IV. Monetary Policy

1. General Survey

Against a background of insufficiently restrictive fiscal policy and deep financial crisis, BNB scope to pursue efficient monetary policy in 1996 was severely limited. This may well have been the result not only of the central bank's actions throughout the year, but also of trends and developments emerging in the second half of 1995, which signaled the onset of bank and forex crises prompted by fundamental factors such as delayed restructuring of the real and banking sectors. Radical measures to eliminate state-sector losses and thus end quasi-fiscal deficit financing at the expense of banks' decapitalization were postponed yet again.

In the autumn of 1995 the loss of sizable interest rate differential on lev and foreign exchange deposits had the effect of not only eroding public credibility in the lev but also calling into question the government's ability to meet its foreign debt obligations in 1996. In the absence of access to international credit markets due to the absence of an agreement with the IMF, a number of residents began fearing that their bank deposits might be forcibly employed to guarantee the country's foreign debt payments. This, plus apprehensions about the stability of certain banks arising from announcements of poor results, prompted the first run on deposits. Subsequently the liquidity of affected banks worsened and withdrawal of funds encompassed nearly the entire banking system, to continue with varying intensity throughout 1996.

Without structural changes intended to resolve fundamental problems in the real sector it is impossible to achieve real and durable stability. Following a period of temporary stabilization in 1995, Bulgaria experienced deep financial and forex crises in 1996, which had an adverse impact both on the banking and real sectors. Developments in 1996 proved that without adequate fiscal policy support central bank monetary policy could not prevent or even alleviate a crisis. BNB efforts to further tighten monetary policy, and its resolute actions to isolate unviable banks were neither supported by government (through rapid and effective restructuring and privatization of the real sector) nor by the legislative branch (through the creation of adequate legal framework for forceful collection of claims, bankruptcy procedures for banks and enterprises; hence imposition of strict financial discipline on all economic agents).

In this complex environment the rise in lev nominal interest rates failed to help restore confidence in the national currency, in practice burdening additionally the real and government sectors. As banking system credit resources declined in 1996 reflecting massive runs on banks, growing needs for budget deficit financing led simultaneously to the real sector being crowded out of the credit market by the government sector, and enhanced pressure for easing monetary policy. To avoid a government moratorium on domestic and foreign debts (which would have had an irreparable impact on the country's financial markets and would have isolated Bulgaria for a long time from international financial markets) the BNB was forced to ease restriction considerably over certain periods. This additionally disturbed real demand for money and very often aggravated the financial crisis through accelerating devaluation of the lev.

Amid a lack of hard budget constraints on state-owned enterprises and loose financial discipline in a number of private firms, their losses were increasingly transferred to banking. This caused a further acceleration of bank decapitalization and increased the number of banks with liquidity problems, sending the first signals of their insolvency. BNB measures to place one-third of banks under conservatorship and subsequently petition the institution of bankruptcy proceedings had a short-term stabilizing and containing effect and failed to bring about the desired comprehensive cure for banks. Main reasons behind this are the slowness of taking such measures (due to an absence of a legal framework for bank closures), and unduly prolonged court proceedings.

A provision giving the BNB powers to exercise supervisory measures in respect of commercial banks at risk of insolvency was only introduced into the Law on Banks and Credit Activity as late as May 1996. At a time of dynamic changes and banking system expansion the lack of legal grounds to declare banks bankrupt meant that management and shareholders did not feel responsible for the outcome of their own decisions in regard to commercial bank management and activities, taking it for granted that the BNB and the state would come to their rescue every time they ran into trouble. After enforcement of the required legislative framework, the BNB petitioned the institution of bankruptcy proceedings against 14 banks. By the close of 1996 not even one court procedure had been finalized: no clear disciplining signal was sent to managers of other banks and their depositors and borrowers. Delays in declaring banks bankrupt were paralleled by a lack of rapid and efficient mechanisms for receivables collection, including declaring debtors bankrupt. An economic and financial paradox became apparent: the BNB was applying to court to petition the institution of bankruptcy proceedings against banks before the banks had satisfied themselves as to the bankruptcy of their chief debtors.

During the first four months of 1996 the central bank attempted to reconcile, to the extent possible, two contradictory objectives set forth in the Law on the BNB: "to contribute to the maintenance of internal and external stability of the national currency" (a major task pursuant to Article 2, para. 1), and "regulate and supervise other banks' activities in this country for the purpose of ensuring the stability of the banking system" (a supplementary task as stipulated in Article 2, para. 3). As the run on banks continued, the BNB was compelled to increase unsecured refinancing of commercial banks with impaired liquidity in order to ensure the integrity of the payments system. Simultaneously, for the purpose of withdrawing liquidity inherent in its lender-of-last-resort capacity, the BNB intensified its open market operations which normally resulted in higher interest rates. The rise in the basic interest rate from 34% at the end of 1995 to 67% in March 1996 did not bring about the desired stabilizing effect, given eroded confidence in the lev and the banking system and the resulting contraction in real demand for money. The BNB was pressured to sell foreign exchange in support of the lev in the forex market, where a typically high seasonal demand for forex to meet import costs on energy commodities and to service foreign debt obligations multiplied by a speculative demand from commercial banks and their clients. In the absence of other efficient monetary policy instruments in practice the central bank was forced to mop up liquidity it had itself provided as lender of last resort by depleting its foreign exchange reserves. Certainly, this compilation of monetary tools was not likely to endure more than a few months, but it provided time, albeit at a very high cost, to develop the required legislative framework for isolating unviable banks. Unfortunately the time thus made available was not used in the most rational manner to curb losses in the real sector through rapid restructuring and privatization. As a result of growing losses in the national economy, coupled with expensive refinancing from the BNB which replaced cheaper deposit funds, temporary liquidity deficiencies of several big private and state banks evolved into persistent problems, revealing their insolvent state.

In May 1996, when the country's forex reserves came down to a critical level that threatened foreign debt service through year-end, the BNB stopped its support for the lev in the forex market. By a shock rise in the basic interest rate to 108% and by tightening other lev monetary instruments the central bank sought to 'buy' another temporary financial stabilization needed for reaching a new standby agreement with the IMF. After enforcement of the required legislative framework and in the context of ongoing negotiations with the IMF, the BNB put under conservatorship several private and one state bank, subsequently applying to court to petition the institution of bankruptcy proceedings against them. These measures again had no lasting effect because the country had entered a deep financial crisis that threatened to paralyze the real sector as well. This was additionally compounded by the legal provision (in the newly adopted Law on State Protection of Deposits) for depositors' access to their accounts with banks under conservatorship immediately after BNB petitions to court for the institution of bankruptcy proceedings against these banks. The limitation on deferred withdrawal of deposits proved ineffective because a large portion of lev deposits was drawn and forex deposits were converted to lev, to be subsequently drawn as well. These funds were then used to purchase foreign exchange from change shops, which accelerated lev devaluation. The disturbing effect was later recognized, and amendments to the Law on State Protection of Deposits were made, providing depositors' access to their bank accounts no earlier than court decisions on the state of their banks. Major macroeconomic indicators were increasingly volatile and difficult to foresee in this setting, notwithstanding the country's restored access to international financial markets. The hastily prepared (after a delay of one year) fourth standby agreement with the IMF could not therefore rest upon a sufficiently realistic assessment of the state of the Bulgarian economy and short-term outlook for its development. Eroded confidence in the lev and the banking system was not restored even after the first tranche was released and just a few days after the agreement was signed the parameters of certain financial indicators deviated substantially from target values, putting at stake the implementation of commitments undertaken. Subsequent political swings held up structural reform commitments undertaken by the government and contributed to further rapid worsening of agreed performance criteria. As a result, foreign financing was delayed early after the first tranche, followed by the inevitable subsequent termination of the agreement.

The lack of political will for resolute action to liquidate and isolate loss-making enterprises held up negotiations with the World Bank. As no financing came from this organization under the agreement with the IMF, the BNB was forced to compensate for the lack of funds by easing monetary policy. This took the form of increased lending to government, with the BNB participating in the primary market for government securities, and their onward sale to commercial banks. In September, when foreign financing was not temporarily but permanently halted, it became impossible for the BNB to sell all government securities bought in the primary market even through reverse repurchase operations in the open market. Naturally, this had an increasingly inflationary and disturbing effect on the banking system and financial markets.

At the end of September, the BNB made its final 1996 effort to restore financial stability through a package of restrictive measures. For this to succeed, the BNB relied heavily on government to initiate rapid privatization and structural change in line with commitments under the standby agreement with the IMF; to reach agreements with the World Bank; and to restore foreign financing from official sources. The BNB package of measures involved isolation of nine more commercial banks from the banking system through conservatorship, raising interest rates to a real positive level, and support for any remaining viable banks through various monetary policy instruments. Monetary policy tightening had a short-term positive impact consistent with a stronger lev in the first half of October, providing for a decrease of the basic interest rate on two occasions. However, this stabilization again proved short-lived, because the inflow of foreign financing could not be restored without rapid privatization and implementation of structural reform by government. The BNB sought to coordinate its actions with government, advising it that without political will for a comprehensive reform in the real sector performance criteria under the standby agreement could not be attained. In fact, the BNB package of measures did not receive any genuine government support. As a result, the fourth standby agreement was terminated and at the beginning of November the IMF recommended the establishment of a currency board arrangement in the country as the only alternative for a new standby agreement. In a letter to the Chairman of the National Assembly and the Prime Minister the BNB expressed its stance on the risks that may arise from the establishment of a currency board arrangement and suggested that urgent consultations be held with independent international experts on the matter.

The crisis deepened in the second half of November and in December as the BNB left the lev without support in the forex market, seeking to avoid acceleration of inflation through fully liberalizing interest rates on reverse repo-operations. In December, after the cabinet resignation, the country faced a political crisis as well, which removed the last barrier to hyperinflation. The National Assembly decision at the close of December for the BNB to extend a direct credit to the government, totaling BGL 115 billion (over 6% of GDP), to meet all financial needs of the government budget through the end of the fiscal year, contributed to this. In a letter to the Minister of Finance and the Chairman of the National Assembly Budget Commission the BNB expressed its disapproval in principle with such an inflationary way of budget deficit financing. To prevent a complete disruption of financial markets, however, the central bank had to comply with the decision.

2. Money Supply

Money supply (measured through broad money, including cash outside banks and all types of deposits) rose by BGL 726.6 billion and reached BGL 1,310.3 billion in 1996. This marks a nominal growth of BGL 560 billion compared with 1995. Deflated by the consumer price index, however, money supply contracted about 45% in real terms. Main factors behind the sharp real decline in money supply are BNB efforts to pursue a restrictive monetary policy, and low real demand for money as a result of eroded confidence in the banking system and accelerating inflation.

MONETARY AGGREGATES GROWTH

Monetary aggregates	1995 XII'94=100, %		1996 XII'95=100, %	
	nominal	real	nominal	real
Broad money	39.6		124.5	
BGL	50.9	13.5	52.7	-62.8
Foreign currency	16.4	8.7	316.5	-39.6
Monetary aggregate M1	43.6	8.1	119.3	-46.6
Currency outside banks	60.0	20.4	105.2	-50.0
Demand deposits	26.3	-5.0	138.1	-42.0
Quasi-money,	38.8		117.5	
including:				
time deposits in levs	54.9	16.6	27.6	-68.9
deposits in foreign currency	17.1	9.3	300.0	-42.0

Source: BNB.

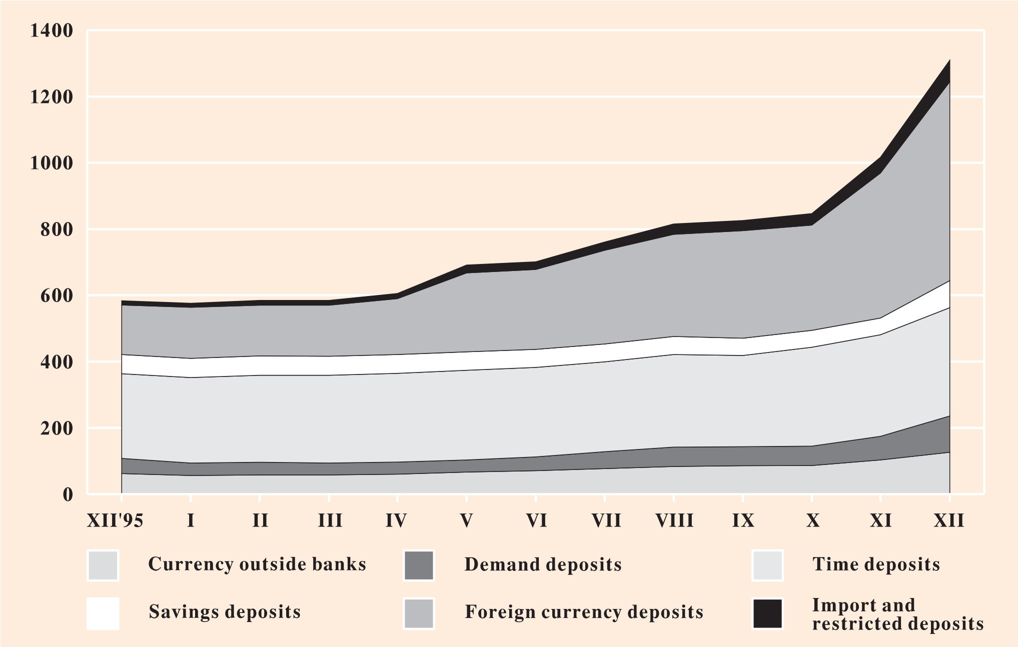
Only 30% of broad money growth is attributable to the lev component; the other 70% is prompted by lev devaluation. As a result, the share of lev component in total money supply fell from 72.8% at end-1995 to 49.5% a year later. This has been the worst broad money structure recorded since price liberalization in 1991, which strongly limited BNB scope to control money supply through monetary policy instruments.

In 1996 monetary aggregate M1, including highly liquid funds (cash outside banks and demand deposits), displayed a similar growth rate to that displayed by total money supply. M1 growth in nominal terms was BGL 128.7 billion, but in real terms it fell 46%. Cash outside banks has contracted at a faster rate in real terms, about 50%, against 42% in demand deposits. It may be argued that this contraction is attributable not so much to a real decline in the real sector but rather reflects eroded confidence in the banking system and in the lev, and increasing dollarization of the national economy.

No significant changes occurred in the structure of monetary aggregate M1 at the end of 1996 compared with 1994 and 1995 year-ends. The share of cash outside banks stood at about 10% of total broad money, which gives grounds for assuming that economic agents generally preferred cash holdings and were therefore unlikely to be influenced substantially by the acceleration of inflation. Although high in nominal terms, strongly negative interest rates on deposits were not likely to affect significantly the demand for cash for transactions. With higher inflation and increasing distrust among individual contractors, the relative rise in costs for the use of cash was offset by higher liquidity needs to effect transactions, and probably by continued interest in operating under partial financial transparency since this facilitated concealment of business activity and tax evasion.

MONETARY AGGREGATES DYNAMICS IN 1996

(billion BGL)



Source: BNB.

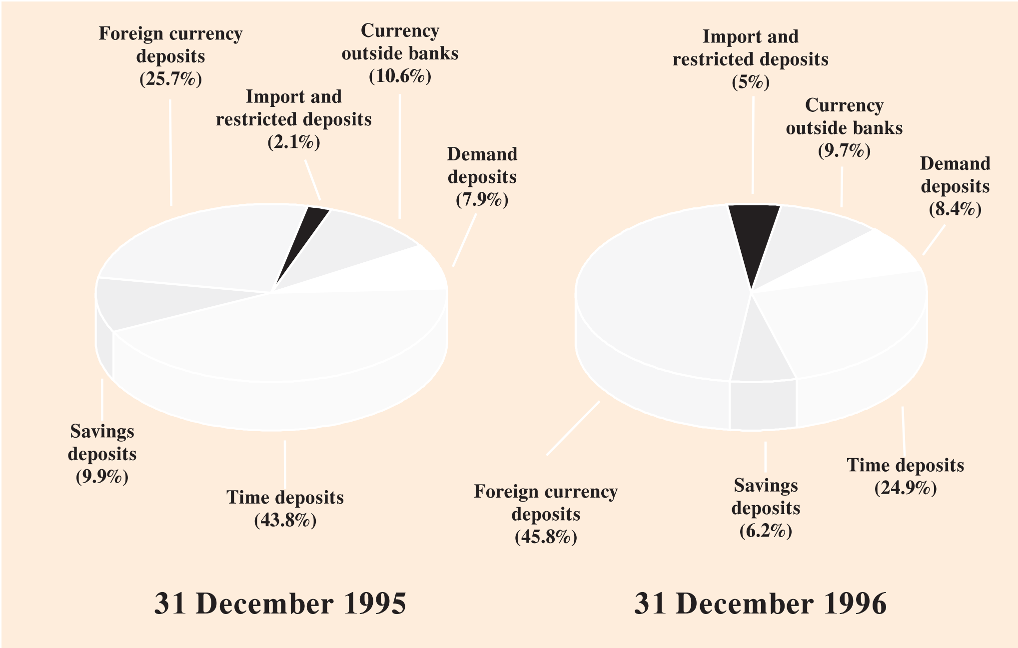
Despite higher interest rates and a strong nominal effect from lev devaluation in 1996, quasi-money (including less liquid funds: lev time and savings deposits and foreign currency deposits) displayed two percentage points slower growth than that displayed by monetary aggregate M1. This is indicative of an extremely low confidence in the banking system since growth in cash for transactions exceeded (albeit insignificantly) nominal growth in demand for money for savings. This is also ascribable to eroded confidence in the lev. In contrast to 1994 and 1995, it may be argued that most economic agents, especially the public, preferred to hold their cash savings in foreign currencies.

Throughout 1996 lev time deposits rose a mere 27.6%; deflated by the consumer price index however, this marks a decrease of 68.9% in real terms. Lev time deposits rose by BGL 70.6 billion, but their growth was BGL 195 billion less than interest accrued. These figures indicate a sizable withdrawal of funds prompted not so much by the necessity to meet current needs but mainly a result of deeply eroded confidence in the national currency and the banking system.

Foreign currency deposits accounted for the highest share of total quasi-money growth (BGL 545 billion; a growth of over BGL 450 billion). This nominal increase in foreign currency deposits is entirely attributable to lev devaluation, while in dollar terms a reduction of USD 890 million (42%) was recorded. The amount of foreign currency deposits drawn by individuals and firms was USD 100 million less than foreign debt service payments in 1996. This spelled a serious loss of credit resources to the banking system, which had a negative impact on both government and nongovernment sectors.

Eroded confidence in the lev and the banking system made it impossible for the BNB to pursue effective monetary policy. BNB efforts to stabilize real money demand through various monetary policy tools, and hence restore financial stability in the country and the banking system were not supported by rapid and comprehensive government actions to strengthen the real sector by structural changes and quick cash privatization. Periods of monetary policy tightening alternated with periods of forced easing; positive results proved short-lived, and were followed by further worsening financial and forex crises resulting in further economic decline.

STRUCTURE OF MONETARY AGGREGATES



Source: BNB.

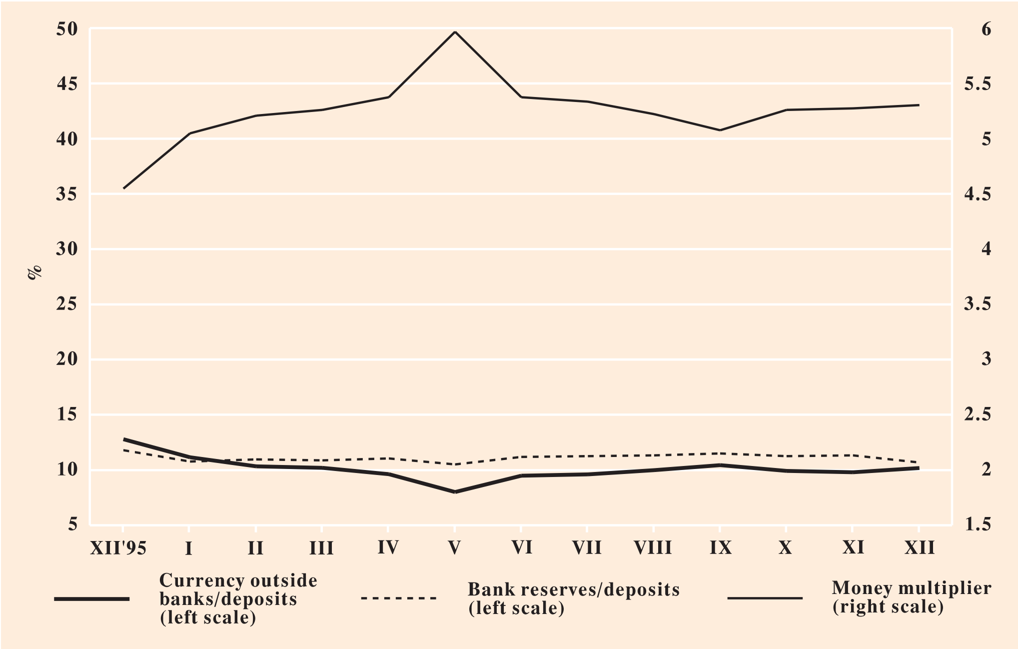
3. Reserve Money and Money Multiplier

In 1996 reserve money management continued to be instrumental in regulating money supply (measured through the broadest monetary aggregate). Against a background of sharp decline in real money demand prompted by eroded confidence in the lev and the banking system no significant changes occurred in money multiplier and the hypothesis of its relative stability and projectability throughout the year was sustained. Difficulties in reserve money management as an instrument of money supply regulation arose not so much from abrupt changes in the velocity of circulation but were mainly a result of disturbed money demand prompted by deep crisis in the banking system.

Reserve money was included for the first time as an indicative target in the fourth standby agreement because it strongly influences BNB net domestic assets: one of the country's performance criteria. Thus in the second half of 1996 daily reserve money management became a major instrument in monitoring performance of this criterion but the possibilities for its efficient use were limited by fundamental economic factors: growing budget financing needs and chronic liquidity problems in banks. The BNB was not able to tackle these problems on its own within the scope of its monetary policy instruments without support from government through restructuring and privatization of the real sector. As a result, reserve money management was seriously hampered and could not be sufficiently effective.

In 1996 reserve money growth lagged behind broad money growth by over 30 percentage points. Within reserve money components, bank reserves rose rather modestly. This is ascribable to the reduced level of minimum reserve requirements decreasing about one percentage point per annum on average, and to a contraction in bank excess reserves reflecting lower liquidity in the banking system prompted by massive runs on banks and monetary restriction. At the same time cash outside banks displayed a 13 percentage point faster growth rate than that displayed by reserve money. This is mainly due to declining confidence in the banking system whereby economic agents preferred to make cash transactions. The impact of negative real interest rates on deposits should not be overlooked either: high inflation rendered the loss of interest significantly less damaging.

MONEY MULTIPLIER IN 1996



Source: BNB.

RESERVE MONEY AND MONEY MULTIPLIER

Indicators	XII'95	III'96	VI'96	IX'96	XII'96
Broad money (billion BGL)	583.7	584.2	697.9	826.5	1,310.3
Reserve money (billion BGL)	128.4	111.1	129.9	162.8	247.0
Money multiplier	4.55	5.26	5.40	5.08	5.30
Currency outside banks/deposits (%)	11.8	10.9	11.2	11.5	10.7
Bank reserves/deposits (%)	12.8	10.2	9.5	10.4	10.2
Broad money change (billion BGL), including:		0.5	113.8	128.5	483.8
– money multiplier		91.4	12.6	-38.4	37.0
– reserve money		-78.6	99.0	176.7	427.7
– both factors		-12.3	2.1	-9.7	19.1

Source: BNB.

Throughout most of 1996 the ratio of cash outside banks to deposits was about one percentage point higher than in 1995, which contributed, other conditions being equal, to a reduction in money multiplier. The ratio of bank reserves to deposits, which dropped two percentage points compared with 1995, had a stronger impact on money multiplier but in the opposite direction. Owing to the combined impact of the two factors money multiplier in 1996 was about 0.5 higher than in the previous year.

Reserve money growth was the major factor behind money supply growth. During the first quarter of 1996 reserve money contracted, mainly due to seasonal factors as well as to reduced minimum reserve requirements; the drop in reserve money, provided the multiplier remained unchanged, would have caused a BGL 78.6 billion reduction in money supply. However, the drop in reserves was entirely offset by multiplier growth and the combined impact of the two factors aforementioned, as a result of which reserves in the first quarter of 1996 accounted for BGL 0.5 billion alone. In the remaining three quarters of 1996 reserve money growth contributed more significantly to money supply growth accounting for 90% per annum on average. During the second and fourth quarters of 1996 money multiplier growth and the aforementioned factors also played a role, albeit an insignificant one. As in the first quarter of 1996, reserve money had a completely different effect on money supply in the third quarter from that displayed by money multiplier but in contrast to early 1996 it was much stronger than that of the multiplier. Based on aggregate annual data for the whole of 1996 it may be assumed that reserve money growth, which remained under BNB control, was the major factor impacting money supply growth. Reserve money growth in nominal terms could not be ascribed to monetary policy easing but was mainly a result of lev devaluation and the growth of cash outside banks.

Analysis of reserve money sources indicates that BNB monetary policy was exposed to pressures during the year and reveals the combination of tools employed by the central bank for its implementation. During the first quarter reserve money growth related to increased claims on government and commercial banks. However, this impact was weaker than the opposite effect associated with a contraction in net foreign assets, thereby contributing to an overall contraction in reserve money. During the first quarter of 1996 the BNB came under a typically high seasonal pressure to finance the government through temporary direct credits, which could not be offset by liquidity withdrawals through open market operations, despite considerably raised interest rates. At the same time, the BNB increased refinancing of commercial banks and often performed its lender-of-last-resort function. In a situation of growing distrust in the banking system and the lev the central bank had to withdraw liquidity provided through forex sales to support the lev. This inevitably led to a contradiction between the major goal of its monetary policy and the supplementary goal of maintaining stability in the banking system. In the first quarter of 1996 the conflict was resolved at the expense of depleting foreign exchange reserves, but such a solution could only be temporary.

DEVELOPMENTS IN MONEY SUPPLY BY RESERVE MONEY SOURCE

(billion BGL)

Indicators	III'96	VI'96	IX'96	XII'96
Developments in money supply by reserve money source	-78.6	99.0	176.7	427.7
Sources of reserve money change:				
claims on government,	32.0	-94.0	235.9	120.6
including:				
direct credit	53.4	-40.7	59.0	492.6
government securities	-8.4	44.1	215.1	-53.4
claims on commercial banks,	78.3	264.5	163.8	546.3
including:				
Lombard loans	9.3	4.8	12.2	-0.4
discount loans	-3.8	-4.5	-0.2	-2.0
unsecured loans	64.9	125.0	7.7	-276.0
foreign currency refinancing	9.8	91.0	79.3	122.0
net foreign assets	-156.1	-38.1	74.8	306.9
other, net	-32.9	-33.4	-297.8	-546.1

Source: BNB.

During the second quarter pressure for budget deficit financing weakened and liquidity was successfully mopped up, given ever rising interest rates. This resulted in decreased central bank claims on government and – other conditions being equal – a contraction of reserve money. However, BNB claims on commercial banks had a considerably stronger impact but in the opposite direction. As the crisis deepened, lender-of-last-resort financing increased and the lev equivalent of forex financing rose, despite its fall in dollar terms, because the lev devalued further.

After mid-April support for the lev through forex sales was halted because forex reserves fell to a critically low level. This led to a less sizable reduction of BNB net foreign assets compared with the previous quarter, and hence of reserve money. As reserve money grew at a slower rate than the rate of lev devaluation, reserve money declined in dollar terms.

During the third and fourth quarters of 1996 significant changes occurred in BNB monetary instruments and the way individual reserve money sources impacted developments in reserve money. Refinancing of commercial banks was completely halted and increased BNB claims on commercial banks were entirely accounted for by ongoing lev devaluation. The scope of reducing commercial bank refinancing was strongly limited: the BNB placed five such banks under conservatorship, each had received support during the first five months of the year. The BNB subsequently applied to court to petition the institution of bankruptcy proceedings against these banks, and enforced the same procedure on ten other banks in late September, among which were banks that had also obtained refinancing from the BNB.

At the same time pressure to finance the increasingly expanding budget deficit grew, prompted by higher interest rates on the one hand, and absent foreign financing as a result of delays in structural reform and privatization, on the other. Furthermore, in the third quarter the SSB channeled a portion of its resources to finance agriculture in compliance with a government decision and the BNB had to take its place in the primary auctions for government securities to prevent financial market disruption. Just at that time government requested the BNB to bail out one state-owned commercial bank by buying back its bonds issued under the LSNC. (The popular Bulgarian acronym for this Law is ZUNK.) However, this operation failed, and the BNB portfolio increased significantly, leading to a further increase in BNB claims on the government, and hence in reserve money. In the fourth quarter the parliament's decision on a BGL 115 billion direct credit to the government to meet all government budget needs at the end of the calendar year had the same, or even stronger effect.

Analysis of reserve money sources impacting reserve money growth indicates that in 1996 it was impossible for the BNB to simultaneously meet its major goal of maintaining national currency stability with the supplementary goal of maintaining banking system stability. Pressure to finance the ever increasing budget deficit also contributed to this, rendering reserve money management difficult and monetary policy ineffective. In this complicated setting, the BNB itself could not prevent further worsening of the financial and forex crises by tightening monetary policy, and periods of temporary stabilization were usually followed by a further crisis cycle.

4. Domestic Credit

In 1996 domestic credit, including credit to the government and nongovernment sectors, rose by BGL 1,366 billion, or 217.3%. Domestic credit growth considerably exceeded broad money growth at the expense of the country's deteriorating net foreign assets, a determinant of Bulgaria's position in the rest of the world.

CREDIT AGGREGATES GROWTH

(%)

Indicators	1995 XII'94=100%		1996 XII'95=100%	
	nominal	real	nominal	real
Domestic credit,	15.7		217.3	-22.8
including:				
Government sector				
BGL	72.6	29.9	101.3	-51.0
Nongovernment sector	34.8		226.3	
BGL	36.7		15.3	-71.9
foreign currency	32.3		503.8	-12.4
Public enterprises	-11.0		211.0	
BGL	-12.7	-34.3	-1.7	-76.1
foreign currency	-8.6	-14.6	501.4	-12.7
Private enterprises	148.1		240.0	
BGL	183.5	113.4	31.0	-68.1
foreign currency	114.1	99.91	505.8	-12.1

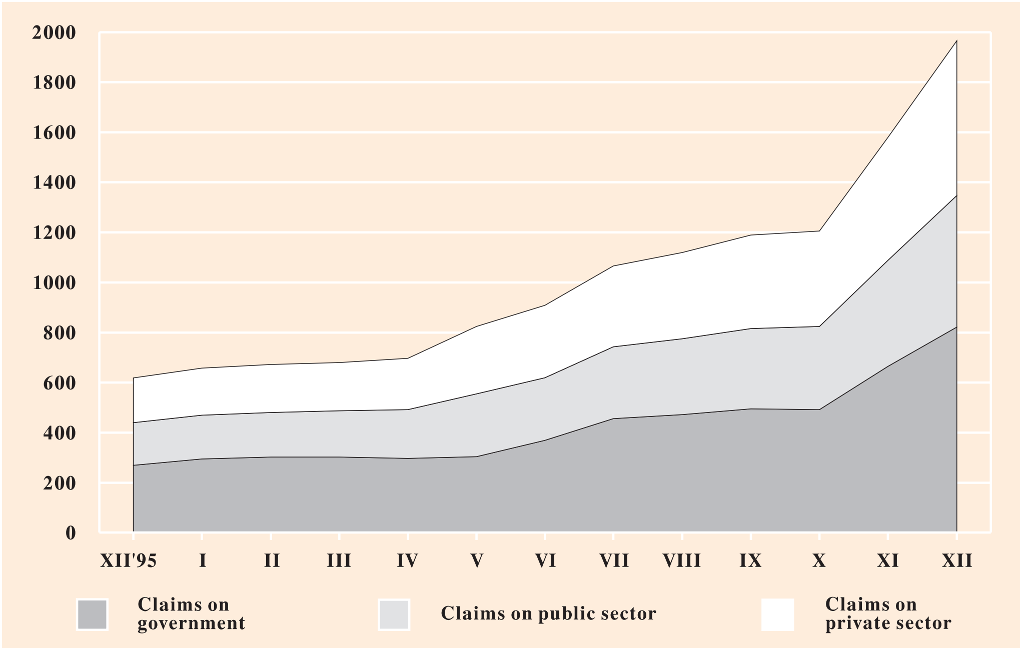
Source: BNB.

Nominal domestic credit growth was lower than inflation over that period and a real contraction of 22.8% was recorded. This occurred not because of significant changes such as accelerated and enhanced repayment of loans but was primarily a result of reduced credit resources in the banking system prompted by massive runs and limited possibilities of the country for compensating the shortage of domestic credit funds with externally sourced funds.

Domestic credit growth is primarily attributable to the devaluation of the lev. The nominal growth of domestic credit was nearly BGL 1,125 billion but in dollar terms a reduction of USD 321 million occurred: over 10%. These figures indicate a dramatic decline in demand for forex credits related to a sharp rise in real interest on these credits consistent with a substantial depreciation of the lev, particularly at the turn of 1996. This changed significantly the structure of domestic credit: the share of its lev component fell from over 65% to below 33% and the share of its forex component rose from 35% to 67% respectively.

DEVELOPMENTS IN DOMESTIC CREDIT IN 1996

(billion BGL)



Source: BNB.

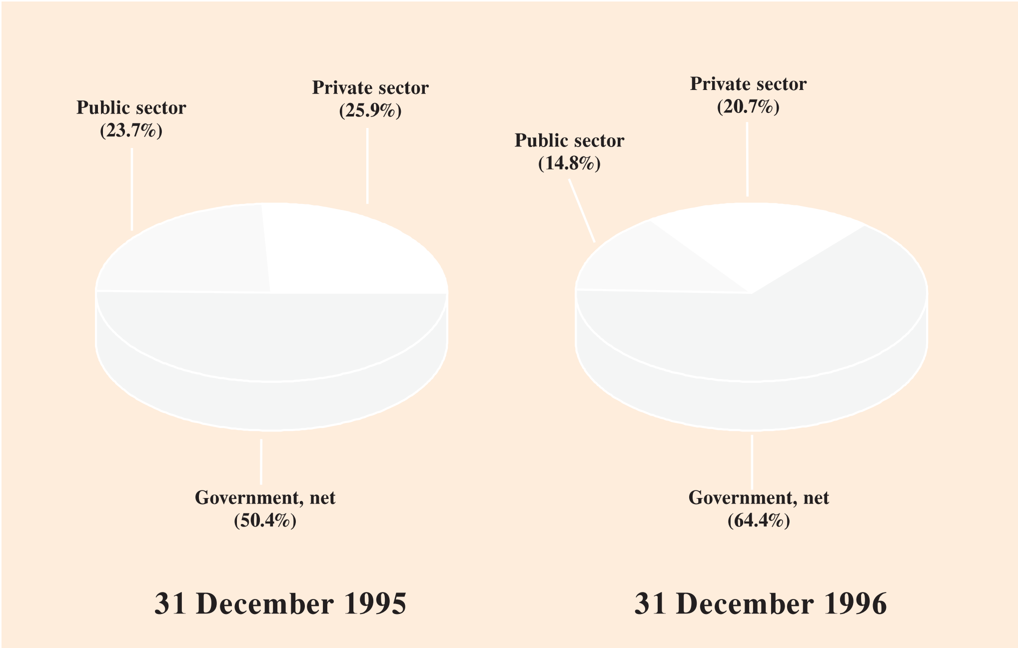
Lev devaluation and an ever increasing borrowing by the government sector provoked significant changes in the sectoral structure of lev domestic credit. At the end of 1995 the share of credit to the government was just above 50% while at the end of 1996 it moved up to about 64%. Nevertheless, the share of credit to the private sector continued rising, from 30.2% to 32.4% for total credit, and considerably faster in terms of its forex component, from 13.3% to 25.4%.

In 1996 lev credit to the government rose by about BGL 210 billion, practically double compared with end-1995. In contrast to the previous year, when credit to the government accounted for little over 60% of total growth, in 1996 its share exceeded 85%. Reduced lending capacity of the banking system contributed to further crowding out of the real sector from the credit market by government, and depressed economic activity. This generated great pressure for an easing of monetary policy, which impeded monetary policy implementation and reduced its efficiency in achieving financial and exchange rate stability.

Nominal growth in lev credit to the nongovernment sector, mainly achieved on a residual principle, was just BGL 31.2 billion: 15.3%. Lev credit to the real sector contracted in real terms by about 72%, contributing to a reduction in real sector debts to the banking system, on the one hand, but limiting the possibilities for accelerated growth, on the other, given the insufficient amount of credit resources to meet operating costs and investment.

At the end of 1996 lev credit to nonfinancial public enterprises decreased by nearly BGL 2 billion, 1.7% compared with end-1995. Growth in lev credit to private enterprises rose by BGL 33 billion, 31%. These figures clearly indicate that the bulk of credit resources to the nongovernment sector was allocated to the private sector, notwithstanding its small share in the national economy. Therefore there are no grounds to argue that the lack of credit resources and their high prices have held up private sector development. The prime reason may relate rather to the overall economic and financial instability currently obtaining in Bulgaria which inhibits normal operation of profit-oriented businesses responding to domestic and external demand for goods and services.

STRUCTURE OF DOMESTIC CREDIT
(lev component)



Source: BNB.

Trends in credit aggregates developments in 1996 are disturbing and would require significant adjustment to strengthen the bank and credit system. The considerably higher share of forex credits framed a worsened structure of domestic credit since the latter was heavily influenced by devaluation of the lev. Furthermore, further increasing credit to the government render impossible its rational use in the banking system. While no data is available to back the contention that rather too much credit resource has been provided to loss-making state enterprises, in a number of cases the behavior of private companies did not differ significantly from that of state-owned enterprises. In this respect there are grounds for assuming that a substantial improvement in the allocation of credit resources may occur, and may have a positive economic effect not only by their growing significantly as a result of restored confidence in the banking system, but also by their improved allocation by borrower on a market basis.

5. Monetary Instruments and the Money Market

Basic Interest Rate

In 1996 BNB interest rate policy continued to be employed as a major monetary policy instrument. However, in contrast with 1995, it was less effective since the deepening forex and bank crises were prompted by fundamental factors such as belated restructuring of the real and banking sectors. Consequently, the shock rises in interest rates in May and September had only a transient stabilizing effect.

In order to tighten monetary restriction, over the first four months of 1996 the BNB raised the basic interest rate on three occasions, increasing it from 34% at the end of 1995 to 67%. This did not help restore confidence in the lev and the banking system as it was not supported by decisive action to isolate unviable banks due to the lack of adequate legal framework, as well as government action to restructure the real sector.

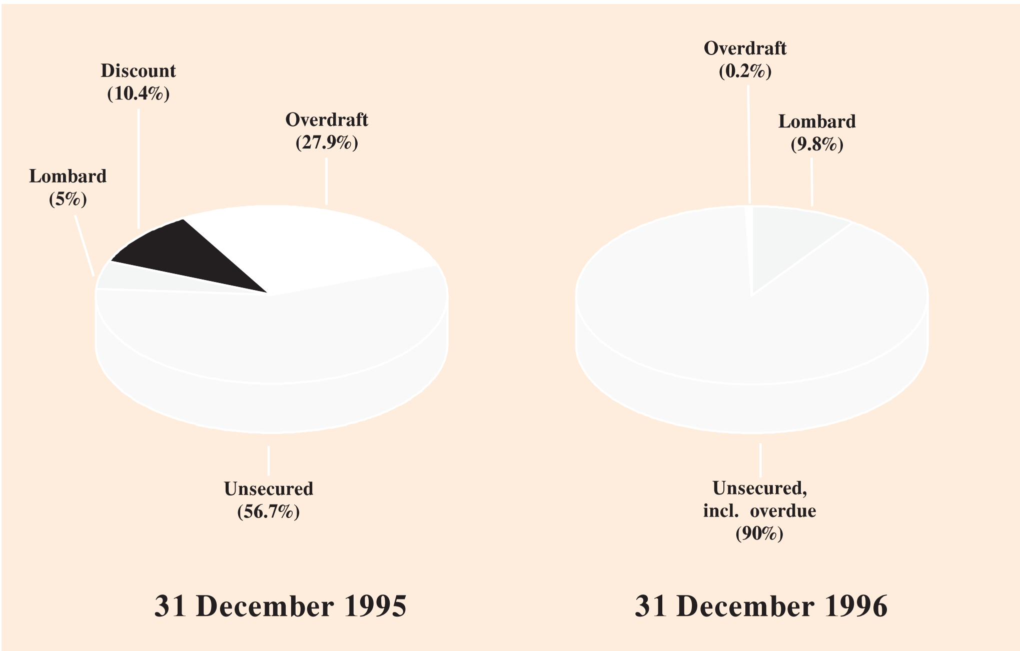
In May the BNB sharply raised the basic interest rate to a record high of 108% in order to compensate for its withdrawal from the forex market in support of the lev. By drastically tightening monetary policy and isolating five unviable banks under newly adopted legislation, the BNB gained time to finalize negotiations under the fourth standby agreement with the IMF and start the implementation of comprehensive reform intended to resolve fundamental problems in the real and banking sectors. BNB measures again had only a short-term effect because on the one hand, the financial crisis had an extremely adverse impact on the national economy, and on the other, there were inconsistencies and delays in restructuring the real sector.

In September the BNB implemented another shock rise in the basic interest rate, to 25% per month (300% annual simple interest), this being an element of the package of restrictive measures aimed at strengthening the banking system and restoring credibility in it. This also involved isolation of a second group of nine unviable banks. Thereafter the central bank commenced setting the basic interest rate monthly, stressing its relatively short-term duration consistent with an extremely high nominal level. As a result of tighter monetary restriction the lev temporarily stabilized and in October the BNB was able to decrease the basic interest rate twice, respectively to 20% and 15% monthly. As central bank actions were not supported by rapid structural reform, foreign financing was halted and the crisis deepened. By November the possibilities of profoundly influencing and hence reversing unfavorable developments were completely exhausted. Consequently, the BNB left the basic interest rate unchanged until year-end, despite interest on credits and deposits turning strongly negative due to accelerating inflation.

Refinancing in National Currency

By the end of 1996 funds extended by the BNB to refinance commercial banks totaled BGL 62,336 million, an increase of 3.24 times compared with end-1995 refinancing which had totaled BGL 20,171 million. Refinancing by the end of the first half of 1996 accounted for BGL 57,570 million, or 92.4% of outstanding loans by the end of the year.

STRUCTURE OF ACTUAL OUTSTANDING DEPOSITS AND LOANS OF COMMERCIAL BANKS



Source: BNB.

Of the 48 commercial banks in the country, 13 were refinanced in levs by the BNB. The central bank ascertained the insolvency of 11 of them and applied to court to petition the institution of bankruptcy proceedings against them. Refinancing these banks cost BGL 56,186 million, or over 90% of total commercial bank refinancing.

Proportionally, the share of unsecured loans was the largest (90%), followed by Lombard loans (9.8%) and overdrafts (0.2%). In terms of its share in bank liabilities, however, refinancing at the end of 1996 decreased significantly, from 2.2% at 1995 year-end to 1.9% a year later.

Unsecured Refinancing

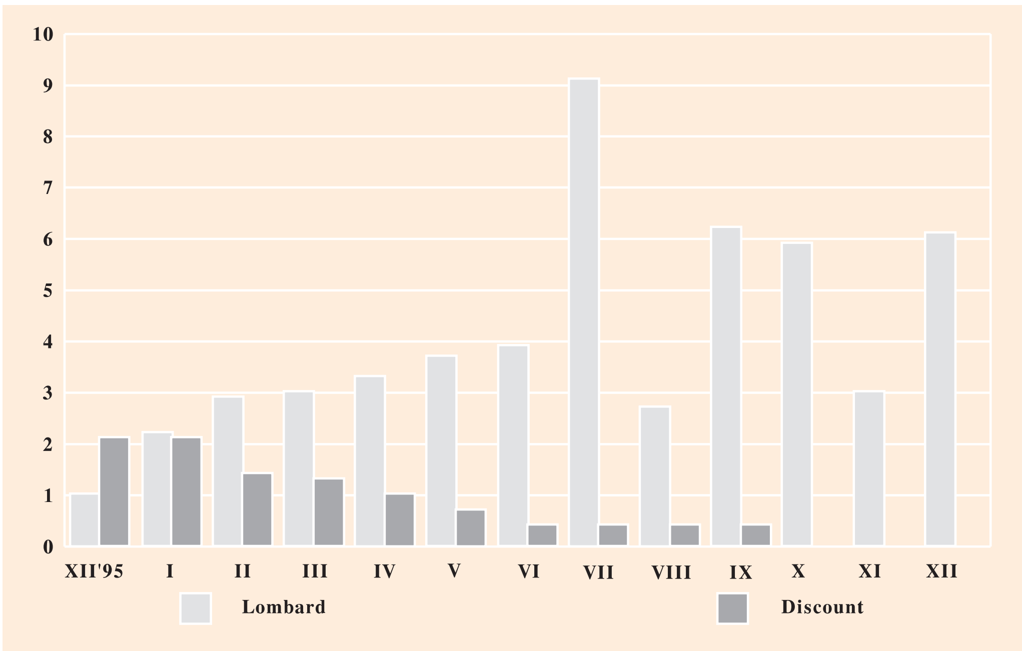
The liquidity crisis in the banking system deepened in 1996. In its efforts to alleviate the operation of the payments system and restore eroded confidence in banks, the BNB extensively used its legal right pursuant to Article 30, para. 3 of the Law on the BNB to extend unsecured refinancing to banks with liquidity problems. This reached BGL 54,106 million by the end of the third quarter and was then halted. This support proved insufficient and the nine commercial banks which had received unsecured refinancing became persistently insolvent. After the BNB applied to court to petition the institution of bankruptcy proceedings their liabilities were listed as arrears.

Lombard Loans

In 1996, the amount of Lombard loans varied dramatically in various months: from BGL 999 million by 31 December 1995 to BGL 3,994 million by the end of June 1996 and BGL 6,150 million by 31 December 1996.

LOMBARD AND DISCOUNT LOANS DEVELOPMENTS IN 1996

(billion BGL)



Source: BNB.

During 1996, Lombard loans were extended to eight commercial banks with temporary liquidity deficiencies, as well as banks with acute liquidity deficiencies. On 23 September 1996, the BNB placed some of these banks under conservatorship, and a month later a petition for institution of bankruptcy proceedings was filed in the court. A portion of Lombard loans totaling BGL 1,584 million extended to these banks were classified as overdue and are not included in the actual amount of outstanding balances on Lombard loans by 31 December 1996.

In 1996, 87 Lombard loans were extended, totaling BGL 32,661 million, and 76 of them, worth BGL 25,926 million, were repaid. As of 31 December 1996, Lombard loans extended were completely pledged by long-term government securities.

Since early 1997, the bulk of Lombard loans disbursed was repaid, including a portion of those classified as overdue. Consequently, total outstanding balance by end-February stood at BGL 1 billion.

Discount Loans

During 1996, 30 promissory notes of BGL 2,602 million were discounted to finance spring sowing, 51 promissory notes of BGL 4,266 million were discounted for cereals purchase, 1995 harvest. Forty-two loans of BGL 4,374 million on cereals were repaid. Compared with 1995, the number of discount loans fell by 50 of BGL 5,250 million. As of 31 December 1996, outstanding discount loans totaled BGL 389 million, with the whole amount classified as overdue. Outstanding discount loans decreased by BGL 1,745 million compared with 31 December 1995.

Open Market Operations

The interbank money market in 1996 reflected an insignificant volume of operations, mainly exchange of deposits between several financial institutions. According to reported data, average daily volume in the interbank market totaled BGL 885.5 million. At the same time the BNB, through its refinancing instruments, extended daily liquidity of BGL 2,931 million on average. Concurrently, liquidity of BGL 32,200 million was taken out from the banking system through repo-operations. Under the conditions of restrictive monetary policy, the BNB gradually centralized the interbank market. The major factors behind the reduced interbank market and active BNB participation in it related to the worsened macroeconomic environment due to delayed structural reform and eroded confidence among interbank market participants. As a result, BNB open market operations increased, and by the end of 1996 their volume totaled BGL 2,065,161 million in reverse resale agreements and BGL 2,112,197 million in reverse repurchase agreements. The absolute extent of the BNB government securities portfolio denominated in national currency totaled BGL 82,594 million nominal by the end of the review period. Government securities of BGL 169,464 million were acquired at primary auctions and from secondary market purchases. During the review period, outright sales totaling BGL 89,870 million nominal value were effected.

Reverse repo-agreements were most extensively employed in the open market, consistent with BNB restrictive monetary policy. The employment of three interest rate levels in reverse repurchase agreements with a term of up to six days and the introduction of auctions with a term of over six days improved the efficiency of this monetary policy tool in regulating liquidity in the banking system. On the other hand, by mid-April, reverse resale agreements were concluded at regular auctions with 14-day terms. By the end of April, the auctions were stopped, and operations to cover liquidity deficiencies were specified in line with the current state of banks.

Interest rates on BNB open market repo-operations were set to comply with BNB goals in regulating liquidity in the banking system. Under conditions of intensive liquidity absorption, consistent with fourth standby agreement performance criteria, interest rates on reverse repo-agreements stayed high, persistently diverting bank funds from government security primary auctions. However, despite the IMF recommendation to liberalize these interest rates, their dramatic increase did not help balance the open market, instead additionally burdening the budget.

Commercial Bank Refinancing in Foreign Currency

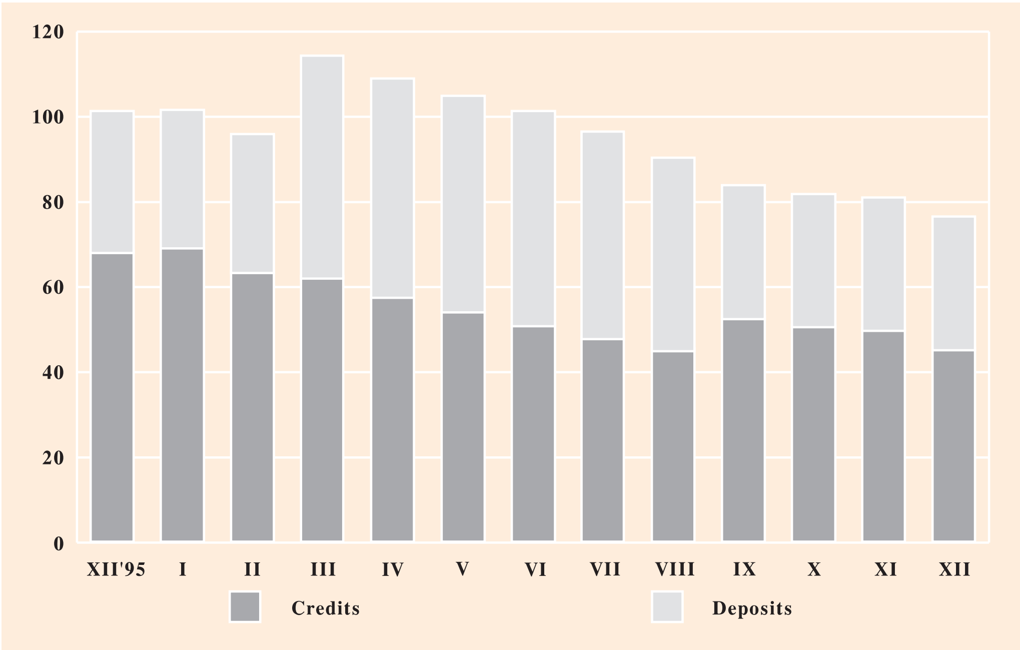
During the first half of 1996, the BNB continued to employ its traditional instruments (discount loans and deposits) to refinance commercial banks in foreign currency. Taking into account the state of financial markets and adverse trends in the real economy, the BNB tended to reduce the use of these instruments. During the second half of 1996, refinancing in foreign currency stopped, consistent with central bank policy aimed at reducing refinancing in foreign currency. By year-end, the bulk of outstanding foreign exchange loans and deposits remained with such banks in respect of which the BNB had petitioned the institution of bankruptcy proceedings.

Foreign Exchange Loans

The amount of commercial banks' outstanding foreign exchange credits to the BNB was reduced to USD 50.5 million by the end of the first half of 1996, and to USD 45.3 million by end-1996, against USD 68.2 million by end-1995. During the second half-year, deposits of DEM 10.3 million and USD 1 million were converted into secured credits. The BNB extended three-month discount loans to commercial banks against a pledge of commercial paper (promissory notes). Forex credits were denominated in US dollars and Deutschemarks, and the interest rate applied stayed unchanged from previous years, at 9% per annum.

REFINANCING OF COMMERCIAL BANKS IN FOREIGN CURRENCY IN 1996

(million USD)



Source: BNB.

Foreign Currency Deposits

The volume of BNB forex deposits with commercial banks was increased in the first six months of 1996 to assist normal foreign trade in a period of growing problems in the banking system. During the second half of 1996, this refinancing instrument was not employed, but a number of disbursed deposits were rescheduled for short periods due to banks' financial difficulties. A portion of unsecured deposits were converted into secured loans. By the end of 1996, the volume of BNB forex deposits with commercial banks totaled USD 31.2 million, a decrease of USD 26.8 million from the end of the first half-year. Forex deposits were denominated in US dollars and Deutschemarks. Interest rates on forex deposits matched their previous years' levels: between 6.5% and 8% per annum on USD-denominated deposits and 7% per annum on DEM-denominated deposits.

Minimum Reserve Requirements

In 1996 minimum reserve requirements continued to be employed by the BNB in regulating bank liquidity. To come into effect under the January regulation, commercial banks' minimum reserve requirements (SSB excluded) with the BNB were decreased by one percentage point (from 9.5% to 8.5%), provided the released funds would be entirely transferred to the Bank Deposit Insurance Fund to cover contributions due as per Regulations No. 1 of the BNB, and that remaining funds would be used for purchase of government securities by the BNB.

As of 15 March 1996, a new system of minimum reserve requirements was introduced, with a view to more efficient employment of this tool in regulating bank liquidity and its improvement by establishing a more flexible regulation system. The BNB principal requirement is to hold minimum reserves required in levs on commercial banks' current account with the BNB, and to maintain an average daily amount equal to the minimum reserves required for the month, calculated on the basis of balance-sheet data from the previous month. This enabled commercial banks and the SSB to use daily a portion of the funds on minimum reserve requirements in settlements. In accordance with the new system, commercial banks are allowed (as per the March regulation) to hold in foreign exchange up to 25% of required reserves on attracted foreign exchange funds.

To counterbalance lev devaluation, the BNB raised minimum reserve requirements to 10%, effective under the June regulation. By the end of August, the central bank limited the access to minimum reserves required from 50% to 20%, and in early September to 10%, with a view to drawing liquidity and releasing the tense forex market. As a result of lev stabilization, the BNB restored access to 50% of minimum reserves.

To go into effect under the August regulation, commercial banks were allowed to hold up to 100% of required reserves on attracted foreign exchange funds in foreign exchange, and in lieu of the lev equivalent of minimum reserves required, the BNB sold to commercial banks government securities with terms over one year. Besides, under the August regulation banks' and SSB funds on their current accounts with the BNB up to the required minimum reserves in levs accrued interest equal to two-thirds of the basic interest rate; no interest accrued on the minimum reserve requirements in foreign currency. Interest rates on minimum reserve requirements of commercial banks and the SSB, upon nonfulfilment of required minimum reserves in the period of regulation, were changed from the basic interest rate plus 18% per annum to the monthly basic interest plus three percentage points.

Due to intensified crisis by the end of December, the BNB decreased the admissible amount of minimum reserve requirements to be used by commercial banks and the SSB to 40%, and in early January 1997 to 30% of the required minimum reserves. It was set at 15% under the February 1997 regulation.

Given the intensified adverse trends associated with the dramatically devalued lev, commercial banks' minimum reserve requirements with the central bank were increased by one percentage point (from 10% to 11%) on funds attracted in levs and foreign exchange under the December 1996 regulation on the basis of annual balance-sheet data. The amount of required minimum mandatory reserves (11%) of operating banks and the SSB totaled BGL 111,044,960,000, an increase of about 101% compared with 1995. The reasons behind this increase are complex but a sevenfold lev devaluation in 1996 contributed most significantly to this effect.

Interbank Market

Interbank Market Volume

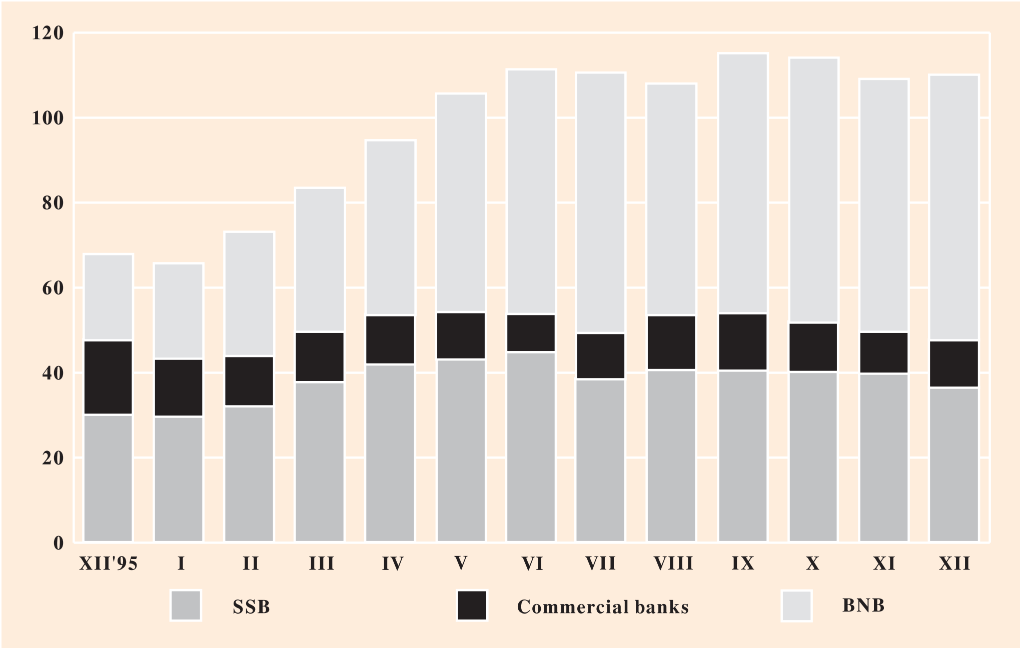
By the end of 1996, debt on interbank lev resources extended in the interbank market totaled BGL 46,929 million, a decrease of BGL 600 million compared with end-1995 (BGL 47,529 million). Despite the at first glance insignificant decrease in the interbank market, developments in 1996 indicated an apparent fall, a natural consequence of the acute liquidity crisis experienced by a number of banks and eroded confidence among credit institutions. After the BNB had found 14 commercial banks insolvent and petitioned the institution of bankruptcy proceedings, more than half of the interbank resources were frozen in these banks. Operating banks mostly renegotiated and expanded the term of contract channeling their free funds to the guaranteed repo-operations in government securities with the BNB.

Interest Rate

In general, interest rates throughout 1996 followed the frequently changing basic interest rate. The average interest rate on credit extended in the interbank market in 1996 was 108.93%, or 6.68 percentage points below the average basic interest rate (115.61%). However, analysis of the interbank market interest rate indicates that the spread ranged between two and five percentage points over the basic interest rate in various months. Only in the closing months of the year were funds exchanged at an interest rate slightly below the basic interest rate.

VOLUME OF THE MONEY MARKET IN 1996

(billion BGL)



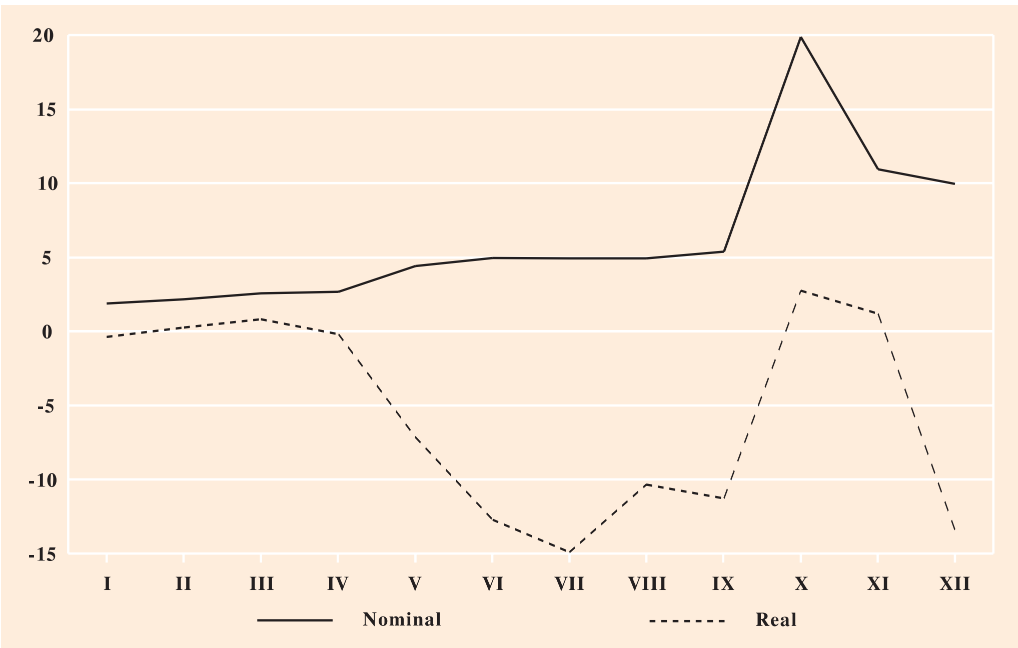
Source: BNB.

6. Interest Rates on Commercial Bank Operations

In 1996, commercial bank lending and deposit rates followed the changes in the basic interest rate. Under conditions of growing financial instability and eroded confidence in the banking system, commercial bank rates reflected more precisely the state of each individual commercial bank. Amid the deep financial crisis, interest rate policy appeared to be not only a challenge for depositors and borrowers but also a survival strategy of commercial banks.

MONTHLY INTEREST RATES ON ONE-MONTH DEPOSITS IN 1996

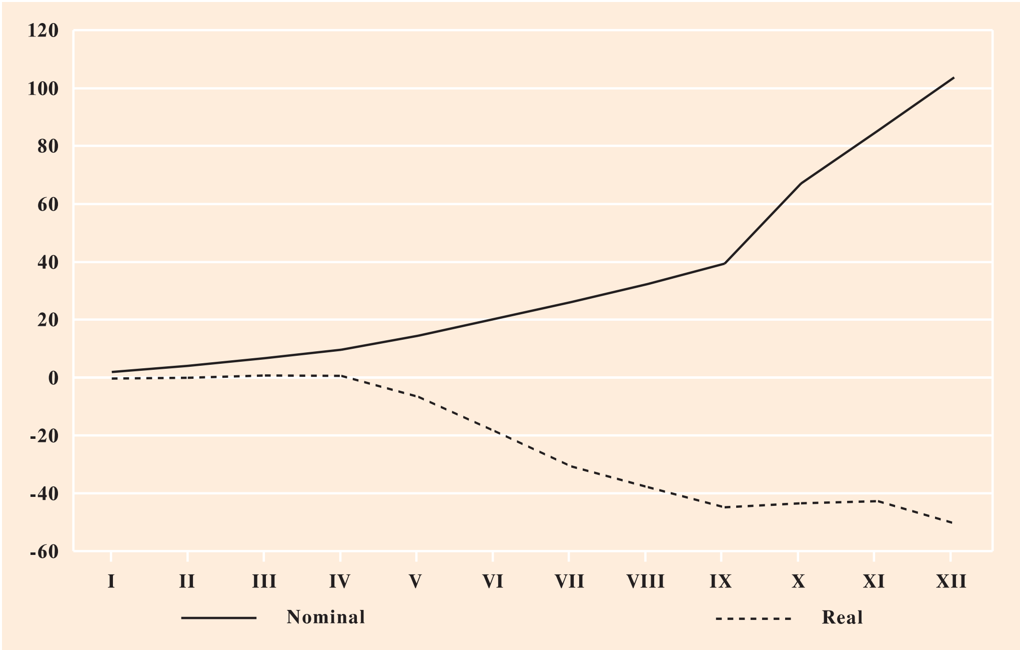
(%)



Source: BNB.

INTEREST RATES ON ONE-MONTH DEPOSITS IN 1996
(cumulative as of January 1996)

(%)

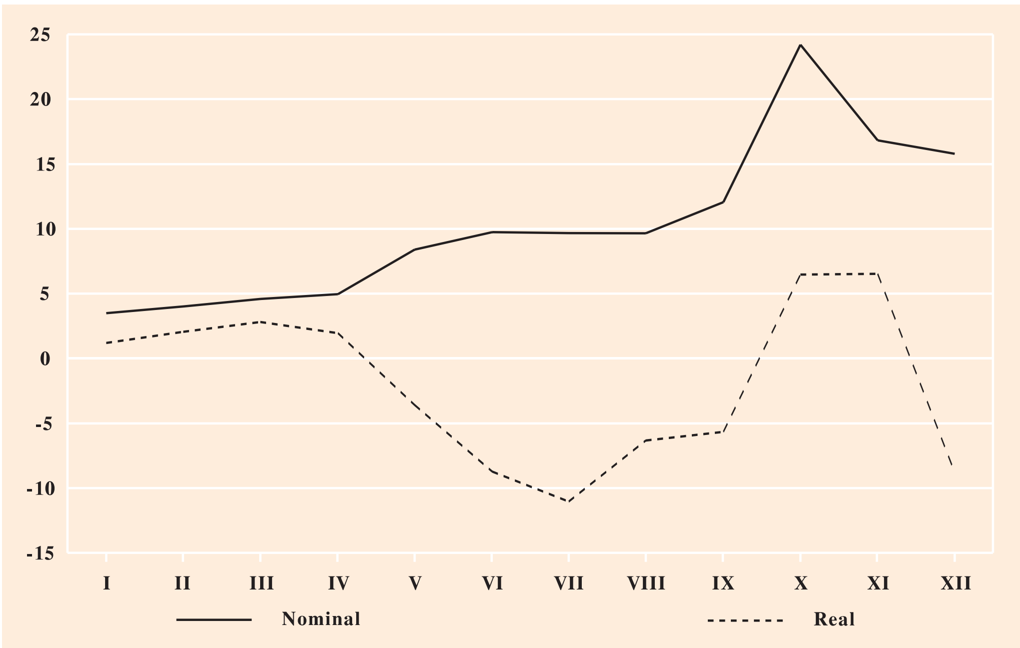


Source: BNB.

Between January and April 1996, interest rates on one-month deposits in levs increased from 1.88% to 2.7%, following the increase in the basic interest rate. Over this period, interest rates stood slightly positive, and the real interest accrued approximated 0.5%, which was insufficient to attract depositors, though the real value of their savings was preserved. Due to eroded confidence in the banking system and the lev, the rate of deposit withdrawal was sustained between January and April irrespective of relatively favorable real interest rates as compared with the following months.

MONTHLY INTEREST RATES ON SHORT-TERM CREDITS IN 1996

(%)

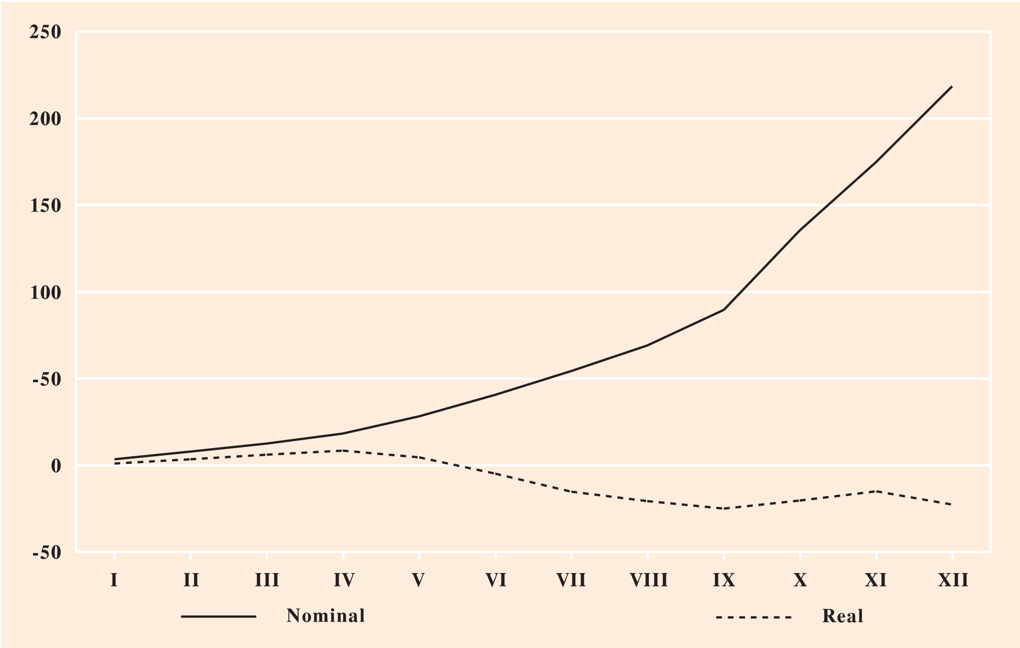


Source: BNB.

May saw the beginning of a five-month period of strongly negative interest rates. Despite the nominal increase from 4.41% in May to 5.37% in September, interest rates stayed strongly negative due to accelerated inflation, reaching the monthly low of approximately -15% in July. As a result, depositors lost over 45% of savings. Negative interest rates additionally contributed to a growing run on banks, with the speed of deposits' decrease depending on banks' liquidity. Following the dramatic rise in the basic interest rate to a monthly peak of 25% in September, nominal deposit rates of commercial banks followed its movements but not absolutely due to the jump in lending rates. Despite accelerated inflation, the growth in nominal rates challenged these rates' service and provision of funds for interest payments on deposits. In October and November, real deposit rates were positive but savers' yield remained low: 4%. This was an insignificant compensation, reducing savers' losses to 43% from early 1996.

INTEREST RATES ON SHORT-TERM CREDITS IN 1996
(cumulative as of January 1996)

(%)



Source: BNB.

Despite the new burst of inflation and the unchanged basic interest rate, one-month deposit rates were decreased by about one percentage point in December due to the inability of commercial banks to sustain the high nominal rates. By the end of the year, real interest rates were strongly negative again and savers' losses in 1996 surpassed 50%. This was a new signal of deposit base erosion. Along with shaken confidence in the lev and the banking system, and disappointment with interest rates, deposit withdrawal reflected primarily the dramatic drop in incomes which forced more and more people to use their savings to provide for existenz-minimum.

Nominal interest rates on short-term credits repeated the movements in the basic interest rate, with their real value depending on the inflation rate. Despite the real negative value throughout most of the year, lending rates moved dynamically, thus additionally impeding economic agents' business plans and price policies.

Following the increase in the basic interest rate between January and April, nominal lending rates rose from 3.49% to 4.96%. In real terms, they stood positive, ranging within 1.2% and 2.84%. During this period cumulative lending rates exceeded 8%, signaling a significant burden for the real sector. However, this should not be considered the major reason behind the new slowdown in economic activity since through most of 1995 real lending rates had also been high but confidence in the banking system and the lev was not undermined, and the real sector was provided with sufficient (though costly) lending.

Between May and September, interest rates on short-term credits (despite the nominal increase from 8.4% to over 12%) lagged behind the growing inflation. In real terms, interest rates stood negative, at between -3.6% and -11%, with cumulative interest exceeding -30%. Between January and September, the real cost of borrowing reached -20.6%, but the effect of the price factor on the national economy significantly diminished under the increasing shortage of lending funds in the banking system.

In October and November, nominal interest rates on short-term credits followed the dramatically increased basic interest rate, reaching the highs of 24.2% and 16.8% respectively. Commercial banks reacted automatically, although the heavily depressed real sector was unable to regularly service even the significantly lower interest repayments of previous months. Given the lack of financial discipline and hard budget constraints on most economic agents, an increase in real interest rates to about 6.5% per month can be considered a greater burden on banks than on the national economy as a whole, since bank decapitalization accelerated.

In December, real interest rates on short-term credits became strongly negative again, with real depreciation of credit resources over 1996 approximating 22.5%. This interest rate level, combined with acute deficiency of lending resources, impeded lending on a sound market basis. The cost of borrowing lost its role of an automatic regulator balancing supply and demand, and as providing the most rational distribution of credit funds among credit borrowers dependent only on the economic feasibility of their projects.

During 1996, the increase in the basic rate was accompanied by an increase in the spread between lending and deposit rates of commercial banks, from 1.6 percentage points in January to 6.7 percentage points in September. In the following months, the interest rate spread narrowed slightly but remained within 5.5 and six percentage points. Despite the insignificant decrease in the spread between lending and deposit rates in relative terms, the negative effect of its nominal increase on banks and the real sector should not be underestimated. Against the background of growing instability in the banking system, it reflects the worsened quality of commercial bank portfolios due to unfavorable economic conditions. The impact of this factor contributed to further deepening of the bank crisis as the increasing amount of nonperforming loans intensified bank decapitalization on the one hand, and had a strong repressive effect on the economic activity, on the other. To this end, the radical solution to the bank crisis through rehabilitation of the real sector and banks will lay grounds for the reduction of the spread between lending and deposit rates, thus ensuring the normal functioning of the economy and banks.

7. Issuing Activities

Volume of Issues

By the end of 1996, currency in circulation, including currency in the vaults of commercial banks and outside them, reached BGL 138.2 billion. It grew by BGL 69.6 billion (101.5%) compared with 1995, lagging three times behind consumer price growth.

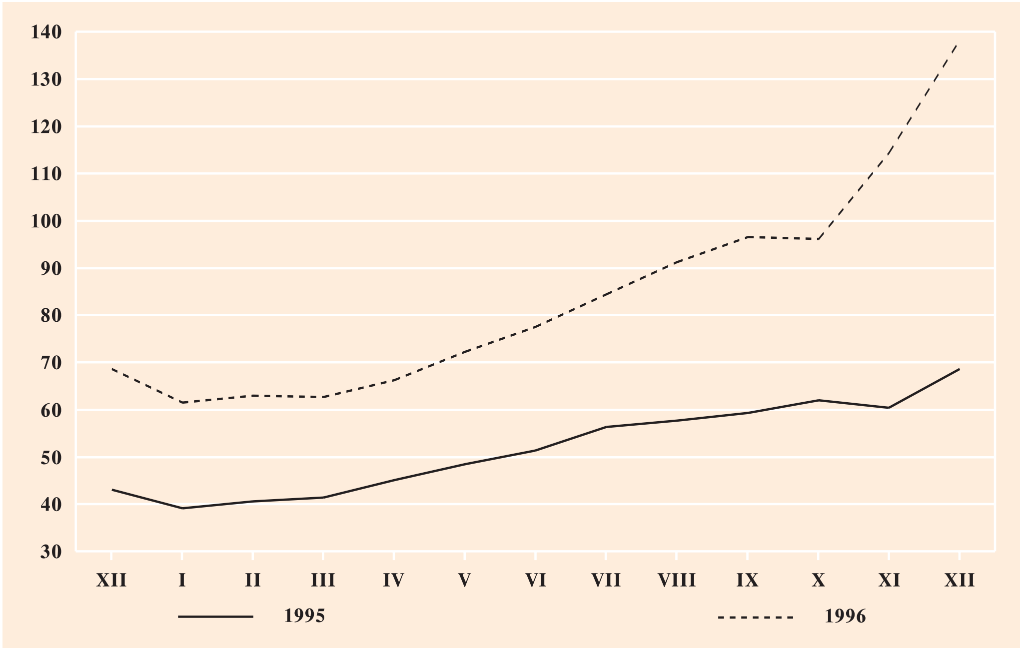
During 1996, broad money growth surpassed the increase in currency outside BNB vaults by 23 percentage points. By the end of the first half of 1996, this growth was 6.6 percentage points. The share of currency in circulation relative to broad money decreased from 11.8% at the end of 1995 to 10.5% by the end of 1996.

An analysis of developments in currency in circulation indicates a decrease from the end of 1995 through January 1996. In February and March, the currency in circulation slightly increased, reaching BGL 62.7 billion by the end of the first quarter, a decrease of BGL 5.9 billion from the end of 1995. During the second quarter of 1996, the amount of currency in circulation increased by BGL 14.8 billion.

In the third quarter, currency outside BNB vaults continued to increase, growing by a total of BGL 19 billion by the end of September. In October, currency in circulation decreased insignificantly following the BNB resolution for a dramatic rise in the basic interest rate. High interest rate levels had a short-lived character, and in November and December did not affect significantly individuals' aptitude for saving and the amount of money in circulation. Between November and December, money in circulation rose by BGL 42 billion, or 43.6%.

CURRENCY IN CIRCULATION
(outside BNB vaults)

(billion BGL)



Source: BNB.

The growth in money in circulation pertains primarily to accelerated inflation, accompanied by increased nominal incomes of households due to wage fund rises, compensations, pensions, scholarships, benefits, etc. Other factors behind the increased currency in circulation were: delays in the settlement system due to banks' liquidity problems; the insolvency of several commercial banks; and the tense forex market in November and December. Eroded confidence in the banking system also had a strong effect on currency in circulation. Withdrawal of deposits continued, although commercial bank deposit rates exceeded the monthly inflation rate in October and November. Problems in the settlement system forced companies to pay for deliveries of goods and services in cash, which also added to the increased amount of currency in circulation.

Following an insignificant increase by BGL 0.2 billion by end-June, cash in commercial banks' vaults rose dramatically, totaling BGL 11.7 billion by year-end: an increase of BGL 4.7 billion (67.1%), against BGL 7 billion in 1995. Enhanced commercial bank cash liquidity at the end of 1996 was associated mainly with inflation and increased turnover, as well as with expected withdrawal of deposits due both to eroded confidence in the banking system and Christmas holidays.

By the end of 1996, currency outside banks totaled BGL 126.5 billion, an increase of BGL 64.9 billion (105.4%) relative to end-1995. Currency outside banks grew by 3.9 percentage points compared with currency in circulation and lagged behind broad money growth by 19.1 percentage points.

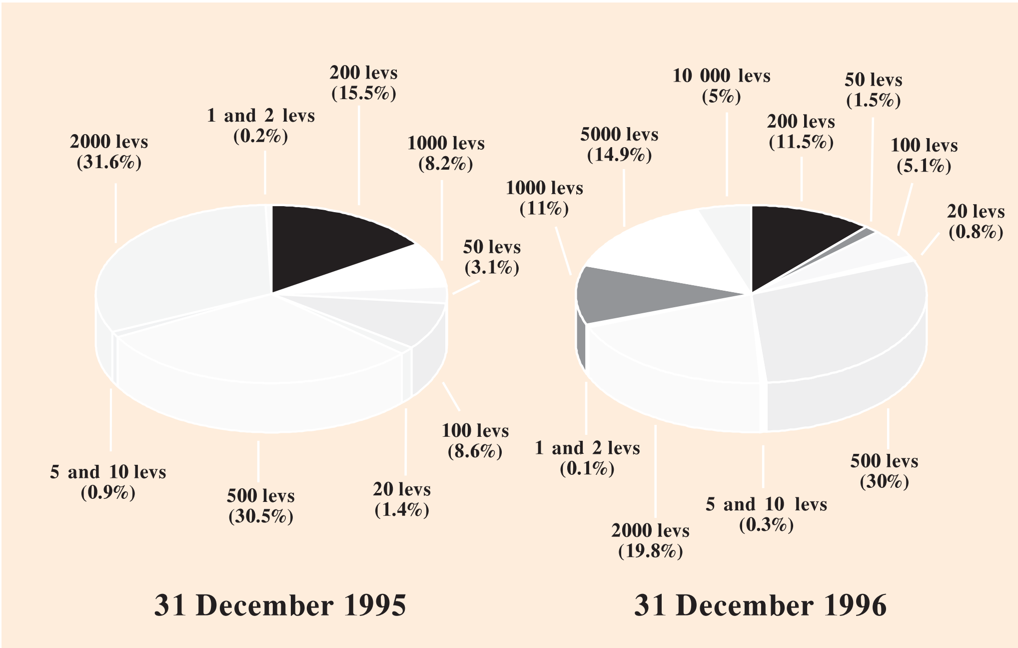
Denomination Composition

Developments in currency turnover brought about changes in the composition of currency denominations. Compared with end-1995, banknotes of higher denominations (BGL 500, 1,000, 2,000, 5,000 and 10,000) proved to be more convenient. By the end of the period in review, high denomination banknotes accounted for 80.8% of the total value of denominations, against 70.3% at 1995 year-end. The share of these denominations in the total amount of banknotes comprised 23.2% against 14.1% at end-1995.

The BNB continued to gradually withdraw old-design banknotes after normal wear. BGL 1, 2, 5 and 10 banknotes (1962 and 1974 issues) were more intensively withdrawn but they were in circulation until 31 December 1996. These banknotes will be exchanged until the end of 1998 only at BNB tills.

The ‘average’ banknote in circulation by the end of 1996 had a face value of BGL 254, against BGL 128 at 1995 year-end, an almost twofold increase. The increase in the face value of the ‘average’ banknote was a result of higher denominations in circulation on the one hand, and withdrawal of worn banknotes of smaller denominations, on the other. Compared with end-1995, the number of banknotes in circulation increased to over nine million despite the withdrawal from circulation of BGL 1, 2, 5 and 10 banknotes (1962 and 1974 issues), and intensive withdrawal of worn banknotes of BGL 20 (1962 and 1974 issues) and BGL 50 (1989 issue). This was attributable to escalating inflation, eroded confidence in the banking system and instability of the foreign exchange market.

DENOMINATION COMPOSITION IN THE BANKNOTE ISSUE



* The share of denominations is based on values.

Source: BNB.

To meet the needs for currency circulation of lower-denomination banknotes, the BNB issued coins. BNB efforts in 1996 were aimed at optimizing the denomination composition of currency in circulation, meeting the nominal increase in currency circulation with banknotes and coins of higher denominations.

During 1996, BNB issuing activity was performed in conditions of continuously escalating inflation. On 17 June 1996, the BNB put into circulation a banknote of BGL 5,000, and on 9 December a banknote of BGL 10,000, consistent with the needs of currency in circulation.

By the end of 1996, the design of a new series of circulating coins of BGL 10, 20 and 50, issue 1997, began. The BNB Board proposed and the Council of Ministers approved the face value, subject, form and design of the new series of circulating coins. Inflationary processes entail the process of design, issue and launch into circulation of new higher denomination banknotes and coins to continue in 1997.

Commemorative Coins’ Issues

In February 1996, the BNB Board approved the minting of four commemorative coins with a nominal value of BGL 1,000, issue 1996, in commemoration of Bulgaria’s association with the European Community, the 1998 Winter Olympic Games, the 120-th anniversary of the April Uprising, and Bulgarian navigation. In accordance with Article 25 of the Law on the BNB, the Council of Ministers approved the nominal value, subject, shape and design of the following silver coins:

‘Kaliakra,’ ‘St. Ivan of Rila’ and ‘Speed-skating’; the first two launched into circulation on 1 August and the third on 2 December.

The BNB Board approved the minting of two commemorative coins in commemoration of the 1998 World Football Cup in France with nominal values of BGL 500 and BGL 1,000; a coin commemorating the 50-th anniversary of UNICEF foundation with a nominal value of BGL 1,000; and a coin commemorating the 100-th anniversary of the foundation of the National Academy of Arts with a nominal value of BGL 500. The Council of Ministers approved the nominal value, subject, shape and design of the four commemorative coins, issues 1996 and 1997. Of these, the BNB put into circulation the coin ‘Two Football Players’ with a nominal value of BGL 500 on 2 December 1996.

Precious Metals

By the end of 1996 BNB gold reserves were 1,031,222 troy ounces.

The BNB purchased precious metals from domestic producers and gold coins from individuals. At the same time, the needs of domestic consumers were met by circulating precious metals in accordance with the established procedure.

PRECIOUS METAL STOCK IN THE BNB

(in troy ounces)[1]

Indicators	31.XII.1995	31.XII.1996
Gold reserves of the BNB[2]	1,031,222	1,031,222
Circulating precious metals[3]		
Gold	51,000	59,996
Silver	530,548	867,326
Platinum	11,949	12,239

[1] One troy ounce is equal to 31.10348 g.
[2] The gold reserves are in bullions, stock market standard.
[3] The circulating precious metals include gold, silver and platinum of standard type (bullion, strip and officially minted coins).

Source: BNB.

8. Foreign Exchange Policy

In 1996, BNB foreign exchange policy, an integral part of its monetary policy, failed to achieve its goals. Given the acute financial and bank crises, nominal national currency devaluation approximated 590% throughout 1996 and was the major factor behind accelerated inflation. Exchange rate movements were relatively smooth only in the first quarter of 1996 when BNB forex reserves were sufficient to intervene in the forex market in support of the lev. Subsequent months were characterized by rapid, even jump-like, depreciations followed by temporary stabilization, rarely indicating a nominal appreciation of the lev. The periods of stabilization reflected BNB efforts at financial stabilization by tightening monetary restriction through employment of lev instruments. Central bank measures aimed at steady stabilization proved ineffective due to inconsistent government actions to speed up elimination of losses in the real sector and their transfer to the banking system.

In the conditions of dramatically weakening confidence in the lev and the banks, BNB foreign exchange policy failed to attain a relative independence, consistent with the peculiarities of international settlements, within the framework of the monetary policy pursued. Maintenance of external lev stability completely depended on the development of the financial crisis and BNB efforts to curb it. As the crisis deepened, periods of dramatic lev devaluation pushed up tension in the forex market and had a follow-on destabilizing effect on prices and banks.

The 1996 experience clearly shows that foreign exchange policy aimed at a relative external stability of the lev and a smooth movement in the exchange rate cannot be achieved without a solution of fundamental monetary policy problems. Amid a bank crisis, foreign exchange policy is particularly vulnerable since the exchange rate becomes the most transparent indicator of economic agents’ expectations and the depth of ongoing processes. However, stability in the forex market is assessed mainly in the context of general trends; therefore, the short periods of lev stabilization do not help greatly any steady revival of confidence in the lev.

Forex Market

Foreign exchange in the banking system and in the forex market was supplied primarily by the chemical industry (including soda, pharmaceuticals and cosmetics), metallurgy, engineering (ship building, electrical engineering and foreign electronics companies), construction, construction materials production, cellulose and paper making, the leather, sewing and food industries, tourism, etc.

Final buyers of foreign exchange were mainly oil processors, power generators and budget and budget-supported organizations, as well as importers of automobiles, metals, sugar, etc.

The volume of forex market transactions registered by the central bank (prior to deleting possible double entries) totaled USD 4.4 billion in purchases and USD 4.8 billion in sales. Compared with 1995 (a period of considerably increased supply of foreign exchange), the volume of purchases and sales in the market contracted by one-third. At the same time, this volume exceeded by one-third that of 1993 and 1994 and even more those of the preceding two years.

FOREIGN EXCHANGE SPOT TRANSACTIONS

(million USD)

Market volume	A. Bought	B. Sold	C. Balance
1. BNB with customers	251.6	637.7	-386.1
domestically licensed commercial banks	141.7	74.4	67.3
companies	52.4	11.5	40.9
budget organizations	0.5	31.0	-30.5
MF for foreign debt		502.7	-502.7
other transactions with MF	31.1	17.9	13.2
Privatization Agency	25.8		25.8
other	0.1	0.2	-0.1
2. Fully licensed commercial banks with customers	2,438.5	2,479.3	-40.8
3. Interbank, fully licensed commercial banks	639.8	652.1	*
4. Interbank, BNB included (3+6A)	1,045.2	1,057.5	*
5. BNB, total (1+6)	657.0	1,272.0	-615.0
6. BNB with fully licensed commercial banks	405.4	634.3	-228.9
7. Intercorporate**	19.2	19.2	
8. Total with customers (1+2+7)	2,709.3	3,136.2	-426.9
including commercial banks with customers (1+2)	2,690.1	3,117.0	-426.9

Note: Including today, tom value and spot transactions of commercial banks whose operations are reported for the needs of central exchange rate calculation.

* Some imperfections in reporting lead to a minimum difference between purchases and sales which are identical in the interbank market.

** The data is for the minimum volume of the market as currently monitored.

Source: BNB.

Within the biggest market sector – operations of fully licensed commercial banks with customers – the volume of purchases and sales declined from 1995. Both purchases and sales considerably exceed the amount of forex bought and sold in each of the years before 1995, and the amount of forex bought by commercial banks from customers in 1996 exceeds commercial banks' sales to customers in each of the year before 1995. The amount of foreign currency drawn by banks from customers during 1996 was large enough to ensure an excess over customers' average consumption of foreign currency, typical of comparable periods in each of the years after 1991 except 1995. During the second half of 1996, the amount of commercial banks' purchases from customers exceeded their sales to customers, resulting in a positive balance of banks with customers. The negative balance reported for 1996 was insignificant, decreasing almost twofold from the first half of 1996.[34]

[34] The volume of operations of the fully licensed commercial banks with customers group includes domestically licensed banks and financial houses. Unlike operations with nonfinancial customers such classification is conditional since they act as intermediaries both for companies and interbank market participants, and this part of operations actually forms an expansion of the interbank market. However, this does not affect fully licensed banks' balance with customers provided entries have been correctly made.

The decline in the volume of operations with customers pressured the volume of interbank operations in the second half of 1996. The increased share of interbank market turnover reported in the first half-year declined at the expense of operations between fully licensed commercial banks. Their operations with the central bank remained active, and BNB reported a positive balance (though insignificant) on forex spot operations with fully licensed banks which helped lessen the annual negative balance with these banks as compared with the first half of 1996. The balance of USD 230.4 million almost matched the minimum estimated volume of foreign currency (USD 221.6 million) purchased by fully licensed commercial banks from the BNB and immediately sold for imports of energy resources (oil, gas, coal, nuclear fuel) or for compensation of such purchases. (The BNB sold additional USD 11.3 million to the energy sector for imports of same raw materials; this amount almost covered the entire amount of BNB sales to companies.)

SHARE OF INTERBANK OPERATIONS AND BNB NET OPERATIONS IN THE FOREIGN EXCHANGE MARKET

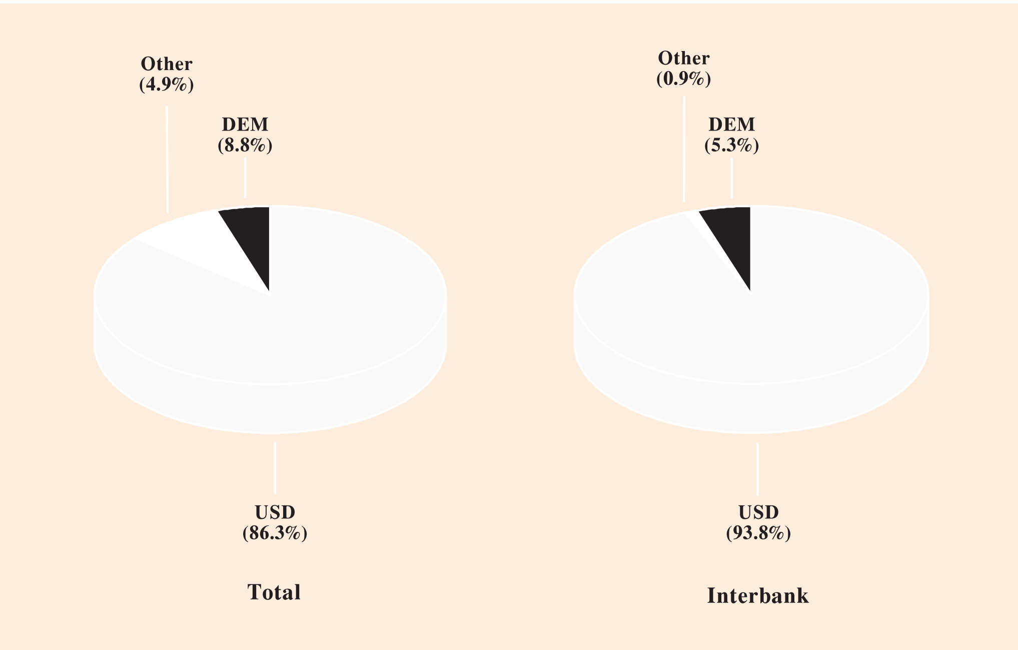
(%)

Interbank turnover/forex bought from customers (commercial banks)	26.7
Interbank turnover/forex sold to customers (commercial banks)	26.3
Interbank turnover/forex bought from customers (commercial banks and BNB)	39.3
Interbank turnover/forex sold to customers (commercial banks and BNB)	33.9
Net BNB sales/total sales to customers (commercial banks and BNB)	19.7
Net BNB sales/balance of banks with customers (commercial banks and BNB)	144.1

Source: BNB.

BNB spot operations with other commercial banks (except fully licensed banks) resulted in positive central bank balances in the first half-year and particularly in the second half-year. This was the largest positive balance reported by the BNB among all sectors of its operations.

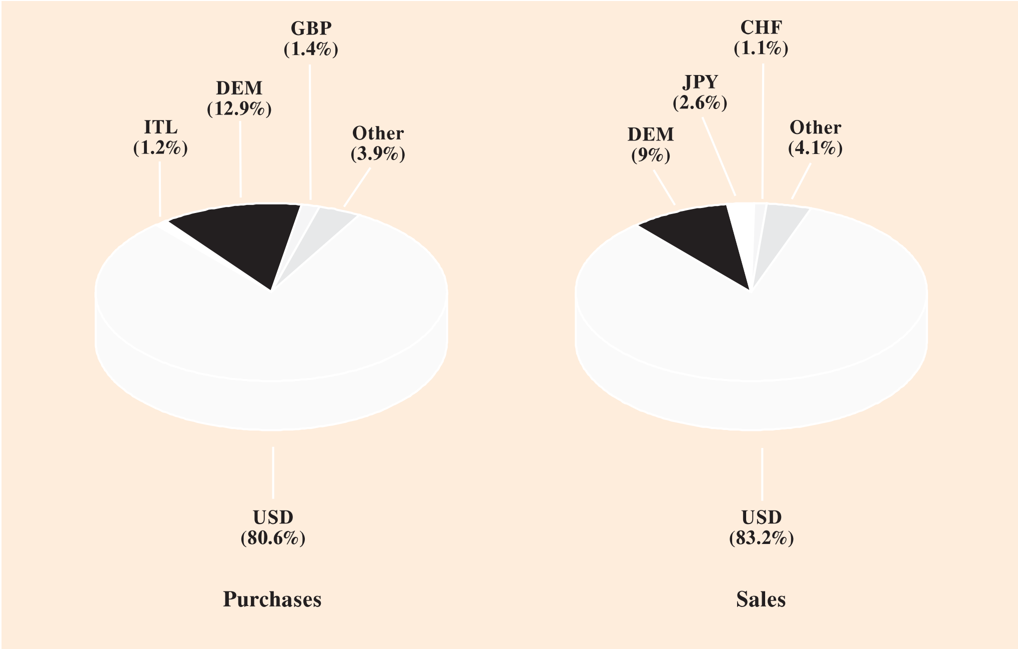
STRUCTURE OF FOREIGN EXCHANGE MARKET IN 1996



Source: BNB.

The amount of foreign currency sold by the BNB to the Ministry of Finance for foreign debt payments (USD 502.7 million on principals and interest) exceeded the amount sold in 1995, and the balance was covered by the tranche received under the fourth standby agreement with the IMF in July 1996.

PURCHASES FROM AND SALES TO CUSTOMERS IN 1996



Source: BNB.

The US dollar retained its dominant position in the structure of traded foreign currencies in the domestic forex market. The Deutschemark ranked second by significance. Compared with 1995, the share of the US dollar in interbank operations slightly increased, while the share of Deutschemark decreased. A small decline was displayed in the shares of both the US dollar and Deutschemark (particularly in sales) in operations with customers.

The volume of intercorporate transactions for exchange of foreign currency against levs registered in commercial banks increased from 1994 and 1995 but remained smaller than in 1992 and 1993. Since early February, the reporting of intercorporate transactions where one of the parties is a financial and brokerage house was discontinued. This was the reason behind the small volume of intercorporate transactions reported in the first half of 1996. By the end of June, reporting was restored.

Exchange Rate

The estimated nominal effective exchange rate[35] based on the basket of currencies (US dollar, Deutschemark, Japanese yen, French franc and British pound) constituting the special drawing rights (SDR) indicates a devaluation of 6.8 times (85.22%) against the SDR over 1996. The comparison is purely statistical since the lev exchange rate has not been pegged to this or another basket, and the change in the ratios of the lev to this basket is not a direct indication of the movement of effective foreign exchange resources.

The lev's average nominal exchange rate against the aggregate of foreign currencies indicated similar movements, but this depreciation was less than that against reserve currencies, reflecting an appreciation of reserve currencies against the aggregate of other currencies. In 1996, weighted by Bulgaria's foreign trade in the first nine months of 1996[36], the exchange rate of the lev fell by 5.9 times (83.11%) against the aggregate of currencies of all Bulgaria's trading partners (57 currencies and 59 countries).[37] The lev devalued by approximately 5.9 times (82.95%) as weighted by Bulgaria's exports, and six times (83.28%) as weighted by Bulgaria's

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[35] As an average exchange rate with reserve currencies universally used in international settlements.

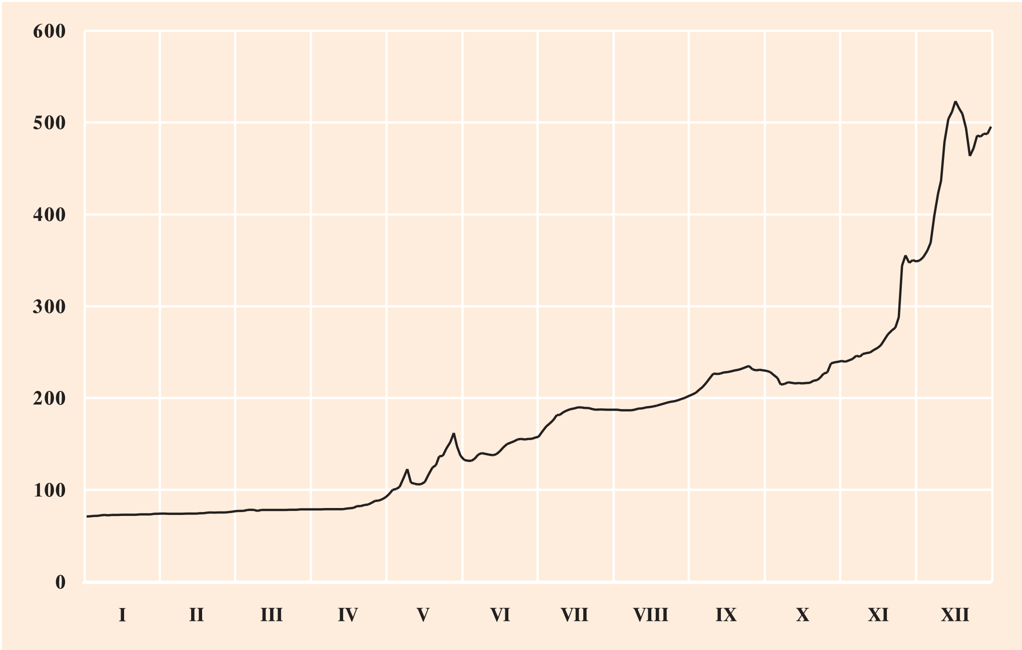
[36] In contrast to the 1995 report, foreign trade volumes are weighted in US dollar terms, since computing of the geographical structure in lev terms displays greater share in latest months due to dramatically changed exchange rate.

[37] The NSI has released data about Bulgaria's trade with these countries and BNB central exchange rates of their currencies against the lev.

imports. Against the currencies of Bulgaria's ten major trading partners (the same as included in the previous year's comparison[38]), the lev depreciated at almost the same rate.

US DOLLAR CENTRAL EXCHANGE RATE IN 1996

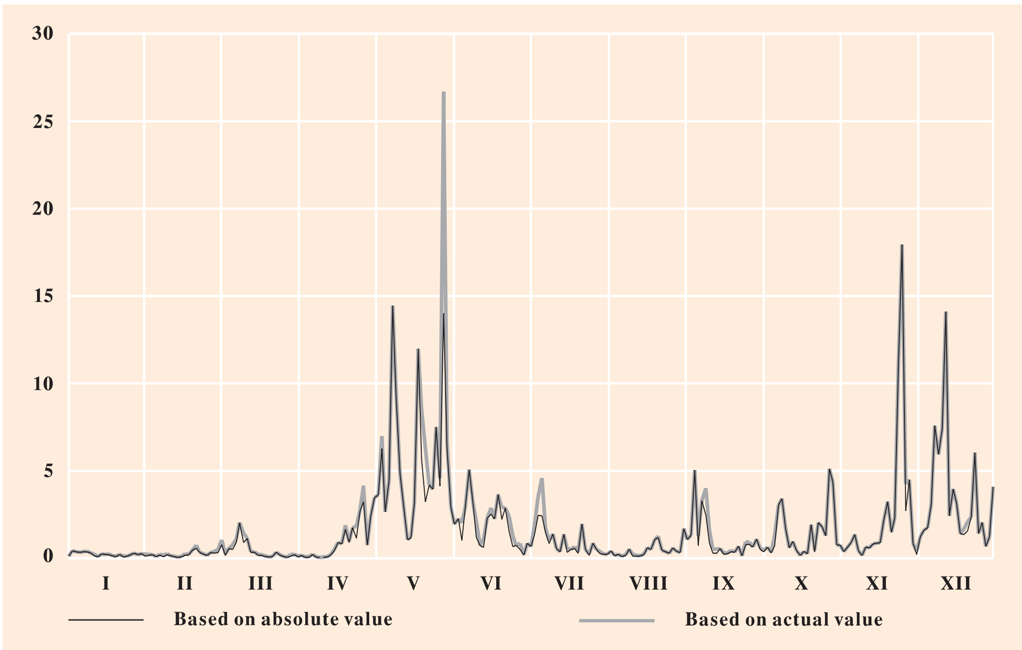
(BGL/1 USD)



Source: BNB.

BGL/USD EXCHANGE RATE VOLATILITY IN 1996

(%)



Source: BNB.

Lev devaluation was smaller against those currencies subject to gradual depreciation against reserve currencies under currency corridor and crawling peg mechanisms: 5.5 times (81.71%) against the Russian rouble, 5.6 times (81.99%) against the

[38] Except the Yugoslav dinar whose central exchange rate to the lev is only published since December 1995, and has therefore not been included in the comparison for that year.

Hungarian forint, 5.7 times (82.34%) against the Polish zloty. Lev depreciation against other benchmark foreign currencies used in international settlements, as well as against currencies of Bulgaria's major trading partners was as follows: six times (83.22%) against the Swiss franc, 6.2 times (83.95%) against the Japanese yen, 6.5 times (84.70%) against the French franc, 6.7 times (85.10%) against the Greek drachma, 6.3 times (84.06%) against the Ukrainian hryvna, 6.1 times (83.70%) against the Yugoslav dinar, six times (83.40%) against the Macedonian denar.

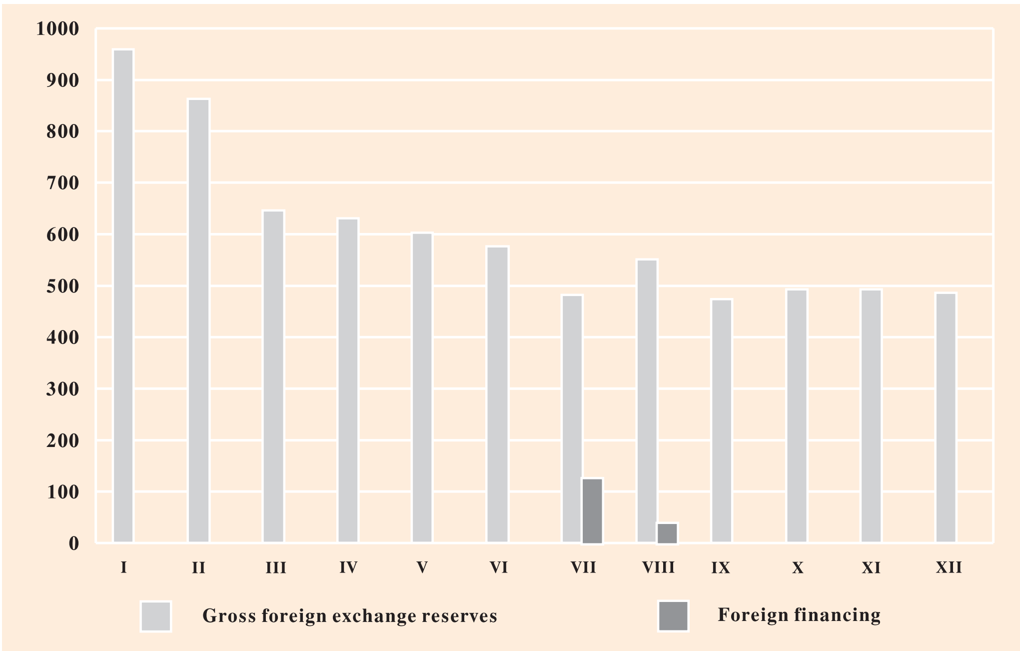
The volatility of BGL/USD exchange rate increased in May with the withdrawal of forex deposits and completion of the first stage of the presidential election campaign; in early September, due to speculations related to the postponed tranche under the fourth standby agreement with the IMF, depletion of BNB forex reserves and pending placement of some commercial banks under conservatorship; in October, due to a cut in the basic interest rate to 240% and 180% (from 300% in September) and the approach of presidential elections; and finally in November and December, reflecting the acute political crisis.[39]

Foreign Exchange Reserves

In early 1996, BNB gross foreign exchange reserves totaled USD 1,236.4 million; by the end of 1996 they totaled USD 483.4 million: a fall of USD 753 million, including USD 661.6 million in the first half-year alone.

GROSS FOREIGN EXCHANGE RESERVES AND FOREIGN FINANCING IN 1996

(million USD)



Source: BNB.

Following the initial sizable foreign debt payments in January and intensive interventions in the domestic forex market (to compensate the eroded confidence in the lev and the banking system respectively, and to meet the seasonal demand for foreign exchange for importation of fuels), BNB forex reserves fell from USD 1.2 billion to USD 0.6 billion in the first half-year. During this period, foreign debt was

[39] Volatility based on absolute values computed for each working day by averaging the differences between the highest and lowest interbank exchange rate for the current day, and between each of these values and the average quotation from the previous day. The index is converted into cents or percent by dividing it by the central exchange rate quoted the previous day and valid for the current day. In order to display both movements in quotations and changes in the exchange rate trend, volatility is based on actual values. Provided the average value between the US dollar's highest and lowest exchange rates exceeds the exchange rate of the previous day, the volatility is the average value of components mentioned above in actual (not absolute) terms. In all other cases the absolute value of the average actual quantities of the differences between lowest and highest exchange rates for the current day, and between each of them and the average quotation of the previous day, is used. The method of conversion in percent is sustained.

serviced without foreign financing. The extremely low level of forex reserves, coupled with the fast rate of their fall, following a record high in 1995 (accumulated almost without official foreign funding) had an adverse effect on economic agents' expectations during the second half-year.

The sizable foreign debt payments by end-July were compensated to a certain extent by the first tranche extended under the fourth standby agreement with the IMF. Due to another huge payment in mid-July, forex reserves fell to USD 0.5 billion by end-July. Postponement of the second tranche under the standby agreement with the IMF and the amount of forex reserves became a major indicator of the expected stability of the lev. Following an insignificant disturbance the international debt market calmed, assuming that international financial institutions would extend funds in support of Bulgaria's foreign debt repayment. This helped preserve the high yield and attractiveness of Bulgarian debt.

In August, forex reserves increased due to funding extended under a loan agreement with the European Community, but interest payments effected in September on loans drawn by the IMF, EU and EFTA prompted a new fall. Additionally, BNB sales in the domestic market exceeded purchases, though the central bank was an active buyer over this period.

Given the lack of significant foreign exchange revenues from privatization, the bulk of expenditures from BNB reserves during 1996 was on foreign debt service. Beside the sales of foreign exchange to the MF for foreign debt payments, the BNB effected payments from forex reserves to cover debts to international creditors. Net forex sales to fully licensed commercial banks immediately compensated the import of fuels but the small amount of the negative balance of those banks with customers (much less than both that balance and the net inflow of foreign currency from domestically licensed banks to the BNB) turned this compensation into a compensation for withdrawn forex deposits by individuals.

V. Bank Supervision

1. The Impact of Macroeconomic Conditions on the Banking System

The unfavorable development of the economy in 1996, combined with eroded confidence in the lev appeared to catalyze the processes in commercial banks. Bulgaria's banking system experienced its most severe crisis since the start of post-1989 reform. The turmoil both in individual banks and in the banking system as a whole was a result of inadequate commercial bank management, reflecting a disregard for lending, liquidity and foreign exchange risk, failure to take a realistic view of situations, violation of the principle of caution, increased exposure to few sectors of the economy and to few clients. All these factors deteriorated the structure of the credit portfolio (an increase in the share of nonperforming credits), resulting in negative financial results and further decapitalization of commercial banks. The ineffective legal framework concerning the collection of claims from unfair borrowers also added to the deterioration of the credit portfolio. In addition, the underdeveloped market impeded realization of securities. The high margin between interest rates on extended credits and attracted funds could not compensate for the losses, thus reducing the opportunities to service debt.

Until early 1996, the central bank was prevented from taking radical measures against insolvent banks or banks with poor financial performance, due to the lack of a legal framework concerning bank bankruptcy and deposit insurance.

The BNB Board initiated a number of actions consistent with the agreement with the IMF. The most important of these was the placement of 14 banks under conservatorship in respect of most of which the BNB petitioned the institution of bankruptcy proceedings. Approximately 24% of banking system assets are concentrated in banks under conservatorship.

2. Financial State of the Banking System

Banks are divided into four groups for the purpose of this analysis.

Group I includes seven big state-owned banks and makes up 67% of the banking system as per end-1996 balance sheet figure. Bulbank and the SSB are also included but the analysis on the SSB is based on accounting statements only. The large relative shares of these banks in the group, dramatic changes in their values in various periods, and the specific structure of their balance sheet distorted the real picture of the group and the entire banking system.

Group II includes small and medium banks, mostly with private shareholder capital (only one bank has majority state capital and one bank has municipal capital). This group comprises 17 banks and makes up 7% of the banking system.

Group III includes all banks with foreign shareholder capital and bank branches. The group includes three banks and four bank branches constituting 2% of the banking system.

Group IV includes all banks in respect of which the BNB has petitioned the institution of bankruptcy proceedings. This group comprises 14 banks and makes up 24% of the banking system.

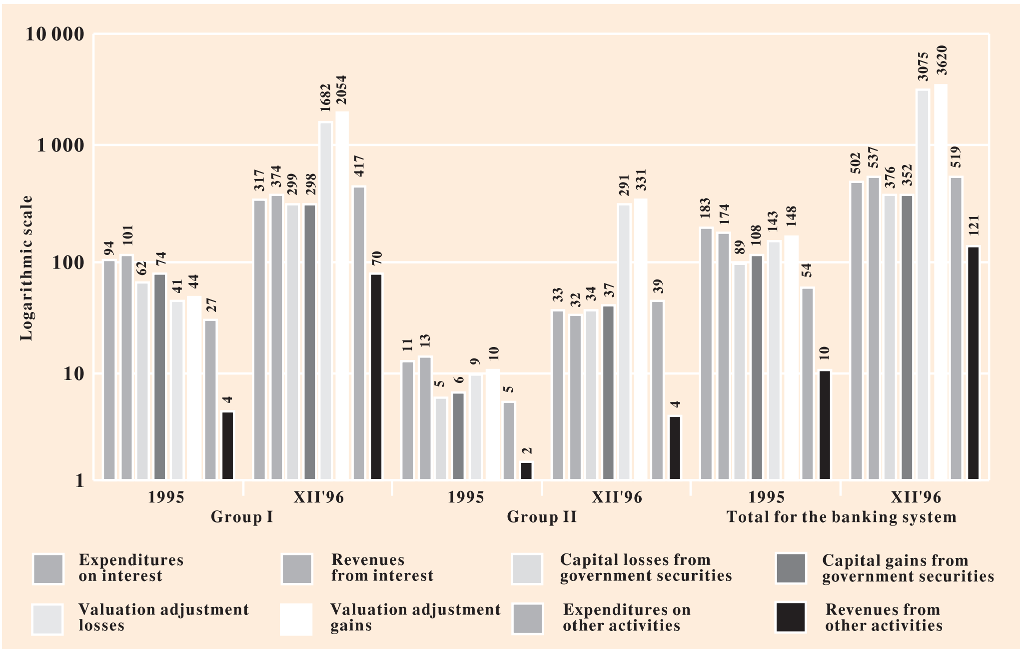
The analysis of banks' financial performance focuses on banks in the first two groups and is based on accounting statements and reports required under banking regulations. Methods of assessment based on ratios and methods established worldwide in banking are used. Additional detail information about credit portfolio state, attracted funds and off-balance sheet commitments is used in the analysis of banks' financial performance. Reported values for December 1996 are preliminary.

Consolidated Income Statement

The income statement as of 31 December 1996 displays the following trends: total expenditures increased by 9.5 times and total revenues by 10.5 times; consequently, a high positive financial result (net) totaling BGL 157.4 billion is reported, a dramatic upturn as compared with 1995 when the result was negative (BGL -28.3 billion). Banks included in Group I are particularly indicative: the profit increased 20 times and no loss was reported by any bank. The pre-tax profit/capital base ratio rose from 12% in 1995 to 50.9% in 1996, and the pre-tax profit/total assets ratio from 0.6% in 1995 to 2.5% in 1996. The profits of banks in Group II increased 15 times and losses declined by 8%. The pre-tax profit/capital base ratio in Group II increased from 8.5% in 1995 to 51.4% in 1996, and the pre-tax profit/total assets ratio from 0.8% in 1995 to 3.6% in 1996. The profit in the group including banks under conservatorship is overvalued due to nonpayment of required funds on statutory provisions. The revenues and expenditures from valuation adjustments indicated the largest growth due to the dramatically devalued national currency against the US dollar and other convertible currencies. The increase in the revenues and expenditures from valuation adjustments is 24 times and 21 times respectively. Despite higher interest rate levels, the share of revenues rose to 77.8% and the share of expenditures to 66.1%, against 31.3% and 30.1% respectively in 1995. The share of noninterest revenue in total revenues totaled 91.9% in Group I and 95.2% in Group II. All items included in the income statements indicated a sharp increase from 1995: the item ‘Total revenue’ displays a tenfold growth. This is attributable to intensive inflationary processes in the economy throughout 1996.

SELECTED INDICATORS OF THE CONSOLIDATED INCOME STATEMENT OF COMMERCIAL BANKS

(billion BGL)



Source: BNB.

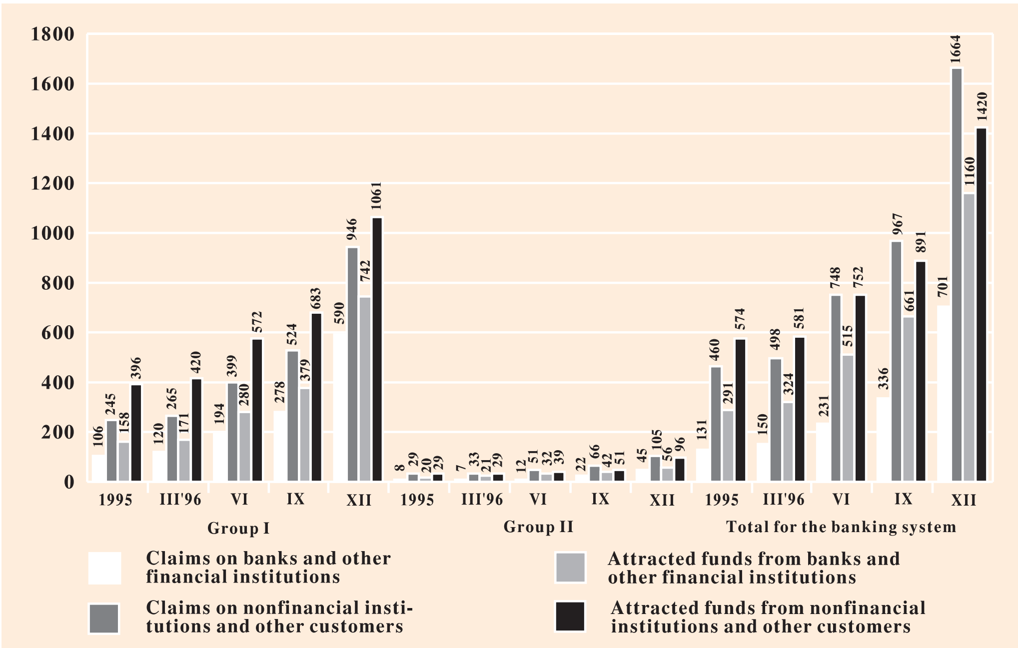
The high positive balance between revenues and expenditures from valuation adjustments, worth BGL 545 billion, completely covers the negative balance reported from operations in government securities (BGL -24 billion). In contrast to 1995, financial results from major bank operations indicated a surplus: the balance between interest revenues and expenditures totaled BGL 35 billion. It should be taken into account that their share in total revenues is small, 11.6% and 10.8% respectively. Interest revenues (net) reported by banks in Group I show a significant growth of BGL 58 billion, while net interest revenues reported by banks in Groups II and IV were negative: BGL -1.3 billion and BGL -23 billion respectively. The share of net interest revenues in balance sheet assets is small, 1.3% in Group I and -0.5% in Group II. The ratio of expenditures on economic elements to total expenditures declined: from 4.3% in 1995 to 0.7% in 1996 in Group I; from 11.1% in 1995 to 1.9% in 1996 in Group II. Significant net revenues from valuation adjustments enabled banks to increase allocated provisions dramatically, BGL 445 billion, or 45 times more than in 1995. It should be taken into account that a significant portion of valuation adjustments resulted from revaluation of uncollectable claims which seriously distorted the picture of reported results.

Consolidated Balance Sheet of Commercial Banks

Total balance sheet figure for all commercial banks as of 31 December 1996 amounted to BGL 3,631 billion, an increase of 234%. This was due to the dramatic devaluation of the lev. The balance sheet figure of major banks totals BGL 2,446 billion. The group includes Bulbank and the SSB which make up 48% of the banking system. The balance sheet figure of banks in Group II totals BGL 254 billion. The balance sheet figure of banks in Groups I and II almost matches that of the entire banking system: these two groups of banks play the major role in the system. The balance sheet figure of banks in Group III increased most markedly, by 11 times. This growth is precipitated by the efforts of foreign banks to establish firm positions in Bulgaria (one more new branch was opened), as well as the significant share of foreign exchange accounts.

SELECTED INDICATORS OF THE CONSOLIDATED BALANCE SHEET OF COMMERCIAL BANKS

(billion BGL)



Source: BNB.

The capital of commercial banks was BGL 184 billion, an increase of 156%. Slower growth of capital compared with the balance sheet figure resulted in a decrease in its relative share. The balance sheet figure of banks in Group I accounted for 51% of capital. It should be noted that unpaid capital totals BGL 17.4 billion, with 89% of it in Group II banks; claims on rights to equity subscriptions rose over BGL 10 billion. The items ‘Reserves’ and ‘Profit’ indicated a more than 12 times growth. This is attributable both to the their small absolute values reported by the end of 1995, and the high absolute growth. The banks in respect of which the BNB petitioned the institution of bankruptcy proceedings reported a profit of BGL 92 billion and losses of BGL 53 billion. The profit is incorrectly formed due to unpaid interest on attracted funds, guaranteed by the Law on State Protection of Deposits and Accounts, and unpaid provisions of over BGL 350 billion.

Attracted funds, totaling BGL 2,580 billion, rose by 198%, while their share in liabilities fell to 71% against 80% in 1995. A downward trend in their relative weight occurred in all groups. Small and medium banks reported lower values of this indicator: below 60%. The increase in attracted funds reflected the revaluation of attracted funds in foreign currency, comprising over 80% of absolute growth. As a result, foreign exchange accounts account for 70% of total attracted funds against 45% in 1995. The slower rate of increase in attracted funds in levs, 62% (against an inflation rate of 311% in 1996), and enhanced growth in attracted funds in foreign currency, 365% (against a 600% depreciation of the lev against US dollar) reflected liquidity squeezes in a number of banks, which led to an erosion of confidence in the banking system and withdrawal of sizable amounts of deposits and other accounts by individuals and companies.

Attracted funds from banks and other financial institutions indicated a higher growth (300%) than funds attracted from nonfinancial institutions (148%), reaching 45% of total attracted funds. Both the forex and lev components of attracted funds marked a growth. This suggests that some banks attracted short-term and expensive resources from financial institutions to regulate their liquidity (the effective average annual interest rate of funds received in the interbank market exceeded 450% against 210% on time deposits). Funds exceeding BGL 150 billion extended by the BNB and SSB to refinance commercial banks should be also mentioned.

Claims totaled BGL 2,365 million, increasing 300%. They made up 65% of the balance sheet figure, against 55% in 1995. This adverse trend is attributable to the increased claims on financial institutions, by 434%; and these on nonfinancial institutions, by 261%.

Claims on banks and other financial institutions grew due to the increased forex and lev components: 654% and 115%. The lev and foreign exchange components of claims on nonfinancial institutions rose by 465% and 117% respectively, but fell in real terms compared with end-1995. The effect of memorandums of agreement concluded with a few banks pursuant to which lending in foreign currency was stopped and lev credit was limited to 50% of principal repayments, being stopped for banks with negative capital adequacy ratio, should be also noted.

Investment in long-term financial assets rose 79%, and made up a mere 1% of the balance sheet figure. The bulk of investments are in shares and partnerships. Exchanges of stock packages among banks and other financial institutions occurred.

Commercial bank nonfinancial assets, totaling BGL 52 billion, accounted for 1% of the balance sheet figure, increasing 33% over 1995. This growth does not reflect the revaluation associated with inflation and their real market price, which would have caused a multiple increase.

The share of future revenues decreased from 8% to 3% of the balance sheet figure as some Group I banks showed unpaid interest from previous years as interest revenues for 1996. A number of banks continued to report unpaid interest under 'Future revenues,' particularly Group IV banks where the share of unpaid interest accounted for 64% of the total.

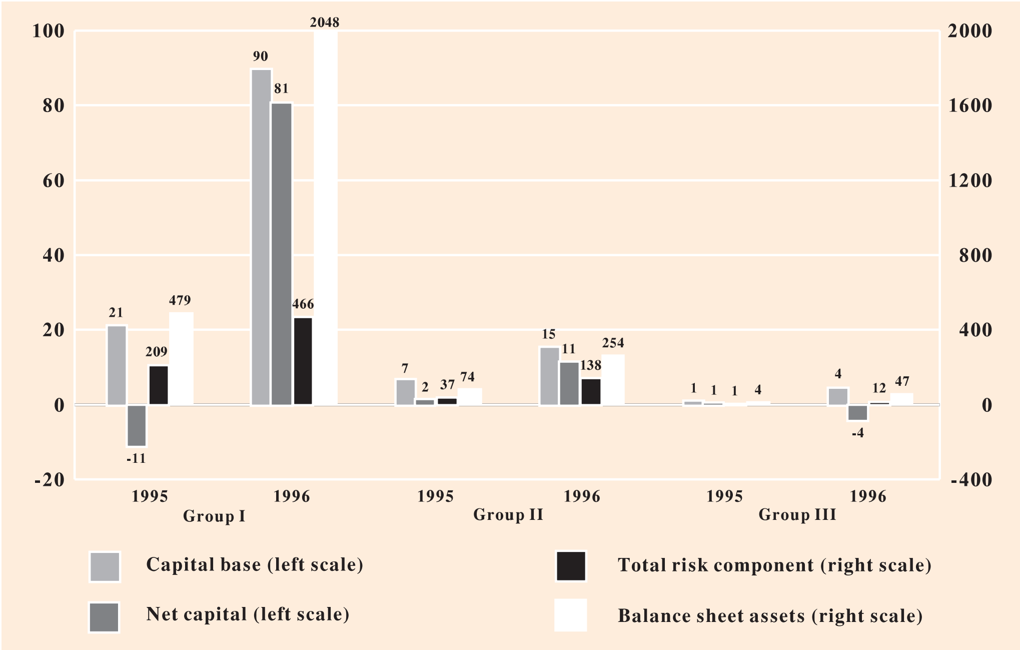
Off-balance sheet assets increased 255% to BGL 2,242 billion; the bulk of these comprised commitments which led to increased commercial bank exposure. On-site examinations in commercial banks established a number of violations relating to unaccounted off-balance sheet commitments.

Solvency

Capital adequacy ratios under BNB Regulations No. 8. Total capital adequacy ratio by the end of 1996 was 19% for Group I banks and 11% for Group II banks. Comparison with the previous year would be impossible due to a change in the methods of assessment. The high capital adequacy ratio in Group I pertains to state-owned banks' increased primary capital through acquired ZUNK bonds under the Bulbank scheme. As a result, the capital base increased more than four times. Slower growth of total risk component compared with capital base led to an improvement in general capital adequacy ratio. This is attributable to the fact that banks included in this group significantly reduced total risk component, a mere 23% of the total balance sheet figure. Only one bank in this group reported a total capital adequacy ratio below the required minimum of 8%. Five Group II banks reported a capital adequacy ratio of less than 8%. The market share of these banks accounted for 46% (as per the balance sheet figure). Should loans under Regulations No. 9 of the BNB be properly classified, the deficiency of provision in Group II would increase greatly, prompting a decrease in the capital base by more than BGL 20 billion to a negative value, and a corresponding decline in the total capital adequacy.

BANK REGULATIONS UNDER BNB REGULATIONS No. 8 ON THE CAPITAL ADEQUACY

(billion BGL)



Source: BNB.

With a view to a more comprehensive assessment of bank solvency, banks' financial performance was analyzed using the net capital indicator and capital adequacy ratios based on total assets. Net capital of state-owned banks totals BGL 81 billion, and capital adequacy ratio based on total assets is 3.9%. If the new requirements for ZUNK bond provisioning are taken into account, banks' net capital would be negative, i.e. the assessment of capital adequacy ratio appears irrelevant (and hence that of the capital base). Net capital of Group II banks totals BGL 11 billion, and capital adequacy ratio based on total assets is 4.5%. Bank capital in Group III netted BGL -4 billion. The default of the net capital indicator is nonreporting of the real state of loan classification which causes similar problems as those in the capital base indicator.

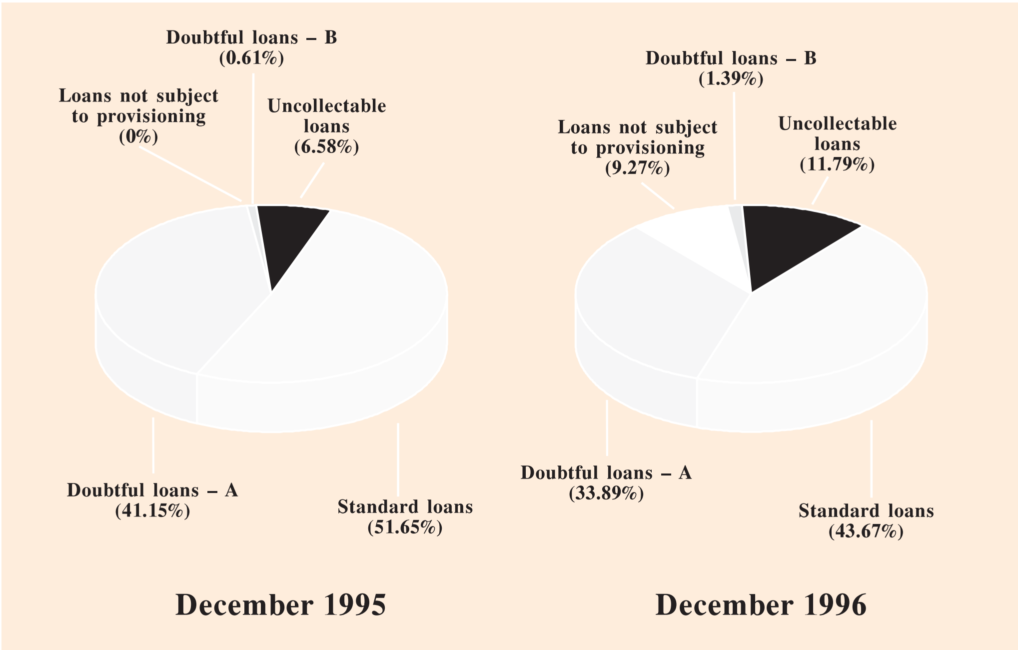
The greater increase in the amount of assets compared with the capital base growth worsened the assets coverage indicator. This showed a fall of 2.4 percentage points (to 4%) in Group I and six percentage points (to 8%) in Group II.

Credit Risk

Loan classification and formation of mandatory special reserves under BNB Regulations No. 9. Loans under Regulations No. 9 in Group I rose five times reaching BGL 1,810 billion, those in Group II rising four times to BGL 170 billion. The reason behind the sizable increase in loans by banks constituting Groups I and II is exchange rate movements. The huge share of Bulbank's loans, totaling BGL 1,313 billion, should also be borne in mind. The latter pertains particularly to standard loans, worth BGL 847 billion, concentrated in Groups I, II and III. Of this amount, Bulbank's loans accounted for BGL 773 billion (91%). Loans of banks with majority foreign participation increased significantly, exceeding 14 times the index of lev devaluation. This reflected foreign banks' efforts to establish sound positions in the Bulgarian financial market and to attract clients from banks with liquidity deficiencies. By the end of 1996, the share of Group III loans under Regulations No. 9 accounted for 2% (0.6% in 1995) of the loans of the other three groups.

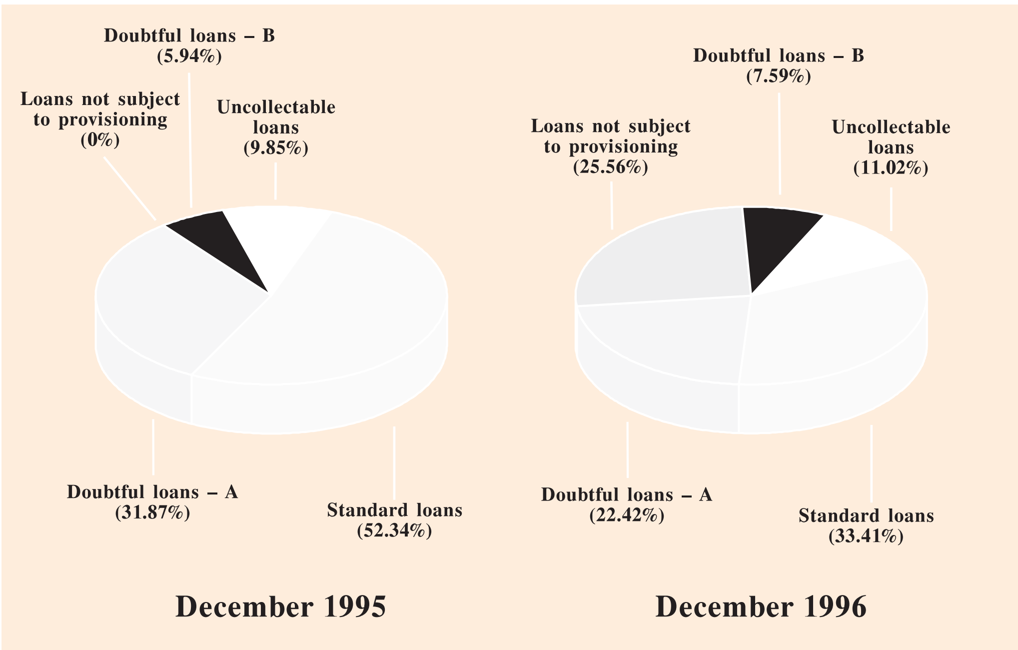
Uncollectable and doubtful loans Group B increased most significantly, with their share growing six percentage points (to 13%) in Group I, three percentage points (to 19%) in Group II and ten percentage points (to 14%) in Group III. The share of standard loans declined eight percentage points (to 44%) in Group I, 19 percentage points (to 33%) in Group II and 11 percentage points (to 0%) in Group III. The worsened credit portfolio structure led to a decline in revenue from loans and their real price, and consequently in commercial bank capital. Reported financial results from the revaluation of bad loans in foreign exchange, and the increased amount of uncollected interest artificially improved the financial performance of a number of banks without writing off uncollectable loans that had been recorded in previous years from their balance sheets.

LOAN CLASSIFICATION UNDER BNB REGULATIONS No. 9, GROUP I



Source: BNB.

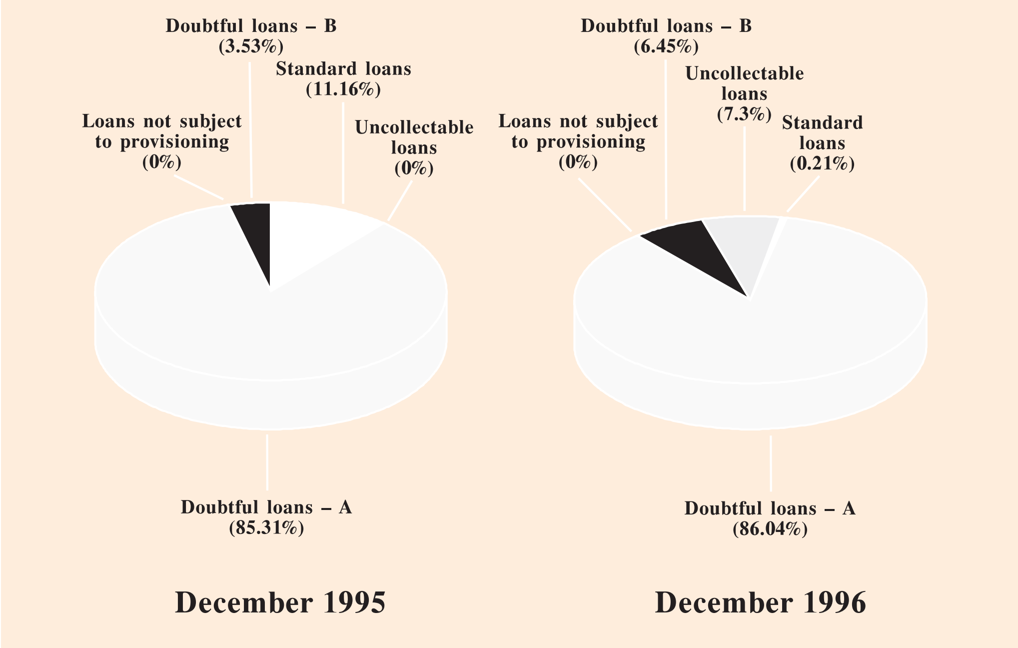
LOAN CLASSIFICATION UNDER BNB REGULATIONS No. 9, GROUP II



Source: BNB.

The ratio of uncollectable loans to the capital base is 214%: thus banks had a BGL 120 billion capital deficiency to cover bad loans.

LOAN CLASSIFICATION UNDER BNB REGULATIONS No. 9, GROUP III

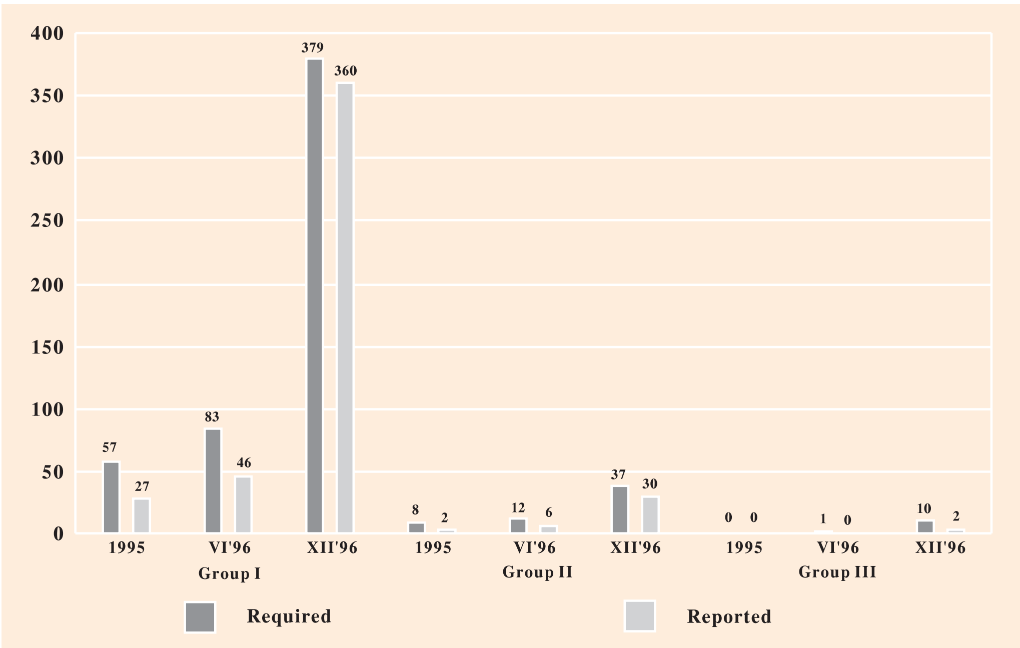


Source: BNB.

Statutory provisions. The reported positive financial result, due in large part to valuation adjustments, made it possible for banks to make loan loss provisions. This entailed a substantial improvement in the reported to required provisions indicator, 95% for banks in Group I (48% in 1995) and 80% for those in Group II (30% in 1995). The reported to required provisions ratio deteriorated in banks from Group III, to 25%. Deficiency of funds for loan loss provisions in the first two groups totaled BGL 27 billion. If allowance is made for the significant amount of loans classified as doubtful Group A, which are not subject to provisioning, and the latest amendments enforced in early 1997 providing for a change in the amount of provisions for forex-denominated ZUNK bonds, and the new requirements for making loss provisions for interest accrued but unpaid on unserviced loans, then the shortfall in special provisions would be even greater. This would have reflected directly on a worsening of the capital base.

STATUTORY PROVISIONS OF COMMERCIAL BANKS

(billion BGL)



Source: BNB.

Big loans under BNB Regulations No. 7. Big loans of banks in Group I rose 120% to BGL 92 billion. As a result of the significant capital base growth the big loans to capital ratio decreased. Two banks reported a total amount of big loans exceeding the legally set maximum limit – eight times the bank's own funds. In Group II big loans increased 290% to BGL 47 billion. The total amount of big loans extended by those banks exceeded their own funds three times. Four of the banks do not meet the regulatory requirements. The largest increase in big loans occurred in Group III banks: 13 times. In one bank's case the amount of big loans exceeded eight times the bank's own funds.

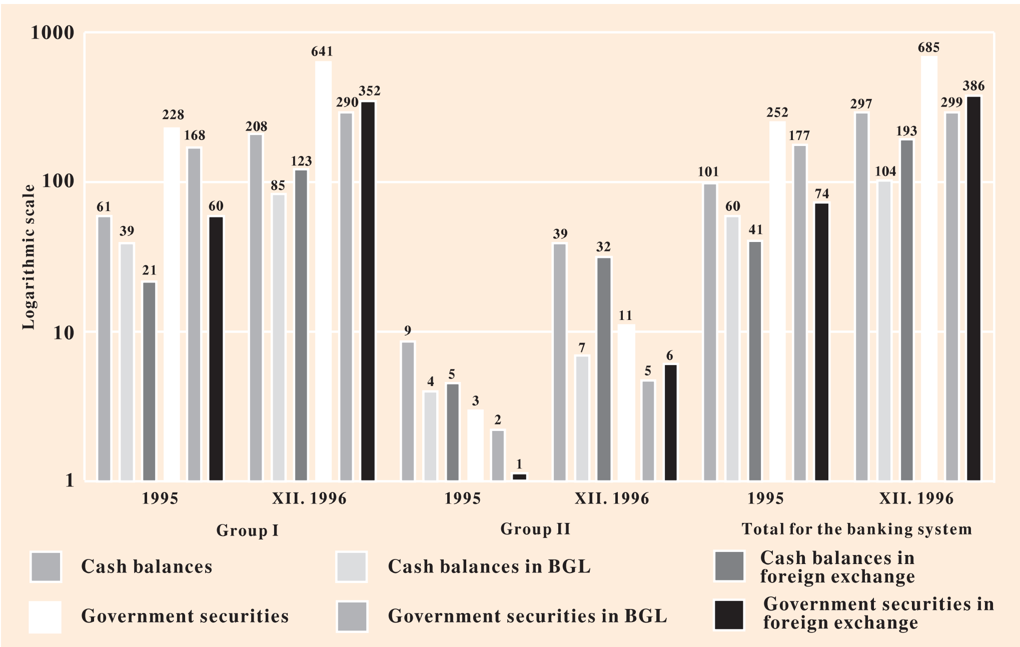
Provided the capital base had been correctly reported (i.e. a real decrease), a greater amount of loans would have been classified as big. A number of banks did not determine correctly the total sum of collateral. Collateral must give first mortgage on a movable, be unencumbered, have an ascertainable market value, be offered for safekeeping by the bank and be fully covered by insurance but these requirements were not always duly observed.

Liquidity

Cash balances rose 195% to BGL 297 billion. Since they grew faster than the balance sheet figure, their share in total assets decreased by one percentage point, to 8%. The lev component of cash balances rose BGL 44 billion alone (73%, much more slowly than the annual inflation rate) and the forex rose 375% in lev equivalent amount, a real reduction of 31% in forex terms. It is worth noting that the minimum required reserves are included in the Cash balances item and at the end of 1996 banks' access to these reserves was limited compared with 1995. This dramatically impaired liquidity for the entire banking system; consequently a number of banks failed to meet their current obligations to customers, and the interbank settlement system was overloaded. This eroded credibility in the banking system and prompted massive deposit withdrawals and reluctance to make payments via banks. Special supervisory measures have been undertaken against a number of banks, involving conservatorship and court petition for the institution of bankruptcy proceedings. Cash funds of Group II banks rose 353% in nominal terms; the increase was prompted by the need to hold more cash to meet depositor withdrawals.

LIQUIDITY

(billion BGL)



Source: BNB.

Government securities rose 172% to BGL 685 billion but their share contracted to 18.9% in 1996 from 23% in 1995. This growth is primarily attributable to forex-denominated securities (accounting for 72% of the increase) due to devaluation of the national currency. Forex-denominated government securities comprised 56% of the total amount of government securities held by commercial banks. The larger portion of government securities (94%) is held by Group I banks which includes several large state banks that own a big package of government securities issued under the Law on Settlement of Nonperforming Credits.

The relative reduction in the most liquid item in bank assets – cash balances and government securities – is the result of inadequate assessment of liquidity risk by bank management in the complicated macroeconomic situation of 1996, coupled with further eroded credibility in the banking system.

Funds attracted from nonfinancial institutions by the SSB totaled BGL 290 billion, accounting for 48% of the total amount of attracted funds in levs from nonfinancial institutions. Obviously commercial banks were not able to attract sufficient amounts of funds from depositors and had to borrow from the interbank market or the BNB.

The share of claims in balance sheet assets rose to 65% in 1996 from 54% in 1995, providing yet another proof of worsened liquidity in the banking system. This development is apparent from the figures for the individual groups: the share of Group I claims rose to 63% from 53%, and to 59% from 49% for Group II. The total claims to total funds attracted ratio tended to increase, from 82% to 95% in Group I, and from 75% to 98% in Group II, also indicating deterioration of liquidity in the banking system.

Foreign Exchange Risk

Review of foreign currency positions in a number of banks and nonbank financial institutions revealed that an unfavorable turn in exchange rate movements and interest rates may result in losses for these institutions as they have large open foreign currency positions. In accordance with Regulations No. 4 a fully licensed bank must maintain a net open foreign currency position up to 30% of its own funds and up to 15% for a bank licensed to operate only domestically. In fact the open foreign currency position of Group I banks was 167% as of 31 December 1996 and 125% for Group II banks. State-owned banks reported a long open foreign currency position of USD 240 million, and that of medium and small banks was USD 74 million. Also of note is the big share of foreign currency assets in the total amount of assets: 40% in Group I and 81% in Group II.

The following violations were found: attraction of foreign currency for trust management by nonbank financial institutions; conduct of bank operations without a bank license; passing of commercial bank forex funds to brokers for international forex market participation without due grounds.

3. Bank Supervision Measures To Overcome Instability in the Banking System

Improvement of the Legal Framework

During 1996 significant amendments were made to laws and bank regulations in the area of bank supervision. Most important of these were:

• in May 1996 the National Assembly passed amendments to the Law on Banks and Credit Activity which created the legal framework for bank bankruptcies as well a legal ground for placing banks under special supervision when faced with the risk of insolvency. May also saw the enactment (and subsequent amendment) of the Law on State Protection of Deposits and Accounts with Commercial Banks in respect whereof the BNB Has Petitioned the Institution of Bankruptcy Proceedings which ensures reliable protection of depositors by the budget. These laws enabled the bank supervision to undertake radical measures with respect to commercial banks experiencing serious financial difficulty and insolvency;

• passing of the Regulations on open foreign currency positions of banks intended to limit the exchange rate risk for commercial banks;

• in February amendments were made to the Regulations on capital adequacy of banks whereby the minimum capital requirement was raised to BGL 1,200 million for banks licensed to operate internationally and BGL 800 million for banks licensed to operate only domestically, revised in August to BGL 2,200 million and BGL 1,400 million respectively: levels which the banks had to meet by 31 March 1997;

• amendments were made to the Regulations on the classification of loans and the formation of statutory provisions by banks whereby banks are obliged to make provisions for their cash holdings and claims in foreign currency and for the portfolio of government securities subject to revaluation, as well as for interest owing but paid late.

Supervisory Measures To Strengthen the Banking System

As early as the beginning of 1996 bank supervision took serious measures with respect to individual banks and nonbank financial institutions in dire financial straits. These measures were coordinated with IMF representatives within the framework of the standby agreement for macroeconomic and financial stabilization. Basic measures involved:

• transfer, free of charge, of over 50% of the voting registered shares of shareholders in BAC Vitosha Ltd. to the BNB;

• revocation of the licenses to conduct bank transactions under Article 1, para. 2 of the Law on Banks and Credit Activity of Crystalbank Ltd. and Private Agricultural and Investment Bank Ltd.;

• placement under conservatorship of Mineralbank Ltd., First Private Bank Ltd., Private Agricultural and Investment Bank Ltd., Crystalbank Ltd. and Agrobusiness Commercial Bank Ltd. and application to court with the petition to institute bankruptcy proceedings against these banks;

• memorandums of agreement were signed with 19 commercial banks aimed at improving their financial state. These involved the following measures:

• a ban on payment of dividends without the BNB's prior permission;

• a ban on the extension of new lev and foreign currency loans;

• undertaking a package of measures to collect loan repayments;

• cutting operating costs – wage costs, outlays for branches, offices and representations, closure of ineffective structural units and branches, shedding of staff, etc.

• limiting interest rates on deposits;

• restructuring and sale of assets to improve liquidity;

• placing of another nine banks under conservatorship: Balkanbank Ltd., Businessbank Ltd., Mollov Commercial Bank Ltd., Slavyani Commercial Bank Ltd., Trade and Savings Bank Ltd., Yambol Commercial Bank Ltd., Dobrudja Commercial Bank Ltd., Elitebank Ltd. and application to court with the petition to institute bankruptcy proceedings against these banks (except Elitebank Ltd.);

• limiting commercial bank investment in fixed tangible assets;

• increasing frequency and scope of examinations (inspections) of commercial banks by the Inspections Division;

• increasing frequency and scope of data required from banks in an unstable financial state by the Off-site Control Division; more stringent sanctions for submitting late and false data;

• holding meetings and talks with potential investors to discuss the possibility of acquiring shares in Bulgarian commercial banks, including those against whom a petition for the institution of bankruptcy proceedings has been filed;

• increasing the number of examinations in nonbank financial institutions and imposition of sanctions for noncompliance with banking laws and regulations, including revocation of licenses;

• final revocation of the license to conduct bank operations from 34 exchange bureaus and 39 financial brokerage houses.

So far 14 commercial banks have been placed under conservatorship and a petition for the institution of bankruptcy proceedings has been filed against them. These banks' assets account for 24% of total bank assets in the Bulgarian banking system. It should be noted that the bankruptcy procedure applied so far has been rather cumbersome. The court often stays proceedings, permits former bank managements to participate in the proceedings, and requires additional financial examinations in preparation of the financial analysis which is to prove bank insolvency. If the current procedure is not improved, it would take years to resolve a case of bankruptcy with respect to banks already placed under conservatorship.

In 1996 no licenses were granted to banks and nonbank financial institutions.

With a view to enhancing the role and responsibilities of bank supervision the Bank Supervision Department was reorganized and the number of staff raised from 65 to 90. Currently the BNB Bank Supervision Department has four divisions:

– a Supervision Policy Division with basic functions of bank licensing , exercising general control and active measures, making general analyses on the state of the banking system as a whole, developing bank regulations and methodological instructions, and liasing with international and other institutions;

– an Off-site (Current) Supervision Division with basic functions of processing data on reported (current) information on banks, liaising with commercial banks' auditors and analyzing their reports, managing correspondence with individuals and companies on issues related to supervised banks;

– an Inspections Division with basic functions focused on on-site bank supervision (supervisory inspections);

– a Supervision of Nonbank Financial Institutions Division with basic functions of granting licenses, exercising off-site control and on-site inspections, and imposing sanctions, including the revocation of licenses.

For the purpose of improving the activity and efficiency of bank supervision and enhancing personnel expertise, broad international contacts have been established with similar international institutions, including bank supervision authorities in Germany and Deutsche Bundesbank, the US Federal Reserve System and the Money Circulation Control Agency, the Financial Supervision in Finland and the central banks of Israel and the United Kingdom.

VI. Financial Results of BNB Activities

The BNB annual balance sheet* was compiled after closing of the state budget and conversion of foreign exchange assets and liabilities into levs at the exchange rate appliable on 31 December 1996. Precious metals abroad were revalued on a daily basis, those held in the BNB treasury on a quarterly basis at the average price of gold, and on 31 December 1996 – at the London Stock Exchange price of gold.

At the recommendation of the international audit conducted in the BNB, the relationships with the International Monetary Fund and provisioning of doubtful loans and interest accrued but unpaid as of 31 December 1996 were recognized as well.

BNB fixed capital is BGL 200 million in compliance with Article 7 of the Law on the BNB.

DISTRIBUTION OF BNB ANNUAL BALANCE OF REVENUE OVER EXPENDITURE IN 1996

(thousand BGL)

I. BNB revenue	524,224,733
II. BNB expenditure	386,978,841
III. Balance of revenue over expenditure (I – II)	137,245,892
Amount to be distributed:	
1. Reserve fund	15,209,072
2. Other special reserves	577,945
3. Social support fund	30,418
4. Allowance for interest under Article 8 of the Law on the BNB	76,409,606
5. Allowance for principals under Article 8 of the Law on the BNB	21,474,039
6. Payments to the Ministry of Finance made by November 1996	23,544,813

Source: BNB.

Pursuant to § 4 of the Transitional and Final Provisions of the State Budget Law, the BNB had to pay the excess of revenue over expenditure monthly in advance to the state budget. This totaled BGL 23,544,813,000 by the end of November. Pursuant to a resolution by the BNB Managing Board and international audit recommendations, the BNB discontinued payments to the general government budget. The residual balance from the excess of revenue over expenditure – after making deductions for fund allocations and to cover payments to the budget made by November 1996 – was used to provision a portion of the principals on extended credits classified as uncollectable and doubtful.

Bulgaria's equity participation in international financial institutions accounted for BGL 358,866,442,000.

Specifically, Bulgaria's equity participation in individual financial institutions is as follows:

			Lev equivalent
International Monetary Fund – subscribed	SDR	354,177,850.00	247,801,949,463.90
International Monetary Fund – paid up	SDR	110,722,150.00	77,560,555,711.10
National Numbering Agencies Association	BEF	557,700.00	8,483,732.40
International Bank for Economic Cooperation	ECU	9,744,806.00	5,893,658,668.80
European Bank for Reconstruction and Development	ECU	16,590,000.00	10,033,632,000.00
International Financial Corporation	USD	1,789,000.00	871,869,150.00
Bank for International Settlements	USD	4,853,725.00	2,365,462,878.75
International Investment Bank	ECU	20,432,704.52	12,357,699,693.70
World Bank	USD	3,653,762.72	1,780,661,261.59
Multilateral Agency for Investment Guarantees	USD	394,930.00	192,469,135.50
Total:			358,866,441,695.74

Source: BNB.

* The annual financial statement for 1996, presented in part IV of the 1996 BNB annual report, is reviewed by the BNB's chief auditor in compliance with Article 22 of the Law on the BNB.

BNB equity in the Bank Consolidation Company remained unchanged, at BGL 1,469,008,000, its equity stake in BANKSERVICE Ltd. accounted for BGL 114,920,000, and its share in BORICA Ltd. rose from BGL 145 million to BGL 272 million. The BNB acquired a 100% stake in the Bulgarian Mint Ltd. amounting to BGL 120,901,000. The central bank acquired stakes in Agrobusinessbank Ltd. for BGL 212,971,000 and for BGL 155,782,000 in Vitosha Bank for Agricultural Credit Ltd.

Financial Revenue

BNB financial revenue in 1996 totaled BGL 524,224,733,000. Interest revenue accounted for the largest portion of total financial revenue, BGL 208,766,974,000, or 39.82%. Interest revenue on credits extended by the BNB to the Ministry of Finance totaled BGL 48,602,980,000, or 23.3% of total interest revenue.

Interest accrued on credits to commercial banks totaled BGL 134,197,713,000 and comprised 64.28% of total interest revenue. Unpaid interest on these credits accounted for BGL 76,409,606,000 as of 31 December 1996, which required an allowance to be made for that amount. Interest earnings from forex operations amounted to BGL 21,456,861,000, or 10.3% of total interest revenue.

Revenue from government securities operations totaled BGL 310,296,283,000, or 59.12% of total financial revenue. Expenditure on government securities operations accounted for BGL 20,504,957,000. As a result of these operations, the BNB netted a loss of BGL 330,801,240,000. This is the cost that the central bank had to pay for its restrictive monetary policy entailing withdrawal of liquidity through open market operations.

Valuation adjustments from forex operations totaled BGL 4,220,479,000 and comprised 8.1% of total financial revenue. Revenue from commissions and fees in foreign exchange accounted for BGL 137,462,000, or 0.3% of total financial revenue.

Financial Expenditure

BNB financial expenditure in 1996 totaled BGL 383,417,269,000, including interest payments of BGL 48,926,487,000, or 12.8%. Interest payments are distributed as follows:

(thousand BGL)

- Ministry of Finance current accounts	5,103,013
- deposits	2,203,974
- forex operations	7,738,989
- settlement accounts	31,256,299
- minimum reserve requirements of commercial banks	916,925
- other bank operations	325,069
- the State Fund for Reconstruction and Development	1,382,218

Source: BNB.

Expenditure on commissions and fees in foreign exchange comprised 0.71% of total expenditure. The BNB's outlays in support of current activities accounted for BGL 3,561,572,000, or 9.2% of total expenditure.

BNB Budget

BNB budget for 1996, adopted by its Plenary Council, amounted to BGL 3,385,682,000 for support of its current activities and BGL 12,858,640,000 for investment in tangible and intangible assets.

PERFORMANCE OF THE 1996 BUDGET OF THE BNB

(thousand BGL)

Indicators	Budget	Budget performance
Section I		
Expenditure for support of current activity	3,385,682	3,561,572
Expenditure on currency in circulation	1,748,355	2,034,271
Expenditure on labor and social securities	763,121	710,695
Expenditure on material services	817,580	774,856
Expenditure on social activity	56,626	41,750
Section II		
Investment in tangible and intangible fixed assets	12,858,640	15,611,469

Source: BNB.

The stage-by-stage construction of the BNB Printing Press continued in 1996 and the Computer Print Production Department came into operation.

Considerable expenditures were made for the construction of the building at 7, Moskovska Street in Sofia, the BNB branch in the city of Bourgas and for the refurbishment of installations at the BNB head office.

In 1996, in compliance with a resolution of the 37-th National Assembly an international audit of the BNB was carried out for the first time, with a mandate to examine the BNB annual report, balance sheet and its budget for 1995. In accordance with internationally adopted procedures, the BNB's auditor was chosen by tender amongst all officially invited international audit companies with representation offices in Bulgaria: Arthur Andersen, Coopers & Lybrand, Ernst & Young, Deloitte & Touche, Price Waterhouse, BDO Binder, KPMG. Procedures for the preparation and conduct of the tender, including performance conditions, were approved by the BNB Plenary Council and the National Audit Chamber. The tender commission included three BNB representatives, two from the National Audit Chamber, and two from the Ministry of Finance. The tender was held on 6 – 7 September 1996 with the following companies as participants: Arthur Andersen, Deloitte & Touche, Price Waterhouse, KPMG, BDO Binder. The tender commission considered companies' bids on the basis of pre-set conditions: assessment of technical proposals made in writing and verbal presentation, comparison of price offers to make a final grading, and award of the audit to the company with the best offer. At its session held on 10 September 1996 the BNB Plenary Council awarded the tender to carry out an international audit of the BNB to Deloitte & Touche. The audit began on 16 September and was completed on 15 November 1996. The National Assembly was acquainted with the audit's results.

Balance Sheet of the Bulgarian National Bank

million BGL

	1995	**1996**
ASSETS		
Holdings in Bulgarian coins	660	**822**
Holdings in foreign exchange	93	**190**
Participation in international institutions	16,238	**358,866**
Holdings in foreign securities	50,522	**200,370**
Deposits and loans extended to commercial banks	111,022	**313,925**
Loans extended to the government	26,052	**138,061**
Securities	52,307	**203,899**
Other assets	45,950	**266,843**
Total	302,844	**1,482,976**
LIABILITIES		
Statutory fund	200	**200**
Reserve and other funds	102,047	**307,146**
Banknotes in circulation	68,146	**137,268**
Current and deposit accounts	125,969	**1,011,738**
Other liabilities	6,482	**26,624**
Total	302,844	**1,482,976**

Lubomir Filipov
Governor

Kolyo Paramov
Chief Auditor

Vanya Paunovska
Chief Accountant

VII. Development of the Banking and Settlement System

1. Development of the Settlement System

During the first half of 1996, the number of settlement system input points continued to increase. From 746 in January they grew to 970 by the end of July. However in subsequent months, given the difficulties in the banking system, the number of bank branches closed or transformed into offices for the first time exceeded the number of newly opened bank branches. Consequently by year-end the number of settlement system input points fell to 962. At the same time, numerous banks were placed under conservatorship and their payment operations being taken over by the central bank. Consequently the number of participants in the settlement process was reduced.

During the reporting period 9,990,790 interbank settlements to BGL 3,101 billion were cleared through BISERA (the system for electronic interbank transfers); average daily settlements accounted for BGL 12.209 billion. As in 1995, the number of interbank electronic settlements in levs increased much more slowly than anticipated – the turnover of settlement system transfers did not exceed 1.76 times GDP, while in 1993 this indicator was above three times GDP. The number of electronic settlements decreased slightly (by about 1%) compared with 1995.

A major factor contributing to the modest decline in interbank transfers was the increasing number of intrabank transfers being effected through the branch network of a number of big banks.

BORICA

By the end of 1996, 70 ATMs were istalled, of which 27 in Sofia, and 28 point of sale (POS) terminals, of which 20 in Sofia. With the updated software loaded in September, all ATMs within the BORICA system accept the following international cards: EUROCARD/MASTERCARD, EUROCHECK, and CIRRUS International.

In November, BORICA performed all certificate procedures jointly with a Bulgarian commercial bank and EUROPAY International for the issuance of EUROCARD/MASTERCARD bank cards and ensured compatibility of these cards with all POS terminals within the BORICA system.

2. Legal Regulation of Bank Activities

In 1996, important banking laws and regulations were passed, which helped improve the legal framework of banking.

Amendments to the Law on the BNB (State Gazette, issue 32 of 1996) concern the mandate of the members of the BNB Managing Board. Where a member of the Managing Board leaves before his term of office expires, the new member shall not replace him but shall be elected, or appointed for a new five-year term. On the other hand, a legal ground is provided for the mandate of the members of the Managing Board to be suspended ahead of schedule by resolution of the body that has elected or appointed them: by a decision of three-fifths of all members of the National Assembly for the Governor and Deputy Governors, and by decree of the President of the Republic of Bulgaria on a motion by the Governor of the BNB for all other members of the Managing Board. The latest amendments circumscribed central bank independence in a period of growing responsibility prompted by a deepening financial crisis.

Significant amendments were made to the Law on Banks and Credit Activity

(State Gazette, issue 42 of 1996). They give the central bank enhanced powers and responsibilities with respect to the protection of creditors' interests.

Rehabilitation measures against a bank which is at risk of insolvency may be applied by the BNB through putting it under conservatorship, whose regulation is set forth in Chapter Thirteen. By its legal nature conservatorship is a system of forcible administrative measures imposed by the BNB Managing Board, and aimed at preventing a bank from insolvency when certain negative tendencies emerge, warning of danger. In order to protect the interests of a bank's creditors, the law gives significant powers to the central bank: to remove from office the managing body of a bank; to mandatorily increase the amount of its capital; to suspend the powers of the shareholders' general meeting. Within the period of conservatorship, the bank is managed by conservators appointed by the BNB. The result of measures applied and the state of the bank's assets will be the basis of determining its future fate: either discontinuation of conservatorship or institution of bankruptcy proceedings.

The new Chapter Fourteen regulates bankruptcy of commercial banks, while the provisions of the Law on Commerce will apply subsidiarily. Deviations from the general practice of bankruptcy regulation take account of the specific nature of banks as a specific category of merchant. According to newly adopted legal regulation, only the BNB may apply to court with the request of instituting bankruptcy proceedings against a bank. The decision establishing a bank's insolvency is taken by the BNB Managing Board on the basis of legally set insolvency criteria. Since rehabilitation measures are excluded within bankruptcy proceedings, by adjudicating on insolvency (which is at the same time a decision to institute bankruptcy proceedings and declare the bank bankrupt) the court decrees commencement of property liquidation.

The Law on State Protection of Deposits and Accounts with Commercial Banks in respect whereof the BNB Has Petitioned the Institution of Bankruptcy Proceedings (State Gazette, issue 46 of 1996; amended, issue 90 of 1996) comes as a logical consequence of the 1996 confidence crisis in the banking system, which arose from the insolvency of certain commercial banks. This Law guarantees reimbursement to a bank's depositors and other creditors from budgetary funds, in whole or in part, of the liabilities of the bank in respect of which the BNB has petitioned the institution of bankruptcy proceedings. Physical persons are fully covered, including claims in foreign currencies, while the protection of legal entities covers half the amount of their claims payable in levs only. The Law does not give protection to financial institutions and persons who have been in a position to influence the policy of the insolvent bank or have managed it. The initial wording of the Law provided the possibility for depositors to dispose of their funds on newly opened accounts contingent on the BNB decision to petition the institution of bankruptcy proceedings against a bank, while with subsequent amendment this possibility was tied to the enforcement of the court decision on declaring the bank bankrupt.

Enforcement of this Law temporarily suspended Regulations No. 1 of the BNB on bank deposit insurance which guarantees only deposits of physical persons up to a set limit and payment of foreign currency deposits in levs only; the Law insures a full cover of physical persons' deposits irrespective of the deposit's currency.

Application of this Law is temporary until a law on deposit insurance is adopted, based on regulatory decisions generally accepted worldwide. Regulations No. 1 of the BNB will serve as a basis in designing the new Bill.

The Law on the Measures against Money Laundering (State Gazette, issue 48 of 1996) regulates the measures intended at preventing and uncovering money laundering activities, involving the acquisition of money through or by crime, and obliges particular institutions, banks among them, to identify their clients, collect and store information on specific bank transactions when they exceed a set amount or on suspicion of money laundering. Information is to be processed by a specialized office at the Ministry of Internal Affairs.

The Law on the State Bank for Investment and Development (State Gazette, issue 95 of 1996) regulates the incorporation and scope of activities of the Bank as a public company with a majority state holding. The Bank is established with the aim of promoting national economic development through investment, providing preferential finance to small and medium-size enterprises and other projects in accordance with national economic policy aims. The Bank will raise funds by borrowing from local and foreign sources and through issuance of bonds inland and abroad; payment of some of its obligations will be guaranteed by the state.

Regulations No. 4 of the BNB Managing Board on foreign currency positions of banks (State Gazette, issue 9 of 1996; amended, issue 64 of 1996) aim to limit possible bank losses which may arise from open foreign currency positions when unfavorable movements in exchange rates and interest rates occur. The maximum amount of banks' open foreign currency positions with respect to their own funds is set at 30% for banks licensed to operate domestically and abroad, and 15% for banks licensed to operate domestically.

Regulations No. 5 of the BNB on the terms and procedure for issuance, acquisition and redemption of book-entry government securities (State Gazette, issue 28 of 1996; amended, issue 17 of 1997) and Regulations No. 19 on the Securities Central Depository were adopted jointly with the MF.

Regulations No. 5 establish the terms and procedure for acquisition of government securities issued by the MF in the primary and secondary markets, their redemption and reverse repurchase prior to maturity. Regulations No. 19 determine the incorporation and scope of Central Depository activities, set up as a public company for registration of book-entry securities and transactions.

Regulations No. 18 of the BNB Managing Board on replacement of damaged Bulgarian coins and banknotes in circulation (State Gazette, issue 29 of 1996) determine the terms and procedure for the exchange at BNB tills of damaged Bulgarian banknotes and coins at their full or partial nominal value.

3. Relations with International Financial Institutions

International Monetary Fund

In 1996, regular negotiations with IMF missions continued. Following a long delay, the parameters of the fourth standby agreement were finalized in May and June. By the end of July, the IMF transferred the first tranche of SDR 80 million under this agreement to the BNB accounts. Due to noncompliance with the commitments undertaken on structural reform and deviation from performance criteria set, the country did not receive further tranches.

In 1996 principals, worth SDR 154.8 million (USD 217 million), and interest amounting to SDR 21 million (USD 29 million) on credits drawn from the IMF were repaid.

World Bank

Due to indecisiveness and a delay in structural reform, the government failed in finalizing the loan agreement on restructuring the real and banking sectors. Lack of World Bank financing further intensified the crisis in the country and contributed to the interruption of the fourth standby agreement with the IMF.

In 1996 no funds were disbursed under the Agriculture Development Project (ADP), totaling USD 55 million. The deadline for projects examination was extended until the end of 1997.

Work on the credit line for Private Investment and Export Financing of Small and Medium Enterprises (PIEF), worth USD 55 million, was discontinued. During 1996, funds totaling USD 1,073,037 were disbursed under three projects approved in 1995. The deadline for projects examination on this credit line was extended until 1997 at the government's request.

Utilization of funds extended by the World Bank under the two credit lines was seriously impeded and proved insufficient. The lack of sufficient numbers of sound mediator banks in the country to meet the requirements of the project and to comply with bank regulation should also be taken into consideration. Foreign banks are not interested in investment lending under the World Bank projects.

European Bank for Reconstruction and Development

By the end of September 1996, the EBRD had approved 21 projects for Bulgaria, totaling ECU 210 million. Of these, eight concern the financial system, six agriculture, two each transport and communications, one each the energy sector, insurance and consumer prices. EBRD estimates indicate that the bank's portfolio for Bulgaria will not match the projected ratio of 60/ 40 in the private and public sectors. EBRD work in Bulgaria closely depends on Bulgarian government agreements with the IMF and the World Bank.

European Investment Bank

The credit line extended under the Project for Small and Medium Enterprises (APEX Project), totaling ECU 30 million (USD 40 million) was discontinued in practice. Loans of USD 3.8 million were disbursed. There are no acting mediator banks.

Commission of the European Union

Following the conclusion of the fourth standby agreement with the IMF, the EU extended the second tranche of ECU 40 million under the loan agreement, stopped after the interruption of the third standby agreement with the IMF in 1994.

Under the 1992 financial agreement, Bulgaria shall be granted aid of ECU 7.3 million earmarked for small and medium enterprises. Financing should be extended through mediator banks with the BNB as a government agent. The deadline for transferring funds is 30 September 1997. Under the first tranche, funds of ECU 4 million were extended. Three banks have access to funds extended under this credit line. Eleven projects totaling ECU 1.1 million have been approved, with ECU 480,000 utilized.

Technical Assistance for Restructuring of the Banking System

In 1996, the BNB intensified its coordination of technical assistance rendered to the BNB and the banking system by international financial institutions, as well as assistance received on a bilateral basis and under special programs.

The special missions of the IMF Monetary and Foreign Exchange Policy Division continued to render technical assistance to the BNB in rehabilitation of the banking system, monetary policy, and economic and monetary policy analysis.

In 1996, the PHARE First Program for the country funded under the 1991 Financial Memorandum was completed. Between 1993 and 1996, contracts on consultant assistance totaling ECU 4.3 million were concluded, thus utilizing 98% of extended funds. Distribution of contracts and funds by sector is as follows:

Sector	Contracts, number	Total funds (ECU)
BNB	3	218,455
Commercial banks	11	2,885,443
Other institutions (IBI, CBA)	5	1,215,428
Total:	19	4,319,326

Source: BNB.

Data indicates that the bulk of funds was directed to commercial banks. Between 1993 and 1996, comprehensive financial and diagnostic audits of five commercial banks and diagnostic audits of three others were made.

A significant portion of funds (ECU 465,000) was used for specialized bank training by the International Banking Institute. In May 1996, the Second Technical Program for the Banking System – technical assistance for consolidated banks, financed under the 1993 financial memorandum, was launched. Total funds extended under this memorandum approximated ECU 3 million. Three technical assistance agreements[40] have been concluded: technical assistance for the United Bulgarian Bank Ltd., worth USD 850,000; technical assistance for Biochim Commercial Bank Ltd., worth USD 895,000; and horizontal bank training program, worth USD 999,000.

[40] The projects are of the Twinning Arrangements type.

As in the previous program, the BNB's major goal is to rehabilitate and stabilize commercial banks. The second annual program for technical assistance in banking finishes in 1998.

4. Personnel and Qualification

The total number of BNB personnel as of 31 December 1996 was 1,335.

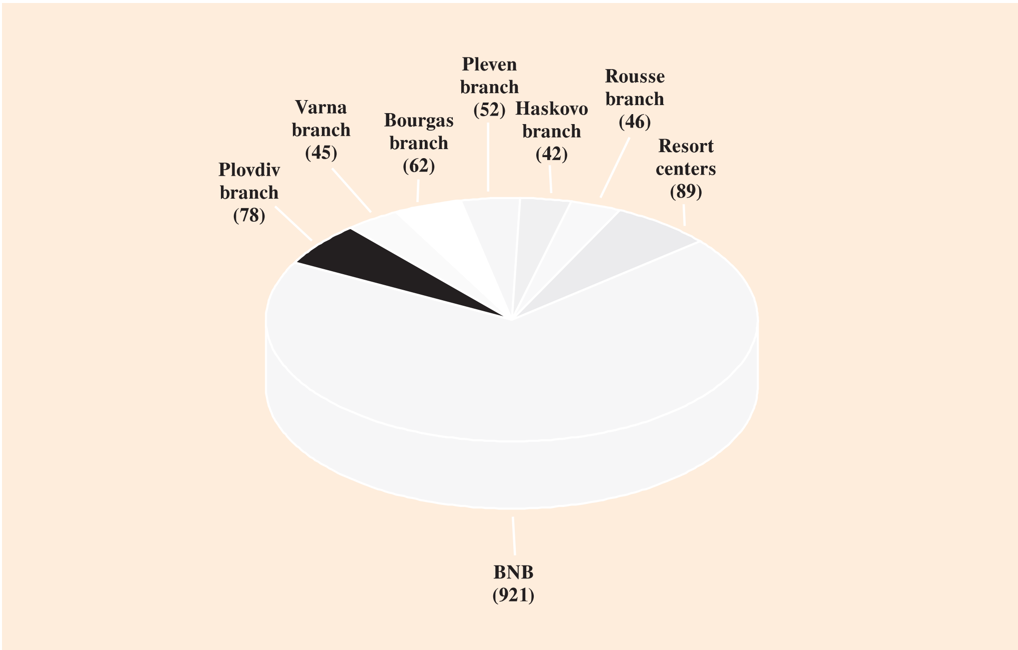
Throughout the year, the BNB continued to pursue an open policy in selecting and recruiting personnel. The major criteria adopted were applicants' expertise and professional experience. Remunerations and social benefits of BNB employees complied with the Collective Labor Contract adopted in the bank and national labor legislation.

Traditional contacts with central banks, institutes and centers for bank training abroad continued. Major BNB partners were the central banks of the United Kingdom, Austria, France, Germany, Switzerland, Italy and Turkey. Ninety-nine BNB employees took part in various training courses abroad.

Training covered the following areas: monetary policy, bank supervision, macroeconomic analysis, foreign exchange operations, and bank accounting and settlement systems.

PERSONNEL OF THE BULGARIAN NATIONAL BANK

(number of persons)



Source: BNB.

Three training courses on 'The Role and Functions of the Central Bank,' 'Management of Currency in Circulation' and 'Management of Central Bank Branches' took place in Sofia in cooperation with Banque de France. In July, a training course on bank supervision was held in cooperation with the Bank of England.

BNB employees took part in programs and seminars of the International Banking Institute.

VIII. Major Trends in BNB Monetary Policy for 1997 and 1998

Bulgaria's transition to a market economy, begun in February 1991 with the price liberalization, the opening of a foreign exchange market and foreign trade, quickly exhausted the opportunities for macroeconomic stabilization through monetary measures. It was not underpinned by effective restructuring of the real sector through fast privatization. Under conditions of a dramatic deficit of internal financial resources and lack of access to international financial markets after the announcment of a foreign debt moratorium, the country became entirely dependent on international financial institutions. Foreign financing was available only under strictest observance of reform implementation agreements and it was discontinued at the end of 1992 after the first deviations from the agreed macroeconomic policy line.

Restored funding from official sources in the second quarter of 1994 was associated with the debt reduction deal concluded with the London Club creditor banks: a decisive step at restoring Bulgaria's positions in international financial markets. However, despite the reduction the country proved unable to service its foreign debt due to delayed structural reform. In addition, domestic debt was rising dramatically due both to increasing government budget deficits and additional sizable quasi-fiscal deficits, the result of replacing nonperforming state-owned enterprise loans with long-term government securities.

The great burden of domestic and foreign government debt against the background of delayed structural reform severely limited the possibilities of independent monetary policy aimed at maintaining lev stability. The first foreign exchange crisis in March 1994 clearly revealed that monetary measures could not compensate for the delay in privatization and reorientation of the national economy consistent with the requirements of international markets. Therefore, despite the relative macroeconomic stabilization of the second half of 1994 (a result of tightened monetary policy), funding from international financial institutions stopped again.

Through most of 1995, the BNB made efforts to maintain lev credibility, hence the country's financial stability by pursuit of a restrictive monetary policy. During the first half-year, BNB interest rate policy was aimed at creating an adequate interest rate differential to attract foreign exchange funds sufficient to offset the lack of foreign financing from official sources in support of the balance of payments. However, this prompted a significant increase in real interest rates which significantly impacted both the budget and the real sector. Due to lack of structural changes in revenues and expenditures, fiscal policy pressure to ease monetary policy constraints progressively increased throughout the year. At the same time, given the lack of hard budgetary constraints since the start of transition in 1991, state-owned enterprises entirely transferred their losses to banks thus rapidly decapitalizing them and setting the scene for the 1996 crisis in the banking system. The delayed structural reform in the real sector proved critical: it was the major factor behind fruitless negotiations with the IMF for a new standby agreement which would have revived the country's foreign financing, and hence the credibility in the national currency and banking system. Thus, the opportunities for pursuit of an anti-inflationary monetary policy were practically halted by the growing budget deficit and destabilization of the banking system.

The severe crisis in the banking system in 1996 reflected the generation of losses by state-owned enterprises over many years, a result of the lack of structural changes such as rapid privatization. The insignificant positive growth reported in 1994 and 1995 was not underpinned by an effective production structure and proved to be short-lived. At the same time, the negative reverse impact of financial destabilization on the real sector should not be underestimated. The bank crisis hit the national economy and dramatically intensified social and political conflict. As a result, the vicious circle begun by the lack of radical economic reform had been closed.

In this setting, monetary policy lost the role of a factor providing sustained financial stability; tightening of monetary policy constraints for fixed periods of time unsupported by other economic policy elements failed to achieve the desired effect. The economic reform program consistent with the IMF fourth standby agreement concluded in July had not begun to be implemented even by the first review in September. Major factors behind this unfavorable result were the delay in structural reform and the inconsistency in expectations as to the depth of recession and revival of economic confidence in the lev and the banks as measured through real money demand. The latter prompted a deficit of revenues from privatization and foreign funding from the World Bank, which irrespective of the significant primary surplus in the government budget did not help release the tension on the financial markets and in monetary policy. Finally, the major reason behind the interrupted fourth standby agreement with the IMF and failed economic policy in 1996 is the lack of political will for rapid and consistent implementation of unpopular but unavoidable economic and financial measures to provide an irreversible break with the past and to put Bulgaria firmly on the path to a market economy.

At the turn of the year, following the failure in accomplishing the required market reforms, the Cabinet resigned from office. The economic and financial crisis grew into political crisis which threatened the national stability. The depth of the economic crisis was apparent from the dramatic devaluation of the lev since early 1997. In less than a month and a half the lev lost as much value as in the whole of 1996. This increased the social cost of transition to a level unbearable for most people and called for an urgent and radical solution to political and other problems.

In early February 1997, political parties agreed on early parliamentary elections and extension of powers to the caretaker government to carry out negotiations with international financial institutions for rapid financial stabilization. The turnround in the political situation was underpinned by the first steps of the caretaker government and the central bank's actions. Tightening of fiscal and monetary policies reversed inflation and lev devaluation and provided a sound base for fast and effective negotiations with the IMF to provide financial support for the rapid market reforms underway. The relative appreciation of the lev and the halt of hyperinflation in its wake again revealed that only coordinated actions between government and the central bank may have a positive effect, providing sustainable financial and economic stabilization.

The fifth standby agreement concluded with the IMF in mid-March includes a package of economic measures intended to stabilize the national currency, restore confidence in the lev and banking system, reduce the extremely high social cost of transition, reflecting the depth of the crisis in 1996, to a level bearable by society. The major task in achieving this is to resolve the structural problems in the real sector by privatization and imposing tight financial discipline. Structural reorganization of the economy coupled with the introduction of currency board arrangements in mid-1997 will make it possible for moderate economic growth to return in medium term, supported by export-oriented production which will ensure regular foreign debt service and strengthening of the balance of payments.

The BNB's immediate tasks under the IMF agreements include: a dramatic reduction and rapid ending of government budget financing by the central bank; improvement of bank supervision functions and further limitation of commercial bank refinancing; development of monetary policy instruments in line with the pending introduction of currency board arrangements. Implementation of radical reform in the banking system, aimed at strengthening the banks by improving their capital adequacy and liquidity, as well as restructuring and privatization in the real sector, prompting a significant decrease in quasi-fiscal deficits and liquidation of unviable enterprises, underlie the BNB's successful monetary policy until the introduction of currency board arrangements.

Pursuant to the current Law on the BNB, the major goal of the central bank is to maintain the internal and external stability of the lev. Following the 393% inflation high in January and February 1997, tightening of monetary and fiscal policies against the background of a favorable political situation resulted in a decreased monthly inflation of 12.3% in March. The BNB, through its monetary policy supported by the government's economic policy, will strive at keeping average monthly inflation within the range of 10% – 15% until the introduction of currency board arrangements. Under currency board arrangements inflation is expected to progressively fall to some 2% per month by the end of the year. Given the extremely high inflation in the first months of 1997, the BNB aims to limit 1996 consumer price growth to 700% – 750%.

Under currency board arrangements in 1998, inflation will continue to decline, approaching price growth in the reserve currency country. Due to inertia, particularly in prices of nontradable goods and services, it is possible that this approach will not be very fast. Taking this into account, an inflation rate of approximately 15% – 20% per annum by the end of 1998 is considered a realistic target. Achieving this target will depend not on the central bank's discretionary monetary policy but on the successful functioning of the currency board.

Following the dramatic devaluation of the lev by about 500% against the US dollar in the beginning of 1997 mainly due to political instability, in the second half of February and March the lev restored almost half of its value against the US dollar, a result of the solution to the political stalemate and significantly tightened fiscal and monetary policies by the caretaker government and the BNB. Initially, the dramatic devaluation of the lev resulted in an immediate inflation jump, with the following partial appreciation serving only to stabilize prices. Under these conditions, in the first quarter of 1997 the lev appreciated by 40% against the American currency in real terms but actually remained unchanged compared with end-1995.

The exchange rate level is an essential factor both in maintaining financial stability and providing competitiveness for Bulgarians exports until the introduction of currency board arrangements in mid-1997. Taking into account the exchange rate level attained by the end of March and the objectives set in respect of inflation, BNB efforts will be aimed at avoiding dramatic fluctuations in the exchange rate of the lev against the US dollar until the introduction of currency board arrangements. Should a market pressure for faster devaluation of the lev occur, the BNB will undertake adequate restrictive measures to take out excess liquidity by employing lev instruments.

Repletion of BNB gross foreign exchange reserves, particularly until the introduction of currency board arrangements, will be of significant importance in restoring lev credibility. Following the dramatic decline in forex reserves (gold excluded) to a record low of USD 408 million by end-February (equivalent to one month of imports), in April the country's forex reserves exceeded USD 1 billion, the result of USD 179 million disbursed by the IMF, USD 150 million from a finalized privatization deal, and significant BNB net purchases in the forex market. Until the introduction of currency board arrangements, BNB monetary policy will be intended to further strengthen the forex exchange reserves to a level providing the normal launch of a currency board. After the introduction of currency board arrangements, the level of forex reserves will depend only on internal money demand and the inflow of foreign capital. In case of accelerated privatization, relatively conservative forecasts about the rate of revival of credibility in the banking system and the lev, and taking into account the projected foreign financing in the fifth standby agreement with the IMF, it may be expected that forex reserves will continue to increase (gold excluded) through the year compared with its level at the introduction of a currency board.

Adjustment of BNB monetary policy tools to the requirements of the future currency board started in early 1997, despite the high risk associated with political instability. The changes in BNB monetary policy were aimed at gradual decrease in the number of instruments employed and reducing the degree of their use. As a result, at the end of January the BNB phased out its daily auctions for reverse repurchase open market operations which had been previously employed to regulate banking system liquidity. Reverse repurchase operations are carried out in one or two days only at low interest rate levels; in practice they are not very active. At the same time, the Ministry of Finance introduced daily auctions of seven- and 28-day discount government securities. They started providing major funds to finance the government budget as well as maintaining liquidity in the banking system. These steps prepare financial markets for the introduction of currency board arrangements when the BNB will not participate in the open market and commercial banks will rely entirely on the interbank market. After the political stalemate had been resolved in early February reduced political risk favored the positive development of aforementioned processes.

By the end of January 1997, BNB interest rate policy significantly changed in line with the general principles of currency board arrangements. While the interest rate policy had been previously used mainly to curb inflation, the degree of discretion was reduced in favor of enhanced influence by market forces. The BNB started to determine the basic interest rate on the basis of effective yield to maturity of the government securities with the shortest term, since their market is most developed. This was an essential step to the entire liberalization of interest rates, typical of currency board arrangements. Prior to the introduction of currency board arrangements, this will enable the establishment of a close connection between interest rates and demand and supply in financial markets, which will later ensure their normal operation and development.

During the period prior to the introduction of currency board arrangements, BNB monetary policy will still depend on the state of the government budget and bank cash deficit financing needs. The extension of a direct credit of BGL 115 billion at end-1996 significantly limited BNB opportunities to pursue stabilization policy resulting in a dramatic depreciation of the lev and a price jump in early 1997. With the changes in BNB monetary policy instruments aimed at preparing the introduction of currency board arrangements, BNB monetary policy becomes strongly dependent on fiscal policy. In this setting, the BNB's role gradually decreases and the responsibility for the achievement and maintenance of the country's financial stability shall be assumed by government fiscal policy.

The general scheme approved for financing of the government budget until adoption of the 1997 State Budget Law allows for an extension of direct credit by the BNB irrespective of its inflationary effect. Under the current complex situation, it is of particular importance for the budget to refrain from drawing direct credits from the central bank. In the absence of a working Parliament to coordinate directly fiscal and monetary policies when necessary with a view to protecting financial markets, the BNB has to fund the government directly, although money issuing contradicts the central bank's major monetary policy objective. To this end, efficiency in curbing inflation will depend on government ability to finance its needs through sale of government securities to commercial banks, companies and individuals, to obtain revenues from privatization and foreign sources, thus voluntarily limiting or even entirely desisting from its legal right to draw direct credit from the central bank.

Discontinued net credit inflow to the government from the BNB in February 1997 had a stabilizing effect. This is attributable to the coordinated fiscal and monetary actions which smoothly rechanneled free commercial banks' and SSB funds from open market repo-operations with the BNB to primary daily auctions of short-term government securities. Further inflow of fresh bank funds to finance cash deficit will depend on the strengthening of money demand, already emerging as a result of lev stabilization. Since this process is relatively slow and includes restoration of confidence in the banking system, which is an even more difficult task, it is of great importance to use all alternative noniflationary sources.

The opportunities of nonbank financing are far from exhausted. Enhanced interest in index-linked government securities, due to the price jump in early 1997, helped achieve monetary policy targets. It should be admitted that initially this is very costly for the budget but the price properly reflects the quality of the commodity: noninflationary financing for a six-month term which bridges the restructuring of budget revenue and expenditure under currency board arrangements. Inflation having once been curbed, the interest of individuals and companies will shift to discount government securities, ensuring significantly cheaper but at the same time shorter-term source of budget funding.

In anticipation of greater revenues from privatization, attraction of foreign investments in government securities will significantly support the pursuit of BNB anti-inflationary policy. Substantial contribution to this will be the gradual liberalization of the market in government securities issued under the LSNC which will release commercial bank funds thus encouraging banks' lending to government and the real sector. It is also important to use the enhanced interest of nonresidents in government securities with a maturity of over six months which is considered foreign investment according to the legislation in force. Despite the initially high cost of this source, its extensive use may cover not only the budget's needs but also increase foreign exchange reserves contributing to the accelerated revival of credibility in the lev. At the same time, the gradual shift of budget requirements to resources with relatively longer maturity will substantially reduce its demand for funds in the auctions for government securities with the shortest maturity. Other conditions being equal, this will result in a dramatic cut in the basic interest rate, and to a decrease in expenses on servicing purchased government securities with longer maturity and floating yield (including those of foreign investors). Thus the yield curve slope will be normalized, acquiring a sloping shape. This will favor both monetary policy by encouraging investment in instruments with longer maturity, and fiscal policy by providing a cheaper noninflationary source of financing.

An increase in privatization revenues, nonbank and foreign financing of the budget will help reduce the pressure of the government sector on the real sector in the credit market. Provided cash deficit is reduced to 4% of GDP in 1997 and the bulk of net funds for its financing are nonbank, the increased funds resulting from restored confidence in the banking system may be lent to the real sector. The 1998 situation is expected to be analogical: the deficit, under currency board arrangements, should be reduced to 2% – 3% of GDP and it will be funded by the banking system only partially. In this setting, during 1997 and 1998 lending conditions would favor restructuring of the real sector, ensuring sufficient funds at relatively low interest rates.

The implementation of an adequate monetary policy, observance of strict currency board rules after board launch, combined with vigilant bank supervision, are the factors behind the establishment of a sound banking system for which the BNB is responsible under the law. Following the isolation of 15 commercial banks in 1996, six state-owned banks will have primary significance for the banking system (SSB excluded). Devaluation of the lev since early 1997 significantly improved their state, since all these banks were on long foreign currency positions (if the government securities denominated in foreign currency under the LSNC held by them are taken into account). With the government's resolution for recapitalization of one big state-owned bank, liquidity of all state-owned banks is sufficient to successfully operate under currency board arrangements. Gradual liberalization of the secondary market of government securities issued under the LSNC, subject of enhanced interest both for privatization and investment, will foster further improvement of commercial bank liquidity.

Problems of state-owned banks, associated with bank management improvement, will be resolved through privatization. The BNB and the government will coordinate their activities in order to remove all legislative and regulatory impediments to foreign strategic investments which will help strengthen the reputation of Bulgarian banks. To achieve this, the fifth standby agreement with the IMF provides for finalization of the privatization of two state-owned banks by the end of September 1997. The program of bank privatization includes privatization of another two banks by end-1997, and the remaining two banks by mid-1998. This way by the end of 1998, country would rely on a sound banking system based on private lending institutions.

The BNB will further strengthen supervisory functions both prior to and after the introduction of currency board arrangements. To limit lending of last resort, all commercial banks are required to adjust their capital adequacy ratios to: 6% by end-1997; 8% by June 1998; 10% by end-1998; and 12% by June 1999. Immediately after privatization of all state-owned commercial banks, their capital adequacy ratio shall be at least 8%. Banks failing to attain the minimum capital adequacy ratio in the set term shall sign programs for adjustment to the required level which will be examined by the Bank Supervision Department at the BNB on a monthly basis.

Further changes in the legislative framework intended to expand the powers of bank supervision will be made. The LBCA will be amended in the part concerning bank licensing. To accelerate liquidation of insolvent banks, a new law substituting the respective part of the LBCA will be designed. To establish stricter requirements to bank managements, amendments to Regulations on licences issued by the BNB will be made, as well as to Regulations on loan classification and formation of statutory provisions by banks, Regulations on the liquidity of banks, etc.

The increase in the share of nonperforming loans in the structure of credit portfolios appears to be the major problem of Bulgarian commercial banks. To resolve this problem, the BNB will establish a credit register which will be used by commercial banks to exchange information about clients and borrowers. As concernes bank supervision, the frequency and scope of on-site inspections as well as collected information will be increased.

In compliance with the agreement among political parties and the country's commitments under the fifth standby agreement with the IMF, the BNB's reorganization to operate under currency board arrangements will be made after the adoption of the respective amendments to the Law on the BNB by the 38-th National Assembly. The major principles of currency board arrangements have been already determined and include: (1) the complete coverage and unlimited exchange of reserve money for foreign exchange at a fixed exchange rate by the BNB Issue Department; (2) a ban on lending to the government by the BNB; (3) support of commercial banks on a discretionary basis within the available resources of the BNB Bank Department provided persistent risk occurs; (4) the complete liberalization of interest rates which will be based on demand and supply in the interbank market.

Changes in BNB functions will lead to appropriate change in its structure. The major changes will be aimed at establishing relatively independent units (departments) where activities typical of currency board arrangements will be concentrated. An issue department (a currency board) which shall provide a 100% foreign exchange coverage of available national currency and bank reserves, and a bank department responsible for lending of last resort under strict rules will be completely separated (with separate balance sheets). Bank supervision will be performed by a third independent department within the structure of the BNB. The introduction of currency board arrangements requires further improvement of functions and interaction between BNB and government. It will be reasonable to make the necessary amendments to the Law on the BNB, expanding the provisions of the currently effective Article 3 under which the BNB and the government will advise each other about their actions in determining major trends in monetary and lending polices. The new provisions shall ensure consistency between government macroeconomic policy and the strict rules of currency board arrangements.

The elimination of the possibility of government financing by the central bank by law is of particular importance for the risk-free and successful functioning of a currency board. Experience reveals that the meaning of Article 46 of the Law on the BNB, pursuant to which the BNB may extend interim loans (advances) under exactly set terms, changes significantly through some provisions in specific state budget laws or amendments made to them. The ability of government to draw long-term direct credit from the BNB provided under these laws stymies the provisions of Article 46 irrespective of legislators' considerations in passing these laws. A glaring example of this is the amendment to the 1996 State Budget Law. To resolve this problem, a constitutional provision would probably be needed.

The restrictive fiscal and monetary policies against the background of political stabilization in March and April 1997 resulted in relative restoration of the confidence both of local and foreign investors. The interest rate differential, although gradually declining in line with the decline in the basic interest rate, provides additional resources to the budget and helps replenish foreign exchange reserves. The formation of a clear parliamentary majority in support of reform also has a strong stabilizing effect. In this setting, it is necessary to accelerate the radical reform underway in order to make use of the favorable political, financial and economic climate, and avoid repeating the mistakes of 1995.