, as the *need for a radical and consistent structural reform was underestimated.*

The real sector continuously incurred losses as a result of the weak financial discipline in industrial enterprises and the prevailing state ownership. The privatisation process was slow and faltering. The underdeveloped institutional environment added to low productivity. The lack of clearly defined ownership rights led to transfer of assets and liabilities in the absence of real economic activity. The hidden economy assumed threatening proportions.

The banking system was decapitalized. It turned into a conduit for transferring budget losses via state banks to households and well-functioning enterprises. Due to poor banking supervision, bad debts were accumulated in the newly established private banks. Pyramid schemes emerged in financial intermediation.

The ***state budget*** was slowly restructured and continued to perform functions inherited from the command economy. Tax collection was low. Budget deficit was a chronic predicament, and the government faced continuous problems with servicing its fast-growing domestic debt.

The central bank was becoming more and more of an appendage to the budget by continually covering (directly or indirectly) the latter's losses by currency issue. Commercial banks were systematically and often unjustifiably refinanced. Monetary instruments and money supply were uncontrolled. Foreign exchange policy was not based on any rationale and led only to forex reserves depletion. Lack of ***confidence*** in monetary authorities was manifested throughout all these years.

The restructuring of our ***foreign economic relations*** was slow. In spite of the accumulated external debt, no adequate measures were taken to open the economy to the development of foreign trade and attracting foreign investments. Foreign banks' presence in the banking system was deliberately restricted.

The negative trend in economic development had to be reversed. A **new beginning** was necessary. This, however, could not be achieved without a radical institutional change in the monetary system. **The currency board was the natural solution to it!**

What were the basic changes in the Bulgarian National Bank's activities ensuing from the introduction of the currency board arrangement?

• The exchange rate was pegged, and the Bulgarian National Bank's monetary liabilities were fully backed up by highly liquid forex assets. Monetary base movements were tied to the balance of payments dynamics, and the money stock became a function of commercial banks and real sector behaviour.

• The central bank discontinued refinancing of commercial banks and the budget, and ceased its open market operations. Internal sources of reserve money growth were eliminated. The central bank subjected itself to stringent budget constraints, restricting its sources of income to the interest earned on the currency board assets. The inflation component of seignorage was completely eliminated.

• Minimised central bank functions as regards money stock brought to the fore its supervisory functions of controlling the banking system, and made banking supervision a priority function of the central bank.

The monetary system in Bulgaria has some **specific** features that distinguish it from a typical currency board (hence in scientific literature it is often designated as a 'currency-board-like system').

• *From an institutional point of view*, presently the central bank is divided into an Issue Department and a Banking Department with separate balance sheets. The balance sheet of the Issue Department reports the activities of the currency board (the most liquid assets and liabilities), while the Banking Department assumes all remaining functions of a central bank with the exception of banking supervision.

• The relation between the two departments is maintained through the residual **deposit** of the Banking Department (the surplus of forex reserves over reserve money, the deposit of the government, and some other liabilities) with the Issue Department. This deposit provides funds for a possible BNB intervention (in the event of a **systemic crisis**) as a lender of last resort. The criteria for the occurrence of such crisis and the lending conditions are provided for in a special Bulgarian National Bank regulation.

• A specific feature of the Bulgarian currency board is the possibility provided to the Bulgarian National Bank to extend loans to the government, only if they are received against a purchase of SDR from the IMF.

• The central bank continues to perform its functions of a ***fiscal agent*** of the government servicing the cash execution of the central government budget and the government securities market.

The introduction of the currency board resulted in the expected stabilisation and in halting the negative trends in the economy. How did they manifest themselves?

The **monetary sector** promptly evidenced positive changes. As a result of containing inflation the credibility of the national currency was restored. Interest rates dropped significantly. Forex reserves increased rapidly, thus allowing not only for an unimpeded external debt service but also for money supply stability. The economy was remonetised as monetary aggregates increased in real terms. Money demand recovered thus putting an end to the flight from the lev. The lev component growth rate of money supply outpaced by far the forex one. The money multiplier, that had grown to unacceptable levels as a result of high inflation and lev depreciation, stabilised on a much lower level. The relative weight of the nongovernment sector in the structure of domestic credit increased noticeably. For the first time in recent years, households obtained real access to the credit market.

The **fiscal sector** became an important element in determining general liquidity in the economy. Initially the budget deficit shrank to grow into a surplus under the impact of improved tax collectibility and low interest payments that followed the abrupt downswing of interest rates. The amount of noninterest expenditures expanded considerably. Financial stability boosted privatisation making it an important source of noninflationary budget financing. The maturity of new government securities issues extended, and the volume of securities with fixed yield and lev-denominated ones increased. The hyperinflation preceding the introduction of the currency board had eroded the lev component of domestic debt. Upon its introduction, MF indebtedness to the Bulgarian National Bank was restructured thus clearing up their relations and putting them on a new, clear footing.

In the **banking sector**, a distinct change occurred in commercial banks' behaviour. They adopted more cautious and conservative lending stance. This resulted in higher liquidity in the banking system, improved capital adequacy and profitability indicators. The interbank money market (foreign exchange market included) resumed its normal operation. The first two privatisation deals of large state-owned banks with foreign investors' participation were effected, negotiations for others are in progress. A particular focus is placed on the presence of foreign banking institutions, in order to promote market competition and reduce systemic risk.

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Please, allow me to conclude my presentation by outlining future directions in the Bulgarian National Bank's activities, and the challenges ensuing from our striving for a full membership in European structures. It is hardly necessary to pursuade you of the importance of the new single currency of a united Europe. We can definitely assert that the beginning of the 21st century will be marked by a continuing and expanding process of economic globalization by means of establishing new and expanding existing monetary unions.

The benchmark that set the beginning of this process was the Maastricht Treaty in late 1992. The introduction of the single European currency was a decisive step on the path towards building a united Europe. For most of the Central and East European countries, which have so far remained outside the euro-zone, accession is an objective whose accomplishment is to come (for some earlier, for others later).

Regardless of the opinion that, as Bulgaria was not invited to enter the third stage of EMU, this should not be considered as the direction of its development, the very introduction of the currency board drives the country this way. The currency board was resorted to as an ultimate measure, as an inside and outside-driven solution. At the same time, the currency board placed Bulgaria in a uniquely favourable situation as to its movement towards the European economic and financial structures. It results not as much from the choice of its reserve currency, as from opting for rules which constitute the highway providing to Bulgaria the opportunity to quite purposefully and transparently head towards the desired goal. In this sense, once implemented, the currency board becomes a prerequisite for attaining financial stabilisation, yet in itself it cannot get the country into European structures. By means of the currency board Bulgaria will have to readily pay the economic and social price of accession to European structures. We cannot help but admit, that strict adherence to the currency board rules imposes restrictions not only on the activities of the Bulgarian National Bank, but also on the government in accomplishing their goals. In this regard, its advantages and disadvantages are yet to be tested.

The success achieved in the past year and a half in the area of macro-economic and financial stabilisation has assured us the direction was correctly chosen, and has made us look further ahead at the uniform macro-economic criteria for EU membership. To meet and keep in compliance with them is an ambitious but quite attainable task.

The currency board ensures certain advantages on our way to full membership in the European Monetary Union.

• Firstly, this is the *accomplishment of a long-term price stability* and the high degree of openness of Bulgarian economy. After the introduction of the currency board, an accelerated reorientation of commercial cash flows can be discerned, presently the EU countries having a share of over 50 per cent of Bulgarian foreign trade commodity turnover.

• Secondly, the currency board has imposed stringent restrictions on the economic policy pursued, which are closely following the criteria for EMU membership set out in the Maastricht Treaty.

• Thirdly, giving up pursuit of a discretionary monetary policy, and its recovered independence, prevent the central bank from the temptation to pursue through monetary policy goals different from the price stability objective.

• And last (but not least), the currency board is the embodiment of *stability and it brings us nearer to a strategic goal for Bulgaria – the accession to the European economic and political structures.*

At the Bulgarian National Bank we cherish no illusions about the timeframes of this accession. It would take many years before Bulgaria could become a full member of the European family. This, however, does not dishearten us, on the contrary, it inspires us for a more active effort to shorten the distance between us and the countries ahead of us in their reforms. From this point of view, preserving the currency board is a guarantee that this country will unswervingly observe its commitment to attain in time and comply with the criteria for EMU membership.

Allow me to conclude with the answer to a question that is often asked to me – whether (and when) the Bulgarian National Bank plans to abandon the currency board arrangement and to return to discretionary monetary policy. I would like to officially declare that our intention is to maintain the currency board until we get into the European System of Central Banks. And when this would happen, will depend on the pace of our economic reform.

Central Banking in Bulgaria: a Historical Perspective*

by Roumen Avramov

Roumen Avramov is Member of the Bulgarian National Bank Managing Board.

Central banking is as much of an art as a craft. In 120 years time, a central bank accumulates many cultural strata that were laid in one way or another throughout the institution's history and are carried over in time. Clearly outlined cycles in its development are produced, related as much to its own history, as to the history of monetary systems. I would like to discuss these two overlapping cross-sections of the history of the Bulgarian National Bank in a way that would help to elucidate the current situation and the prospects for the near future.

1. Cultural Fundamentals in Bulgarian National Bank History

The main cultural layer for each central bank is its corporate **culture of independence (or dependence) on the state**. Underlying this is an issue that is beyond any solution: issuing banks are established exactly for the purpose of financing governments. Each issuing bank is granted some privileges by the government, and in a sense it is indebted to that government. Thus the relationship between a central bank and a government is to a great extent a history of attempts

**Authorized short-hand record of Mr. Avramov's presentation at the Conference.*

by the state to impose self-restriction on its natural strive to interfere with the issuing function. And as with all attempts at self-restriction, success is inconstant, alternating with serious failures, with periods of full subordination of central banks to governments.

In Bulgaria, as elsewhere, the main economic issue of central bank dependence was as follows: it has been periodically decapitalized by the government as the latter accumulated indebtedness to the central bank, which had eventually to be eliminated in one way or another. This led to cycles of rehabilitation and cleansing of central bank's balance sheet, most often achieved by means of external debt. This was the history of the Bulgarian central bank, with 1902, 1912, 1928, 1990 and 1997 as benchmark years. These are all years when the accumulated indebtedness of the governments had to be 'diluted' to set the beginning of a new cycle. That is how the currency board got started. Let us recall that in 1997 an agreement was signed between the Ministry of Finance and the Bulgarian National Bank by which the stock of government debt to the Bank was arranged, thus setting the relationship between the budget and the central bank on a clean basis.

In Bulgaria, the struggle over the Bulgarian National Bank status and independence has been fought all throughout its 120-year existence. This battle started with the very old debate on Bulgarian National Bank ownership. In the Bank's Articles of Association of 1879, and later with the first Law on Bulgarian National Bank of 1885, the principle of state ownership over the issuing bank was established, although even at that time serious concerns were voiced that this could turn to be rather dangerous for the performance of its key functions. In these initial years, the concept that the Bank should be only state-owned and should not be transformed into a privately-owned shareholding entity prevailed.

The consequences of this fundamental choice are important. They are significant and long-lasting not only for the Bulgarian National Bank, but also for the Bulgarian economy in general. Bulgarian National Bank's dependence on the government turned into a premise for the public opinion, and for the financial establishment in this country. A kind of 'financial Aedipus complex' was formed in the public consciousness: the Bulgarian National Bank originated from the state, hence it owes to it, requiring the redemption of the state's debt to the Bank is a kind of patricide. The National Bank had to support its 'national' mission – 'national' was always interpreted as an unconditional assistance to government undertakings in all events, by all means, and at any cost. In a broader perspective, the consequences of the fundamental choice had a decisive incidence on the conflict between the 'private' and the 'state' principles in Bulgarian economy, where the latter has prevailed by far. The history of the strong state presence is not only that of the communist regime. There is a **pre-history**, which dates far back to all the 70 years of primary Bulgarian capitalism down to 1944. This all made the model of Bulgarian economic development more akin to the model of continental Europe, compared to the Anglo-Saxon one, and even more akin to the Balkan model, compared to the West European one.

These processes are explicable, as we used to say in socialist times – they are 'objective'. With the birth of the new Bulgarian state, Bulgarian economy started from a scratch, 'without capitals'. The only place where more significant capital could be accumulated was the state itself. This ensured to the Bulgarian National Bank a central role in all these years.

In spite of the early established state property over the bank, the debate whether Bulgarian National Bank should change its ownership has never stopped. There were such attempts in 1882-1883, when even a law was voted providing for a conversion of the Bulgarian National Bank into a private joint stock bank. This law, however, was never enforced, partly owing to political and partly – to economic reasons, as the subscription of shares of the Bulgarian National Bank failed. The savings potential of the economy was rather weak. The apogee of this debate was reached in 1928, when the League of Nations enforced, as one of the conditions for the extension of a stabilization loan to Bulgaria, the reorganization of the Bulgarian National Bank into a private joint stock bank. Even then the resistance put up by the Bulgarian government was extremely strong, and resulted in a compromised hybrid draft law where it was supposed to distribute Bulgarian National Bank's capital among small shareholders in a kind of 'mass privatization' of the Bank. The project was never realized, and in the final run, the Bank remained state-owned.

All these episodes are very indicative as they are key landmarks in Bulgaria's economic development, where the state leadership has prevailed as a guiding principle in the organization of the economy. This principle's deep roots account for many problems Bulgaria has been facing in the recent seven years in its transition to a market economy.

Attempts at statutory self-restriction, or restrictions imposed on the Bank's issuing function were made throughout its whole institutional history. Restrictions were imposed on lending to the government. There were also binding ratios for the issue coverage. But as any legal framework, they were swept away by **force majeure** circumstances, at moments when the government, due to military, political, or other considerations, had to increase its debt, and to finance it in the easiest possible way: by a banknote issue.

Reform attempts were made, of course, at a change within the framework of the state-owned status of the Bank. After all, the establishment of an up-to-date autonomous central bank in 1991 was such an attempt. Undoubtedly, however, the most decisive and consistent step in solving the fundamental issue of the relationship with the government was the introduction of currency board arrangement in 1997.

Public clashes between the Bank and the government were relatively rare. As a rule, in most cases the government has imposed its position and its will without facing significant resistance. There are only isolated instances where Bulgarian National Bank Governors, or the central bank as an institution, have voiced their opinion clearly and loudly. And exactly because of these, concluding my comments on this cultural stratum in the Bulgarian National Bank history, I cannot help noting that the personal, human, aspect also matters. Mikhail Tenev, one of the Bulgarian National Bank Governors who, at the end of the previous century, most clearly supported the Bank's position against the fiscal authority, said in his day that the independence depended not so much, and not only on the law, but rather on the people who managed the central bank. Other circumstances and other legal norms equal, the strength of the institution in the final run had depended on the staunch principles and unwavering determination of the people that were at the head of the central bank. Greater independence can be asserted even within an unchanged legal framework of the Bank.

The second cultural fundamental I would like to draw your attention to, is the **financial conservatism** that a central bank (like any institution of this type) is bound to develop.

In the case of a central bank, conservatism would mean basically not to waver at outside pressures. But historically the central bank has always been a lending institution. It had to pursue its own lending policy: starting from its early history, when it functioned as commercial bank, and reaching to more recent years when the Bulgarian National Bank turned into a purely issuing institution refinancing commercial banks in one way or another. The crisis in the financial system seen in recent years had to do exactly with the way commercial banks were refinanced, hence this instrument acquired a highly negative connotation. In fact, the refinancing failure of the central bank between 1991 and 1996 is indicative of BNB overall deficiencies as a lender: no matter if as commercial creditor or a creditor of last resort.

In its long history, the Bulgarian National Bank has lent practically to every entity – the government, municipalities, schools, private persons, companies, banks. The lending record of the Bulgarian National

Bank throughout all these 120 years reflects the problems of credit in Bulgaria: accrued arrears, poor financial culture, loan redemption difficulties, freezing funds in long-term assets (which can be lethal for an issuing bank). And the other way round, in periods of 'easy money', excessive credit and imprudent lending, which generate credit inflation and consequently aggravates the crisis, ensuing such periods of credit euphoria. Among Bulgarian public and business community, however, all these negative features have been often presented as major Bulgarian National Bank achievements. 'The facility and lenience' to debtors was pointed out as one of the assets of the issuing/central bank. It is here that we have to look for the deep roots of this 'debtors' economy' culture, which has continued to govern economic life in Bulgaria to the present day.

The third cultural fundamental in the Bank's legacy is related to the contacts with the external world, and to the **tradition of external conditionality** on a small open economy, what Bulgarian economy has always been. The very development of the Bulgarian National Bank is a crossing point of several banking institutional cultures. The Bulgarian National Bank was established by Russian public servants, who could certainly not conceive it in any other way but as a state-owned bank. Later on the Bank sought its points of reference and models of institutional development in the national banks of Greece, Romania, and of other neighbouring countries. The 1885 Law was inspired by the Law on the Greek National Bank. In the 20s, the Bulgarian economy was scrutinized by the League of Nations. Such a distinguished economist as Jaques Rueff, who was at the time a young technocrat working for the Financial Committee of the League of Nations, visited Bulgaria and assisted in designing the model of Bulgarian National Bank restructuring between 1926 – 1928, a precondition for the extension of two stabilization loans. Later on, after 1947, the Bulgarian National Bank was completely governed by the Soviet 'monobank' model. Two years ago, the currency board could be deemed merely an exotic structure, a British model devised for its dominions. But the interest shown in currency board arrangements during the recent global financial crisis indicates that they incorporate principles much more significant that the initial concept.

The Bulgarian National Bank has always been a key element in the Bulgarian economic development model, which, in short, boiled down to accumulation of domestic debt, that in moments of crisis was converted into external. This scheme has operated successfully in the first decade of the century, when the economy could bear the accumulation of domestic debt burden. The model caused problems when Bulgarian economy suffered debt overhang, as in the period after World War I, or at the end of the communist period.

In all cases, what I would like to stress in response to many current critics of the currency board, is that external financing was without an alternative in Bulgaria. Those that criticise the currency board could not point out any period in Bulgarian history when this country's monetary sovereignity had been exercised in full scale and only by the national monetary authorities. No such precedents are known or can be referred to, because Bulgarian monetary independence has always been partially, and sometimes completely restricted. Proposals for exiting the currency board would mean to condemn Bulgaria to a new financial isolation. The country has lived in such conditions in the 20s and the 30s, and in the 90s. So, it is clear that estrangement from international capital markets may not be a solution to the problems of the Bulgarian economy.

However in Bulgaria, both nowadays as in the more distant past, creditors' rights were difficult to realize and respect. They immutably include the 'natural' rights on the collateral pledged against the debt. Among them is the right of overview of the borrower's monetary policy and reserves. Furthermore, the creditor has an unwritten 'doctrinal right'. Whoever, at a certain point in time, dominates financially the country explicitly or implicitly transfers its economic ideology to it.

The Bulgarian National Bank has always been a key piece in the conditionality. Reforms in the Bulgarian National Bank have traditionally been included as a condition for Bulgaria to obtain large stabilization loans both in the 20ies, and in the 90ies. The dynamics of change in the Bulgarian National Bank has always been driven by outside pressures, as the dynamics of any changes in the Bulgarian economy as a whole.

The last layer, I would like to say a few words for, is the '**culture of convertibility**', i.e. the culture of foreign exchange (cambial to use the more archaic term) policy pursued by the Bulgarian National Bank. Each central bank is striving, in one way or another, to ensure the convertibility of its currency. Within the framework of the gold and gold-exchange standard, this is done according to strict rules. In the case of a 'classical' central bank that operated in Bulgaria in the 1991 – 1996 period, this was also its main objective, though within a different institutional framework.

Results in this area are contradictory. Only in rare moments could the Bulgarian National Bank ensure a relatively smooth convertibility of the lev. More often the central bank was not able to attain this goal, and had to administer the foreign exchange market by introducing a complete foreign exchange monopoly. It was pressured by governments to maintain fictitious exchange rates for the sake of image or due to outright political reasons. In many situations, the Bulgarian National Bank was also burdened with purely fiscal goals, which by rule has lead to fixing an artificially high exchange rate of the lev. The history of Bulgarian National Bank's cambial culture is a history of alternating cycles of accumulation of reserves, their depletion, and consequent violent crises leading to a change in the Bank's status, and in the whole economy. It happened so at the end of the last century, and also in 1912, 1923, 1931, and of course in 1990 and 1997.

The convertibility culture incorporates also the way of defining the central bank's reserves. There are many precedents of manipulations, and/or negligence in the Bulgarian National Bank in this regard. The major problem, however, is related to the doubtful assets that have been used sometimes to back up the money issue in the country. The problem took the most dramatic forms during World War I, when Bulgaria accepted as a substitute of the gold cover the mark-denominated conditional war advances from Germany. Eventually, they turned to be a totally fictitious asset, as after the peace treaty they remained blocked in Germany, and with the 1922-1923 hyperinflation they were fully depleted, causing considerable losses to the Bulgarian National Bank.

2. Cycles in the Bulgarian National Bank History

I would like to outline some major cycles in the 120 years of Bulgarian National Bank development. They will better illustrate against this historical background what the introduction of a currency board in Bulgaria is like.

Prior to the World War I, the Bulgarian National Bank was in its essence a heterogeneous institution, amalgamating both commercial bank and issuing bank functions. The combination of these two functions generates, of course, a certain transfer of losses and resources within the institution. Its everyday management has gradually turned the Bank into a large proprietor, as it foreclosed collaterals pledged by defaulting debtors. The Bulgarian National Bank used to extend credit to the government, to municipalities and to private businesses, to open accounts (in particular to outstanding figures of the political and business establishment), to deal with requests by banks for increasing their borrowing ceilings, and so on and so forth.

The main strategic objective of the Bank in this initial period, however, was the introduction of a full-fledged gold standard. It seems strange that against the background of a primitive and undercapitalized economy, what the Bulgarian economy was immediately after the Liberation, the Bulgarian National Bank set itself such a demanding goal. In fact, during the first two decades of its existence, it strove in vain to establish a modern monetary standard in a primitive economy. In mid-90s of the 19th century, the Bulgarian National Bank gave up this goal as an obviously unattainable one. As late as the first decade of this century, with the general improvement of the economic conditions in this country, and the inflow of foreign capital the Bank finally managed to implement the gold standard for a short period of 5 – 6 years (1906 – 1912).

The history of this excruciating experience is very edifying, as it summarizes all the problems the Bulgarian National Bank faced in the following years. These were primarily the problems of a chronic disequilibrium of the balance of payments and of fighting the unsatiable strive of the state to decapitalize the Bank by covering its own fiscal deficits with Bulgarian National Bank's resources and the free seignorage proceeds. This story is repeated with different nuances in the whole subsequent development of the Bank.

During the wars of 1912 to 1918, the Bulgarian National Bank exercised exclusively an issuing function, as the government financed them through banknote issue, and the Bank lost completely its identity. From the end of the wars to about 1926, foreign exchange policy and its endeavours to stabilize the exchange rate of the lev dominated in the Bank's functions.

Between 1923 and 1928, the strategic economic goal of the Bulgarian governments was to reestablish the gold standard as a modified form of a gold exchange standard. Bulgaria managed to attain this goal thanks to two important stabilization loans, negotiated with the help of the League of Nations. Between 1928 and 1931 we had probably the closest architype of the current currency board. The Bulgarian National Bank was reformed into a purely issuing bank. It was prohibited from investing in long-term assets and from financing the government. Its only duties boiled down to maintaining the liquidity in the banking system, including by refinancing commercial banks.

Bulgarian National Bank functions changed again in the 30s, the time of the Great Depression and the widespread clearing arrangements all over Europe. The Bank turned into an institution that meticulously monitored the enforcement of the sophisticated prohibitive currency exchange legislation. Through numerous committees, it set import quotas and engaged in petty bureaucratic trusteeship on practically all foreign currency transactions and transfers. Thus, Bulgarian National Bank involuntarily prepared itself for its next role (after 1947) when the socialist foreign exchange regime inherited the practices established in the years of the Depression without substantial changes.

From 1947 on, Bulgarian National Bank was restructured fully in accordance with the Soviet model into a monobank, which again amalgamated all functions: these of a creditor, a creditor of last resort, and of an issuing institution. It merged to a full extent the functions of an issuing and a credit bank. This may well have been the realization of the dream of the founders of the Bulgarian state, i. e. to use virtually unrestrictedly the resources of the issuing bank. Seemingly, the Bulgarian National Bank was fully depersonalized in these years. Even there was no special organic law for the central bank, and until 1991 it operated under its Articles of Association adopted early in the 50s.

Nevertheless, in reality this was the heyday of the central bank's power. It was in a position to control and supervise all major flows in the economy, to 'punish' any possible deviations from the principles of a demonetized economy, what communist system used to be. And it is quite indicative that while the Ministry of Finance was closed for a certain period (Bulgaria was probably the only country which had no finance a ministry for a period of 2 – 3 years in the late 80s), the Bulgarian National Bank never disappeared, as its decisive and key position was used to the maximum.

With the start of the transition to a market economy after 1991, the Bulgarian National Bank was converted into a classical autonomous central bank with a two-tier banking system. But its history between 1991 and 1997 also turned to be the story of the incapability to use – in the existing social and political context – in a mature way the whole range of instruments available to such an institution. The introduction of the currency board was a verdict delivered on the Bulgarian National Bank policy in this period, on its incapacity to exercise successfully the functions provided for in the Law of 1991.

Thus, several clearly defined cycles are outlined in the Bulgarian National Bank development.

One of the cycles is the alternance of accumulation and elimination of functions. In its early existence, Bulgarian National Bank was a universal bank that did 'everything'. In 1928 it was reduced to an issuing bank with rather simplified tasks. In communist times, Bulgarian National Bank again turned into a bank combining all functions. Currently, under the currency board arrangement, it is 'trimmed' by the outright amputation of many of its former essential instruments and goals.

Another cycle in Bulgarian National Bank history is the alternance of a passive policy, and the use of a more complete range of instruments. Under a gold standard, an issuing bank is to a great extent passive, regarding mostly balance of payments changes. Later, in the Depression years, and particularly more with the eventual Bulgarian National Bank's transformation into a monobank, it became again an 'active' bank, which was empowered to pursue its own or others' (often quite politically voluntaristic) aims. In 1991, authentic monetary policy instruments were again made available to it. And these days, under the currency board arrangement, the Bulgarian National Bank is reduced to the position of extreme passiveness in the monetary area.

Monetary systems in Bulgaria (as elsewhere) have also changed in a cyclically. From the gold standard, and through fiduciary issue, the currency board is bringing us back (in a completely different context) to a kind of ‘gold standard surrogate’.

And finally, major cycles in the 120-year history of the Bulgarian National Bank are the cycles of demonetization and remonetization of the economy. Demonetization through inflation during World War I, and the attempts at remonetization in the 20s. New total demonetization of the economy in communist times and experiments (that failed of course) for its remonetization through various reforms in the 70s and 80s, in which much effort was put to create monetary enclaves within the socialist system. A large-scale remonetization effort was made in the beginning of the transition in 1991 – 1996 period. It also failed with the demonetization of our economy during the hyperinlfation episode at the end of 1996 and early 1997. Presently, we are evidencing another, let us hope the last and irreversible, attempt to remonetize the Bulgarian economy based on the currency board principles.

3. Outlook

Let us conclude by formulating some assertions as to what could be expected for the Bulgarian National Bank future in the light of the Bank’s **long** history. Today, only two years after the consensus on the adoption of a currency board, voices are heard denying this system and advocating its revocation. Often historical arguments from our earlier and more immediate past are resorted to for the purpose.

These attacks only prove once again how short memory is, and to what extent history is not known and/or not understood. Probably, the strongest arguments in favour of the currency board are precisely of historical nature. Referring to 1991 – 1995 as a period of successful independent monetary policy is meaningless, as this exactly was the time that set the foundations of the ensuing financial crisis. To interpret incorrectly the more distant past means to forget the fundamental lesson taught by the Bulgarian economic history – in the area of monetary policy and stabilization, this lesson reads that only attempts at direct, sometimes brutal, separation of the Bulgarian National Bank from the state have produced successful outcomes. Let me remind that in the 20s a special law was voted under the pressure exerted by the Interallied Commission in Bulgaria that strictly restricted banknote issue and government debt to the Bulgarian National Bank to a preanounced nominal ceiling. The currency board is also a form of a drastic separation of the state from the Bank by simply severing the 'active' financial flows between the Bulgarian National Bank and the budget. Only when transferring its monetary sovereignty abroad has Bulgaria managed to stabilize its monetary system and national currency. This may be a sad truth, but it is a truth that we cannot escape from. In this sense, the currency board fits in the Bulgarian economic history, as it tries to correct the negative messages of our economic tradition, and the institutional culture of our central bank. It does not address only problems of the day but rather solves many of the century-old problems that could not find a solution in the Bank's long history: by eliminating the link connecting it to the budget; by implementing an appropriate monetary system corresponding to the financial culture and the development of the markets in Bulgaria; and, the most important, by imposing real and credible restrictions on money supply.

The currency board, however, is not a primitive system, although the temptation to present it as such is rather strong. In the current Bulgarian context, the currency board may turn into the starting point for something much more serious – the accession to the already existing European monetary area. This will not happen with the oversimplified transplantation of the Euro in Bulgaria, as is proposed by some economists. It will happen after we go a long way of institutional changes in the economy, and in the more distant future – in the central bank as well. The unequivocal advantage ensured by the currency board is that many of its principles are also the principles of the new EU monetary area. I have in mind the institutionalized discipline of the macroeconomic policy in the Euro-area, the severing of the link between central banks and government budgets, and finally, the new status of the ‘residual’ national central banks in their relationship with the European Central Bank. It is true that EU national central banks retain a more varied range of monetary policy instruments, than is currently available to the Bulgarian National Bank. However, in one way or another the bulk of their monetary sovereignty is delegated elsewhere – to the European Central Bank. In this sense, the smooth and continuing mid-term functioning of the currency board in Bulgaria is the basis for a learning-by-doing process, which will get accustomed Bulgarian economic agents to European-like behaviour. Bulgaria’s accession to the European monetary area will probably follow the steps and the schedule designed for EU-member countries that have not met Maastricht criteria but have set themselves the goal to shortly meet both institutional and purely quantitative macroeconomic criteria for membership in the EMU.

The ‘monetary’ issue that Bulgaria faces – today and in a medium-term perspective – is not how **to get out**, but how **to get in**. Not how to exit from the currency board arrangement but on the contrary – how to join the European Monetary Union directly from the currency board. Nobody cherishes any illusions that this will happen quickly and easily. At the same time, we have to realize that now we are on the most definite starting point in the long development of the Bulgarian monetary system. We are faced, as it has rarely happened before, with a logically consistent and naturally ensuing perspective. It should not be missed or jeopardized, so that not only the central bank, but the whole Bulgarian economic institutional culture is transformed by joining ‘Europe’.

Central Banking in Turkey

by Gazi Erзel

Gazi Erзel is Governor of the Central Bank of Turkey.

Ladies and Gentlemen,

First of all, I would like to thank Governor Gavriiski and the Bulgarian National Bank for organizing this conference, in which I have a great pleasure to take part. At the same time, let me congratulate the Bulgarian National Bank on the occasion of its 120th anniversary.

I would like to talk about the history of central banking in Turkey, to review Turkish monetary policy, and describe medium-term prospects for the central bank of Turkey.

The history of Turkish central banking dated from Ottoman times. Some of the duties and responsibilities of a modern central bank were performed by the Bank-i Osman-i Sahane in 1863, a state bank which was founded in 1856 as a French and British joint venture named Bank-i Osmani .

The original bank, which was mostly owned by British and French interests, had a monopoly privilege to issue banknotes. The government undertook neither to issue banknotes nor to license any other institution to do this during the privilege period. The Bank-i Osman-i was also in charge of repaying interest and principal on domestic and foreign government debt. The new Bank-i Osman-i Sahane was the only institution responsible for treasury operations, collection of government revenues, repayment of obligations and discounting of treasury bills.

The establishment of a central bank entirely owned by domestic capital was established shortly after the foundation of the modern Turkish Republic. After a preparatory period started in 1926, the central bank was established with the adoption of the Central Bank Law on 11 June 1930 and began operating on 1 January 1932.

Nowadays, the bulk of the shares of the central bank of the Republic of Turkey (CBRT) which is a joint-stock company are owned by the Treasury.

As a result of several amendments to the Central Bank Law, the Board of the CBRT presently consists of the Governor of the central bank, who is the Chairman of the Board, and six members elected by the general shareholders' meeting. The Governor is appointed by the Council of Ministers for a term of five years and may be removed at the end of this term. The Governor is assisted by four Deputy Governors who are appointed for a term of three years.

Responsibilities of the central bank have evolved in parallel with changes in the condition and structure of Turkey's economy. Under the first Central Bank Law, which reflected the recession of the 30s, the central bank's major responsibility was to support the Turkish government during the period of volatile economic development. This involved setting of rediscount rates and improvement of money markets, conduct of treasury operations, and coordinated actions with the government to protect the value of the Turkish lira.

In the following years most of the amendments to the Central Bank Law were intended to facilitate government borrowing for financing government budget deficits. In principle, these changes allowed the central bank to extend loans to the Treasury and state-owned economic enterprises (SEEs).

However, later when a liberal monetary policy was pursued and inflation became the major problem for the economy, the priority of the central bank has shifted: stimulation of economic development was replaced by maintanance of price stability, which practically meant reduction of the amount of credit extended to the public sector. This change was predtermined by two important events.

The first was the adoption of a law in 1994 which gradually reduced the central bank credit to the government to three percent of the increase in annual budget appropriations. (The reduction was initially supposed to be 15 percent of the total budget appropriation.) The idea of giving the CBRT independence like other modern central banks has gained momentum since then.

The second was the signing of a protocol between the CBRT and the Turkish Treasury in 1997, which limited or even stopped government financing by the CBRT, and authorized the central bank to set short-term interest rates.

Now, let me review the central bank's monetary policy over the last seven decades. It can be said that Turkish monetary policy had four general orientations over the last 70 years. These are as follows: traditional, orientation aimed at modernisation, reorientation in response to the 1994 crisis, and orientation towards financial stability and central bank independence. I will describe briefly each one.

The traditional monetary policy was aimed at controlling private and public sector spending directly by imposing lending limits on the banking system. Public Sector Borrowing Requirements (PSBR) were primarily financed by the central bank, which meant that monetary policy was subordinated to the fiscal policy. Under a financial structure where private sector credit demand is satisfied by deposit money banks lending at controlled interest rates, and by rediscounting facilities which automatically provide credit to priority sectors, money supply is largely determined by total credit demand.

In mid-80's, the CBRT initiated modernisation. The new regime allowed the central bank to control the banking system's total reserves, which enabled it to regulate money supply in accordance with the chosen monetary policy. This required new institutional arrangements. The first step was taken in early 1985, with the institution of weekly auctions of government securities used for domestic borrowing purposes. To maintain an equilibrium between total reserves and money supply, deposit money banks' reserves and liquidity should be brought in conformity with required levels, as well as additional arrangements for their adequate management were put in place.

Since the rediscount facility may be employed only for medium-term credits, reserve needs of deposit money banks had to be provided by the central bank. To enable individual banks to acquire reserves through rediscounting, a market oriented distribution system had to be established to mobilize the excess liquidity in the banking system. There should be a market place to bring banks with excess reserves and banks with insufficient reserves together. These measures were also preconditions for conducting open market operations, which would eventually become a tool for controlling total reserves.

Accordingly, the years 1985 and 1986 saw the launch of weekly auctions of government securities, the revision of the system of general liquidity and reserve requirements, and the establishment of interbank money market. With these institutional changes the central bank started performing the classical functions of a central bank and accelerated the transition to a monetary policy based on control over total banking system reserves. Since 1988 the most important aspect of the central bank's monetary policy has been the conduct of the operations, interdependence of the bank in various markets and the use of market forces.

During this period, the central bank's most important policy innovation was the implementation of a monetary program announced in January 1990. If we assess monetary developments in terms of that program, it can be said that the monetary targets were generally realized, providing market stability in 1990. The goals of the monetary program were realized largely by controlling the growth of central bank's domestic assets. This became possible due to favorable conditions in both domestic and foreign financial markets which allowed to finance the public deficit.

However, in subsequent years, the monetary program was under pressure due to several factors. The proximity of the Gulf war in 1991 affected adversely the banking sector by prompting massive withdrawals of deposits, which caused an increase in the exchange and interest rates. In 1991, CBRT attempted to preserve the stability of the exchange rate, **maintaing** foreign reserves to a particular minimum.

The second difficulty related to the inability to control financial requirements of the public sector and budget deficits. As a result the monetary programme failed to achieve the goals set.

The third was the outbreak of the 1994 crisis.

Without analysing the reasons for the financial crisis of 1994, it will suffice to say that this was a difficult year for the monetary policy. The Treasury's insistence on decreasing interest rates on domestic borrowing despite the increased public sector deficit caused a fall in bank demand for treasury bills. On the other hand, prospects for external borrowing were unfavorable, mainly due to downgrading of Turkey's foreign debt by rating agencies which forced the Treasury to cover deficits largely by credits drawn by the central bank. In response to the rapid depletion of a substantial amount of foreign exchange reserves and the rise in interest rates, the CBRT had to focus on replenishing reserves and restoring stability of money markets. For this purpose, and to achieve the inflation target under the stand-by program agreed with the IMF in April 1994, tight monetary and credit constraints were planned. The program also concerned exchange rates, international reserves, and net domestic assets. The program got off on the right track, but as a result of early elections both the program and monetary policy were changed radically in August 1995.

Since early 1996, the central bank's monetary policy has concentrated on slowing the growth of its own balance sheet and monetary aggregates. At the same time, the idea of independence of the central bank began to gather serious momentum. Advances made by the central bank to the Treasury remained within legal limits. Exchange rate policy based on managed floating encouraged stabilization in currency markets, while some depreciation of the Turkish lira helped offset wholesale price inflation. In 1996 Turkey's domestic financial markets again exhibited positive sighs, and interest rates came under the central bank's control.

In 1996 and 1997, the major goal of monetary policy was to maintain stability in financial markets. The policy pursued intended to create reserve money adequate with increases in net foreign assets.

Credit to the public sector continued to decrease in 1997. Monetary aggregates M1, M2 and reserve money declined, whereas M2Y increased in real terms. Exchange rate policy in 1997 was aimed at maintaining stable real exchange rates.

The 1998 monetary policy was announced the beginning of the year. The main goal was to initiate measures for decreasing the annual inflation rate of 70 percent thus achieving macroeconomic targets for the first half of the year. Reserve money were to grow from 18 to 20 percent during the first quarter. The central bank planned to continue limiting the increase in net domestic assets and issue money consistent with the increase in net foreign assets. Exchange rate policy was aimed at keeping the rate in compliance with the inflation target. As of 1 April 1998, the results of the monetary program during the first quarter matched the expectations, and it was decided to sustain the monetary policy unchanged during the second quarter of the year. Exchange rate policy also continued to be guided by estimated inflation rate during the second quarter. Reserve money growth in the second quarter was projected to be less than that in the first quarter.

On 2 July 1998 the central bank announced that in the second half of the year the monetary policy would be laid out by the Staff Monitoring Program (SMP) with the IMF. This called for monetary and exchange rate policies to be consistent with the target of reducing inflation to 50 percent during the second half of the year. Achievement of reserve money targets during the first two quarters of the year required massive sterilizations which had kept interest rates high. Given difficulties in predicting money demand and money multiplier during a period of disinflation and strengthened fiscal policy, the central bank established a new indicator, the net domestic assets item included in the bank's own balance sheet. The target was set as minus TL 1,514 trillion at the end of 1998. By contrast, exchange rate policy was to be more closely aligned with the disinflation effort, that is the exchange rate was to comply with the inflation target for the rest of 1998.

In October 1998 the monetary policy for the fourth quarter was revised to accommodate the new external situation. It remained consistent with the fiscal policy and control over liquidity was sustained unchanged. The central bank achieved the year-end net domestic assets target of TL 700 trillion. The monetary policy is aimed primarily at maintaining Turkey's international competitiveness and confidence in the lira, consistent with the efforts to reduce inflation.

Ladies and Gentlemen,

It can be said that current Turkey's monetary policy form follows four main rules and recognises two principles. The rules are: 1) no direct credits are to be extended to the public sector by the central bank; 2) liquidity in the markets is to be adequate to foreign exchange purchases and open market operations; 3) improvement of transparency and accountability; and 4) a forward-looking approach to interest and exchange rate determination. The principles are: 1) monetary policy support which does not involve the effort to reduce inflation as a key element (we firmly believe this should be a priority of fiscal and structural policies); and 2) the goals of achieving financial stability in the markets and a sound payment system should be carefully pursued.

Our main tools pursuing a monetary policy consistent with these rules and principles are: short-term interest rates, open market operations, reserve requirements and overnight facilities.

Now let me look in the future, with some comments on medium-term prospects of the central bank of the Republic of Turkey.

Recent years have seen a worldwide tendency toward simplifying the goals of central banking which has diminished its responsibilities. Funding of governments, for example, is no longer the main purpose of a central bank. No modern western central bank still aims at achieving full employment of the highest level of production. Modern central banks have only one goal: to maintain price stability. Therefore, it is not a surprise that the CBRT, one of the most important institutions in the Turkish economy aspiring to become integrated with western economies, takes these trends in modern central banking into account in designing its medium and long-term strategies.

And it will be no surprise to learn that the central bank of the Republic of Turkey as well as other central banks has set as its main goal the maintenance of price stability in the economy.

This is the right moment to clear up two issues about the price stability target. First, the central bank's price stability target and its responsibility for price stability are two different issues. Price stability can exist only under low inflation. Before the central bank can assume the responsibility for maintaining price stability, the economy should undergo a 'disinflationary process.' It is also well known that for Turkey, where inflation has been high for years, bringing inflation down to a level close to western economies will require comprehensive measures which is not a subject of central bank's efforts alone. The central bank's role is to track the price stability target as a part of a larger disinflationary program. We believe that once inflation has been curbed by concerted efforts of all economic agents, it will then be possible for the central bank to take over the responsibility of maintaining price stability.

The second issue to be stressed about the price stability target concerns microeconomic functions of central banks. The efficient operation of a payment system and stability in financial markets are two basic functions of a central bank. These two functions can also be performed in a manner to support price stability targets: a sound and effective financial sector and payment system are necessary for provision of price stability.

Economic duties assumed by the central bank of Turkey, that is to provide price stability should be consistent with that goal. Functions inconsistent with the price stability goal or haltering its achievement should not be assigned to the central bank. Avoiding such conflicts should be a basic issue in the central bank's medium and long-term strategic planning.

There are several criteria indicating whether central bank functions (in respect of Turkey's size, geographic location, history, legal structure and degree of technological development) are likely to impede or boost the achievement of the stability goal. An efficient monetary policy is an absolute must for a central bank which assumes price stability as its priority. This calls for the elimination of any functions of the central bank that interfere with the efficiency of the monetary policy.

This clearly means enhanced control of the central bank over its own balance sheet, a major requirement to ensure efficiency of the monetary policy. The importance of this control in achieving the price stability target should be highlighted. The past decade saw substantial improvements in the central bank's balance sheet, particularly in the assets side. Foreign assets have increased and domestic assets fell off sharply due to reduced loans to the public sector, including valuation accounts. The final step in this process will be a legal restriction to zero of the advances established by the central bank to the Treasury. The protocol signed between the central bank and the Treasury in the second half of last year led directly to an increase in the efficiency of the monetary policy pursued by the central bank. An amendment to the Central Bank Law would preserve the achieved effectiveness. Thus, revising financial relationships between the central bank and the Treasury, and increasing the central bank's control over its balance sheet will significantly facilitate the achievement of the price stability target.

Unfortunately, structural improvements in the assets side of the central bank's balance sheet in recent years have not been matched by similar improvements in the liabilities side. The Bank's Turkish lira liabilities represent an insignificant share in total liabilities. To change this unfavourable situation (a consequence of high inflation) requires maintenance of low inflation, since inflation appears as a main source of this problem. Conversion of our liabilities into Turkish lira is a major goal in the medium run.

Independence is another very important factor affecting the medium-and long-term prospects of the central bank. A central bank having a free choice of its goals may chose to promote the achievement of the price stability target. A central bank authorized to choose independently its monetary policy instruments can implement an effective monetary policy.

It is also well known that a central bank independent of political authority can do much to smooth economic fluctuations arising from political uncertainties. Today it can be clearly seen that the economies with independent central banks successfully maintain monetary and financial stability.

In conclusion, let me repeat once again the basic issues of the central bank's medium and long-term strategies. These are: maintenance of price stability as a central bank's main target, consistency between central bank's functions and its principal target, modification or elimination of any functions that can impede the accomplishment of its monetary mission, and finally all these should be supported by independence and autonomy of central bank's actions.

Central Banking in Poland: A Transitional Perspective

by Jerzy Stopyra

Jerzy Stopyra is First Deputy Governor of the National Bank of Poland.

Ladies and Gentlemen,

Expressing congratulations and best wishes on the occasion of the 120th anniversary of Bulgarian National Bank, I would like to share experience and thoughts associated with the role of central banking in a transition economy: the case of Poland.

Overcoming the heritage of times when households were subject to severe financial discipline and enterprises were easily financed, was a difficult and time-consuming process. The attempts to reform the system previously initiated in Poland in 1980s marked just the beginning. They proved undoubtedly that the systemic changes intended to fundamentally restore the equilibrium in the economy were necessary. Nobody in Poland believed any longer in the third way under the conditions of avalanche like hyperinflation. The experience of studying the market by acting in it resulted in attempts to transform the banking sector into a banking sector viable under a market economy. These attempts were initiated prior to political changes. This fact should be emphasised because banks in Poland played, are playing and will play the role of a pioneer in changing the economic system. Understanding the need for the shock therapy contained in the program designed by Leszek Balcerowicz decreased the cost of reforms which were measured by the drop in industrial output and GDP per capita. The fact that fundamental reforms are beneficial for Polish citizens can be proved by the drop in industrial output, which was insignificant, given the uneconomically managed economy, and the full and faster return to the highest level of GDP per capita.

The inevitable cost of economic reform were bad loans of banks and the symptoms of a banking system crisis between 1992 and 1994. Due to these challenges, the necessity to extend the authority of the central bank, which should include organisational actions, occurred. Central banking in transition economies and in developed market economies is different. These differences, however, do not refer neither to the central bank independence in designing and implementing monetary policy nor to the efficiency of supervision on credit and financial institutions.

The specific feature of central banking in eastern Europe is based on the fact that a central bank assumes a set of duties, which are performed by private institutions in developed market economies. The central bank in Poland had to act as an organiser and investor of the efficient system of interbank settlements. The central bank invested in human resources of the banking sector and became one of the founders of the International School of Banking and Finance in Katowice. The lack of private funds and institutions which are necessary for the market economy operation forced the central bank to enter into interbank partnerships which acted to the benefit of the whole banking system.

The second specific feature of the Polish transition is the decentralized approach in dealing with the remainder of the centrally planned economy. The loans extended inadequately or loans which are uncollectible under the new conditions have been recognised as lost. To write them off, restructuring bonds were issued by the Treasury. At the same time, banks were allowed to evaluate which borrowers were able to survive as a result of their debt restructuring. The solutions based on Article 17 of the American Bankruptcy Law were successfully tested in Poland. Banks were released from lending to unreliable state enterprises. It does not mean that we have found the means of fighting the syndrome 'too big to fail'. This syndrome still exists and its liquidation requires a second generation of systemic reforms in the area of social insurance, local government, education and health care. After these reforms are realized, budget and manufacturing sector entities now existing at the expense of other taxpayers will be eliminated.

Between 1992 and 1994, the National Bank of Poland owned private commercial banks in order to lower the total cost of the banking system recovery. Although it was only a temporary owner of the said banks, these actions were criticised. In response the central bank quickly finished the work on establishing Bank Deposits Guarantee Fund. It combines the system of mutual guarantee of deposits and a hospital fund for ailing banks. This way, the central bank really became only lender of last resort.

In the recent decade, the central bank has not limited itself to putting the market into order or setting there equal conditions of competition for domestic and foreign capital. In its licensing policy, we can saw several changes in priorities. Such changes included tax concessions encouraging investment in the domestic banking sector, tie-in transactions under which participation in financing technically bankrupt institutions was a prerequisite for the access to the domestic market.

Looking back we can easily notice what elements of continuing organisational efforts of the central bank led to a change of objectives and instruments of the monetary policy. The strengthening of the financial stability of banks and their consolidation created conditions to improve effectiveness of the monetary policy, enhance the role of the open market and raise the significance of commercial banks as money market dealers.

After eighteen years, Poland saw one-digit inflation. The policy of a gradual decreasing inflation level based on macroeconomic proportions did not result in a rapid drop of the economic growth pace and proved successful. Under the conditions of a decreasing inflation, the motivation for a financial surplus becomes even stronger. It is beneficial to work and respect the ones who create new jobs.

However, the challenges of today and future do not let us be self-satisfied. The need for second-generation systemic changes is connected with the threat of the budget discipline breakdown. The appreciation of zloty is partly a result of attracting inflow of speculative capital. This may lead to a decrease in exports, an increase in imports, which will worsen the balance of trade. The policy of cooling the economy to successfully cope with the crisis of Southeast Asian countries and Russia. It does not mean that this measure will protect us from international economic stagnation.

Therefore, the most important lesson of our experience is setting ambitious objectives and in their fulfillment, observance of international banking situation. The efforts intended to improve activity lead to intensification of product and technological innovations in banks. Innovations in the area of management are not so significant. It seems, however, that changes will also take place in this area in the following years.

Opening of our market for foreign competitors brought some visible benefits to bank customers. Further decrease of transaction costs requires increased investment in information technologies in order to achieve competitiveness of cross-border competitors under the conductions of a systematic decrease of bank profitability. This year will be difficult for banks in many aspects. They have to find new sources of earnings to replace the inflation premium which is gradually disappearing and interest rate margin which is severely falling.

The introduction of euro materially reduces bank earnings from currency operations and liquidates jobs for foreign currency dealers. In the future domestic banks may be under the pressure of the settlement market. The demand for settlements in euro may be bigger than it was forecast.

Although the nearest period seems a trial one for banks and their ability to cope with the price competition, enhanced confidence and the depth of changes in our banking system allow us to be optimistic for the future. Poland's integration with western structures such as NATO and the EU is of key significance. A lot of problems solved by some European countries for decades or even centuries should be solved for months or several years.

With some concern, we will look at the cooperation of two biggest currency areas in the world: the zone of the US dollar and the zone of euro. If they work well for the stabilisation of worldwide financial markets, we can count on the next good year. If challenges win and the friction between the world financial centres occurs, the process of globalization may be costly for us. Then, the response must be the possible earliest Poland's association with the European Union and then, with the Currency Union.

At the end of my comments on the topic set by the hosts of the conference, I would like once again to thank you for the invitation and wish a success to Bulgarian bankers in overcoming the heritage of the past and in searching changes which will guarantee the success in the future.

Central Banking in The Czech Republic

by Jan Vit

Jan Vit is Deputy Governor of the Czech National Bank.

Ladies and gentlemen,

It is a great honour for me to speak to you on the occasion of the 120th anniversary of the foundation of the Bulgarian National Bank, an anniversary that is to envy. The central bank in our country celebrated its 70th anniversary three years ago. It was founded, however, in another, no longer existing state, in Czechoslovakia. The Czech National Bank, on behalf of which I would like to greet this meeting and especially my Bulgarian colleagues, is, as far as its age is concerned, a child among other central banks: it is only six years old, meaning at the elementary school age. Therefore I feel it logical, for a conference like this to deal rather with topical problems of the present time than with a nostalgic view into the past.

Obviously the start of the most recent history was for us – I mean banks in central and eastern European countries – a common and similar one. All of them had first to master the basic banking knowledge proper to market economy. The main problems that our central banks have to solve, were and are similar but not the same. I will try to outline briefly some recent problems in our country as well as the results of the responses by the Czech National Bank. I think that some lessons we have drawn might be of interest.

Initial achievements during the transformation in our country were definitely not bad. From 1992 till 1995, the pace of GDP growth was increasing and culminated with 6 – 7 percent yearly increments. In the first half of 1997, year-on-year consumer price indexes fell under 6 percent.

Perhaps this, at first sight, idyllic development, led to some underestimation of indicators warning against some nearing risk. Mainly a sharp increase in wages was an indicator that should not have been disregarded. Real wages were growing, particularly after the abolishment of wage regulation, by 5 to 8 percent yearly.

Naturally, such developments in wages that were not accompanied by an adequate growth in domestic supply resulted in a deep external imbalance. At the beginning of 1997, the current account deficit was above 8 percent of GDP. Unfortunately, the government played the situation down for a very long time and its desirable response came too late.

The Czech National Bank's response to those – and I repeat, extraordinarily heavy – imbalances and warning indicators was the adoption of a more tightened monetary policy in the summer of 1996. This resulted in an increase of interest rates on average by two percentage points and by an increase in the minimum reserves requirements for banks. Some discussions among our professional public are still continuing about whether that reaction was adequate or not, because of the following significantly slower pace of economic growth. We continue to hold that the measure adopted by the CNB was an adequate response. I have already mentioned some figures that motivated this measure. For illustration, I will add that in the third quarter of 1996, i. e. at the time of the implemented monetary restriction, GDP grew by 3.4 percent year-on-year, while demand grew unbelievably by more than 12 percent. The goal of our monetary restriction was not to limit growth but to limit domestic demand. Monetary measures could have been less strict if the government had responded with adequate fiscal and pension policies.

Monetary measures adopted by the CNB brought the money supply back to reasonable proportions, slowed down private consumption, and, to a certain extent, kept back negative developments in the balance of payments current account. Nevertheless as isolated measures they could not assure the necessary reversal. Under pressure of speculative capital inflow, the Czech crown exchange rate tended to revaluation, which was in a clear contradiction with the development of basic indicators. The exchange rate became unsustainable, which resulted in a monetary crisis in spring 1997. Markets evaluated in a realistic way the vulnerability of the Czech economy and the Czech currency and began to act in compliance with this fact. The Czech Crown got under pressure.

The Czech National Bank tried to act in such a way so that any dramatic fall of the exchange rate did not happen. The extent of its interventions on the foreign exchange market amounted to approximately 15 percent of its foreign exchange reserves. After the first attacks on the crown had faded, the CNB, in agreement with the government, abolished the fluctuation band and the pegging of the crown to the currency basket and introduced a floating exchange rate. Due to this, the exchange rate stabilised itself at a level approximately 10 percent above the initial central parity (today it has almost returned back to this parity) and the decrease of foreign exchange reserves did not become dangerously big. They gradually have returned to their previous level.

To summarise conclusions and lessons that the CNB took from the developments I have described, I would name particularly these:

– Under any circumstances, it is not possible to leave without any response the development that differs extremely from international standards – no matter if it relates to capital inflow, balance of payments or growth in wages. It is only an illusion to think that a particular economy could be so specific that international standards do not apply;

– An isolated action by a monetary institution can never be as good as a coordinated action with the government, i.e. an adequate mixture of monetary, fiscal, and pension policies;

– In the case of a currency crisis, it is crucial first to avoid a domestic panic. A question is, at which moment the defence of the currency through interventions, that has only limited chance to be successful in the globalized world, should be given up.

Under pressure of events, the government adopted in May 1997 a package of measures, implementing restrictions on budgetary expenditure. Monetary and budgetary restrictions resulted in a considerable decrease in domestic demand and the substantial improvement of the balance of payments. The current account deficit began to decrease quickly and will be approximately only 2 percent of GDP this year. The increase in wages was successfully put in line with productivity. However, the restoration of macro-economic balance was accompanied by a sensible slowdown in the dynamics of the economy and later with a decrease in GDP to about 2 percent in 1998. Causes of the present economic recession are explained, in principle, by two streams of opinion.

The first of them insists that the economic decline is only a consequence of the CNB's sharply restrictive policy which started as early as in 1996 and since then has not been eased. Some evidence for this statement is an unusually steep decrease in inflation. The so called 'net' inflation rate, i. e. without the influence of administrative and tax adjustments was only 1.7 percent in 1998, which is a figure by one order lower than the target set by the central bank itself at the beginning of 1998. The solution is then obvious: Money injections in a form of a sudden and strong decrease in interest rates, may also be accompanied by less tight requirements for prudential banking operations. This will provide the necessary credit sources for a quick restart of economic growth.

The second opinion refers to a fact that the economic growth had been slowing down already before the CNB adopted its restrictive measures and that the main cause is not the dampened domestic demand but the supply. The present extremely low inflation is not a phenomenon specific for our country, it does not result from extremely tight monetary policy, but it is a consequence of an unexpectedly steep fall in world prices of raw material and food. Price developments in a very open economy which depends on the import of raw material profit significantly from the fact that our importation prices are nowadays on average by 10 percent lower compared with the past year. Any strong money injection into the economy would result only in an artificial bubble of a temporary growth, accompanied by imbalance, further indebtedness and, therefore, risk of renewed currency turbulence.

I think I do not need to say which concept corresponds better to the CNB's opinion. The justification of this standpoint is, however, very difficult, especially when the inflation rate has been steadily decreasing (and I stress that partly without our effort) and the Bank Board has to respond to the situation by repeatedly decreasing interest rates. This provides the illusion that the CNB now admits its policy in the past was inadequately tightened. Also the strategy of the inflation targeting, introduced a year ago, has been criticised.

Ladies and gentlemen, a few remarks to the issue of changes in the implementation of our monetary strategy.

The main reason for the adoption of inflation targeting was the fact that inflation developments were not satisfying. The consumer price index attained 10 percent at the end of 1997, i.e. it was higher than in the years before. In spite of the fact that the increased inflation rate was partly caused by a depreciation of the crown, the price development in the Czech Republic began to be oriented towards high inflation expectations. Moreover, some insufficiencies of the hitherto strategy of keeping the currency stable by means of controlling the money supply development became more and more evident. We steadily got out of the target corridor for the indicator M2, we also were not able to make credible estimates of the velocity of the turnover of money, and, finally, analyses of the relation between money supply growth and price growth did not provide reliable results in our conditions.

In this situation, the Bank Board decided to introduce a system of inflation targeting and, at the same time, abandoned its idea of the inflation target to be reached in the middle-term horizon (to the end of the year 2000). So called 'net' inflation should be kept within a corridor of between 3.5 and 5.5 percent year-on-year.

In adopting the net inflation rate indicator it was necessary to take into consideration that the state regulates prices of some important commodities – energy, personal transport, rent, etc. – and that the willingness to change the prices depends only on government decisions. The central bank does not have any influence on those changes. Therefore, the Statistical Office calculates the net inflation rate after eliminating these prices from the total index of consumer prices. We saw the sense of inflation targeting in the fact that after the abolishment of the fixed exchange rate, the inflation targeting will become a new nominal anchor for the economy. We expect also that a clearly expressed quantitative idea of an inflation goal will help to avoid negative inflation expectations.

In the initial phase, i. e. last spring, when the year-on-year net inflation rate climbed to 8 percent, most people doubted if the CNB would be able to fulfil its short-term goal or to show evidence that its middle-term and long-term goals are also credible. At present, as I have already mentioned, the situation is completely different and we are constantly criticised from various sides for seriously ‘undershooting’ our own target. As I have already mentioned, in 1998, net inflation achieved the value of 1.7 percent while the total price index growth CPI was 6.8 percent. Initial, very negative inflationary expectations were broken.

When I would review advantages and problems connected with the change-over to the inflation targeting system, I would state that this step definitely was necessary and effective. In this context, changes in the development of import prices, the decrease in demand and an unstable situation in the world economy, that initially made inflation prognoses very difficult, are only temporary factors.

Ladies and gentlemen, in conclusion, let me say some words on the exchange rate. The Czech crown is, in principle, convertible. Persisting restrictions to the capital account are of minor importance. The Czech crown has been traded on international markets in high quantities. The exchange rate is not pegged by any official mechanism to another currency or to any currency basket.

The floating system existing since the middle of 1997 is fully compatible with the inflation targeting strategy. The CNB does not directly influence the developments of the exchange rate. Possible verbal or financial interventions are exceptional and are aimed especially to dampen short-term fluctuations. However, the problem is that the Czech crown has become a favoured currency for short-term investment, because of a high interest rate differential between the Czech crown and other investment currencies, and a relatively stable political and economic environment. Due to those facts, the Czech crown has a tendency to appreciate, in real terms in particular. On the one hand, this favours disinflationary trends in the economy due to cheaper imports. On the other hand, this significantly worsens the position of exporting companies, which impacts on the total dynamic of GDP growth. Negative effects have begun to prevail now, especially as far as the dynamics of exports is concerned.

Although we expect that the considerable decrease in basic interest rates from 15 percent to 8.75 percent within the past half-year will have positive effects, the situation is complicated. And I have to add that our experience with foreign exchange interventions up till now shows us that their effects are very temporary. To be honest, at present, the exchange rate is an open problem for the Czech National Bank.

Ladies and gentlemen, in my presentation I have tried – and I hope it was within the scope of the conference – to show some experience at the CNB connected with the implementation of its monetary policy in the difficult period of the 90s. Instead of making a summary, I will say only one sentence. It shows, or at least in our case it has shown, how important a basic understanding between the central bank and the government in evaluating the economic situation is, and how expensive it can be when such an understanding does not exist.

Thank you for your attention.

Central Banking in Lithuania

by Juozas Aliukonis

Juozas Aliukonis is Deputy Chairman of the Board of the Bank of Lithuania.

Ladies and Gentlemen,

The widespread opinion that central banking is mainly a phenomenon of the twentieth century is overruled once again here today when we celebrate the 120th anniversary of the Bulgarian central bank. This outstanding date for those who are in central banking business arouses once again the feelings of achievement, professional pride and honour and the hopes that our services will be needed and valued for some longer period of time.

Ladies and gentlemen, on behalf of the Bank of Lithuania, I wish you all here today all the best in the future, which reduced its uncertainty to some extent by eleven positions at the start of this year but nevertheless remains uncertain especially for those who face the issue of reconstruction or new construction of the banking and financial systems in their own countries. My country, in this respect, has certain experience and I want to share it with you.

The recent history of Lithuanian banking, including central banking, begins in 1990 when the Bank of independent Lithuania was re-established and we started developing our own concept of monetary and credit system. Right from the very beginning we stressed the independence of the Bank as crucial and vital precondition for the development of the whole system and this kind of provision was incorporated into the Law on the Bank of Lithuania. The reality of life was rather different due to the inheritance from the times of command economy and command banking. Even today in our country not everyone understands the highest priority of the central bank (stability of the currency) and we still feel certain political pressures when there is a wish to use simple and popular measures in solving particular issues for the benefit of only one interest group, and of course, at the expense of others.

Until the introduction of the litas – our national currency – in I993 we were not in a position to run an independent and active monetary policy, so we concentrated more on the accumulation of human and physical resources, foreign currency reserves, development of legal system and, of course, reduction of inflation. The instruments of monetary policy (targeted interventions) were applied immediately after the introduction of the litas and the exchange rate against the US dollar was stabilised. The high figures of inflation were curbed. The Bank was on the way to develop and capitalize the positive trends but the confidence in the litas was not yet strong enough. The previous high inflation and the devaluation of money had left strong negative impact on the society, which at a time like this needed a firm psychological factor with totally stable national currency as the best executive measure for that purpose. The society wished to see a simple mechanism to ensure discipline in the monetary and fiscal policies. Half a year's discussion ended up with a suggestion to have a fixed rate regime and limited functions of the central bank – a currency board was established on 1 April 1994. On the eve of the introduction the rate of the litas floated in the narrow margin from LTL 3.9 to 4 for USD 1.

As it turned out, our currency board arrangement did not become a pure one in a sense that it would not permit the central bank to use the instruments of an independent policy. In other words, the system allowed the Bank of Lithuania to focus on the activities required from a member of the European System of Central Banks. As a result of that, by focusing more on banking supervision we implemented important provisions of EU Directives and the Basle Committee on Banking Supervision. The work was tested by recent troubles in the international financial markets – in spite of all sorts of disturbances the banking system has been functioning normally so far.

As you all probably know, currently we are preparing ourselves to move from the currency board arrangement to a full-fledged central bank model and that is our contribution, as we understand, towards the prospective goal – to enter the EU and in the future to join the EMU. In this respect, it is vital and inevitable to restore the functions of the central bank and to provide a means of pegging the litas to the euro, the successful introduction of which gives us certain confidence and provides the valuable experience.

Nevertheless, we would like to stress the following positive features of the currency board which we experienced in our own case:

– the arrangement contributed to macroeconomic stabilisation and the establishment of an international image of stability in Lithuanian monetary policy;

– as a temporary measure, the currency board is very helpful for the countries that need rapid stabilisation of financial markets and tightening of fiscal policies during the transitional period; to some extent this kind of arrangement can be used before the time when the appropriately functioning central bank is established in the country;

– the currency board helps to avoid possible losses during transition.

Today in Lithuania we have low inflation and interest rates, substantial foreign currency reserves and quite developed financial markets and all that creates the conditions for exiting from the currency board arrangement and expanding the use of monetary policy instruments.

Thank you for your kind attention, ladies and gentlemen.

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Mr. Jan Vit, Deputy Governor

Central Bank of Bosnia and Herzegovina
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Programme

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Member of the Board of the Bulgarian National Bank

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Mr. Svetoslav Gavriiski, Governor

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Mr. Roumen Avramov, Member of the Board of the Bulgarian National Bank

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Chair: Prof. Dr. Norbert Cloten, Former Ex Officio Member of the Decision-making German Central Bank Council

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Discussion: Central European Countries in Transition
Chair: Mr. Villy Bergstrцm, Deputy Governor of the Bank of Sweden

Contributors:
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Mr. Almos Kovacs, Deputy Governor of the National Bank of Hungary

Mr. Jerzy Stopyra, First Deputy Governor of the National Bank of Poland

Discussion: Small Open Economies
Chair: Mr. Peter Nicholl
Governor of the Central Bank of Bosnia and Herzegovina

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Mr. Juozas Aliukonis, Deputy Chairman of the Board of the Bank of Lithuania

Round Table Discussions
Chair: Mr. Svetoslav Gavriiski
Governor of the Bulgarian National Bank