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BULGARIAN FINANCIAL MARKETS DURING 1991 - 1992
INSTITUTIONAL MECHANISMS, ROLE AND RESULTS OF
MONETARY POLICY

BY

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INTRODUCTION

The radical transformation of the nation's economic system requires that a new financial system facilitating the functioning of today's market economy to the utmost degree should be created. The basic tasks it has to face amount to:

- monetary policy should reemerge as a major macroeconomic stabilization tool;
- a two-tiered banking system relying on the agency of a Central Bank, independent of executive authorities and responsible for the implementation of monetary policy with a number of competitive commercial banks should be set up;
- contemporary economic instruments for indirect control in accordance with up-to-date financial theories should be established. The monetary policy effected throughout 1991 had two prime objectives: first, it aimed at establishing an equilibrium on the money market by reducing the extremely high level of money demand to economically relevant levels of money supply and second, at preventing price liberalization from growing into menacing hyperinflation. A variety of economic tools had been used but direct control was assigned a decisive role. The now existing forms of operation of the financial mechanism and the set of instruments for control over its basic parameters have been brought into line with contemporary financial systems. There is now solid ground for the implementation of a monetary policy which will lay greater emphasis on the set of indirect tools of control ('open market' operations) and oust the ones used previously (interest rate and credit ceilings). The consolidation of the banking system through the enlargement of existing commercial banks aiming at a higher degree of their stability is now under way.

The present survey touches on the following points: Paragraph 1. examines the process of restructuring the banking system; paragraph 2. describes the new forms of operation of the monetary mechanism, through which the ground of the indirect control of money aggregates is prepared; paragraph 3. gives an account of the most important tools of the monetary policy;

paragraph 4. dwells upon an analysis of the empirical effects of the monetary policy in effect.

1. RESTRUCTURING OF THE BANKING SYSTEM

The process of decentralization and establishment of the two-tiered banking system in Bulgaria began in 1987 with the creation, mainly on industrial branch principle, of seven commercial banks. Their role consisted of securing investment credits for the enterprises of the corresponding sector, extended in virtue of planned decisions. During 1989/1990, the former branches of the Bulgarian National (Central) Bank (BNB) were transformed by administrative means into independent commercial banks in the form of joint-stock companies. The main shareholder in the established banks was BNB, as a big part of its ownership was transferred to state run enterprises, which turned into main credit recipients of these banks. Because of this, these measures did not lead to the more effective distribution of credit resources. From one side, the banks directed their operations mainly in the interest of state enterprises (shareholders), violating some basic bank rules and norms and exposing the interest of the depositors to unnecessary risk. From other side, a significant part of these banks had very little capital of their own, as their capital and risk assets ratio is far from international standards. There is also ineffective sectorial distribution of their credit portfolio and monopolistic behavior in the small settlements, etc. In order to overcome these shortcomings and to create a smaller number of more stable and competitive commercial banks with diversified portfolios and a wide network of branch banks. The Bank Consolidation Company (BCC) was established in February, 1992, with a three year mandate. It represents a holding joint-stock company founded by the BNB and the Bulgarian Foreign Trade Bank (BFTB), with the following functions: acquisition, management, assessment, and sale of stocks in local commercial banks; organization and control in the restructuring of different banks; and privatization of banks according to existing legal acts. In order to implement those aims, it became necessary that all stocks in the state banks (except for the State Savings Bank) owned by the BNB and other institutions or enterprises that are predominantly state owned, were transferred to the BCC and replaced with its stocks.

Another basic problem of banking system reorganization is that many of the existing banks accumulated a significant amount of bad debts, which raise the question of stability and security of not only separate banks, but of the financial system as a whole. The burden of this debt could make their restructuring into competitive institutions impossible and would incredibly impede their privatization. This necessitates the creation of a program for financial restructuring of these banks, including reassessment of their assets and liabilities and clearing their balances of bad debts, that were granted till the end of 1990. Last year only partial payments were carried out on the moratorium over credits for capital investments, extended by government decisions to low

efficient and losing enterprises (and postponed for pay off after January 1, 1991): Their volume declined from 7.675 bil. BGL (as of March 31,1991) to 5.495 bil. BGL (as of July 31,1992), and almost did not decline after February. At the end of 1991, the government retransformed 4.128 bil. BGL of bad debts of some enterprises into a public long-term obligation loan. This debt was bought by the commercial banks, as they could use Lombard credit from the BNB against the received obligations up to 90% from their nominal value. For the remaining part of the enterprises' bad debts, the government, in cooperation with the World Bank, is preparing a program with a number of options for the resolution of this difficult problem.

Along with the consolidation of the banking system, the creation and development of money and capital market becomes necessary. The foundation of the money market was laid in 1991 with the formation of the interbank BGL and a viable foreign exchange market, as well as the issue of government treasury bills. Also, the introduction of additional instruments and the improvement of the now existing ones are expected to contribute to the more efficient allocation of resources and ensure the needed liquidity. The formation of a capital market will further ensure financial resources are available to firms and facilitate privatization and the use of indirect instruments of monetary control.

2. THE MONETARY MARKET AND ITS FORMS OF OPERATION

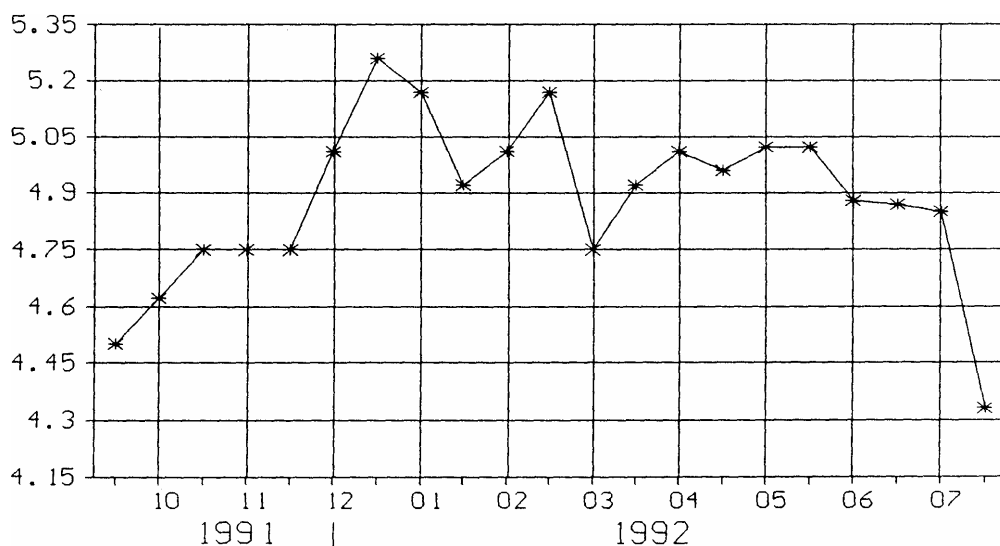
A basic element of the undertaken stabilization program in 1991 was the restrictive monetary and credit policy maintained by the government. Such a policy presupposed the existence of a powerful and influential Central Bank and a number of independent commercial banks in keen competition as well as a system of reliable and efficient mechanisms for interbank regulation.

At the initial stages of the stabilization program BNB had put an end to the limitless amount of credit resources granted to commercial banks which in turn made them all the more anxious to increase deposits coming from firms and individuals as well as to enter into interbank negotiations of resources. Three-month deposits had been largely and progressively used by the BNB as the only form of refinancing commercial banks since January 1991. The maximum deposit amount was not supposed to exceed the 20% credit ceiling allowed to the banks during the first three quarters of the year or hit the 10% point in the last quarter of the same year. A Decision of the BNB's Board of Directors, dated February 1992, brought direct uninsured deposits granted to commercial banks to a close. In spite of this, the actual outstanding amounts from the direct refinancing of the commercial banks through these deposits (as of July 31,1992) was 67S9 million

BGL, of which 5495 million BGL are intended to cover the non-performing and bad debts, postponed to be paid off after January 1, 1991, 746 min. BGL for covering the remaining part of the debt of firms, which are undergoing conversion of the military production, and 548 min. BGL for the banks that credited the Jambol Bank which sank into serious liquidity difficulties.

Since September 1991, when a new form of refinancing commercial banks was introduced, BNB has been holding regular auctions for short-term (1 month) interbank deposits. On the basis of the orders placed with the BNB, an interest rate is announced aimed at achieving an equilibrium between aggregate demand and supply. On the auctions held until July 31, 1992, the larger part of deposits had been granted solely by the BNB (the only exception being the two auctions at which three commercial banks had also acted as depositors but the amount of the deposits was rather insignificant) while commercial banks acted mainly as recipients of deposits. The monthly deposit volume of these auctions ranged between 5.6-7 bit. BGL in the last four months of 1991. The average monthly marginal interest rates, fixed at the auctions, followed an upward tendency - from 54 % (calculated on annual basis) in September to 61.08% in February, and after that rates decreased again to 55.08% in July. The actual amount of the residual interbank deposits (as of the end of July, 1992) was 5194 min. BGL.

Monthly Interest Rate on Interbank Deposit
Auctions



Source: Bulgarian National Bank

January 1991 saw the beginning of an interbank money market where, on the basis of mutual agreement with regard to the term and interest rate of the credits, commercial banks with temporarily free credit resources granted credits to banks in temporary need of such. As of July 31, 1992, the residual of the total credit volume registered on this market amounted to 26557 min BGL, as of which 780 min. BGL had a 7-days' term; 1455 min. BGL - with a 7-day to 1-month term; and 24322 - with an over one month term. The main factor responsible for the rather low relative share of interbank operations handled within a 7-day term is the sluggish interbank transfer system, which takes at least 2-3 days for a single purchase/sale transaction. Commercial banks are granted credit resources in the form of deposits or credits, the latter being widely employed mainly by the State Savings Bank. The advantage of the interbank money market had over interbank deposit auctions found expression mainly in the flexibility of the former, thus allowing the two parties to enter into direct negotiations concerning the conditions (terms and interest rates) of the credits granted. The previously existing structure of the interbank money market, however, created all the prerequisites for destabilization of the financial system due to the chain interdependency among the commercial banks. This in turn led to cases when BNB's control was often evaded and basic banking regulations were left out of consideration. Following the assumption that there is a basic necessity for a reliable and trustworthy banking system as well as for the gradual restriction and subsequent disappearance of unguaranteed deposits granted by the Central Bank, we think that the blending of the two mechanisms of refinancing and the formation of a contemporary interbank market into a single unit is an appropriate measure strengthening the BNB's control over the existing legal banking norms and regulations.

At the end of 1991, BNB introduced new forms of refinancing the commercial banks. The Central bank began granting Lombard credits as a collateral for 3 months treasury bills issued by the Ministry of Finance. BNB grants a Lombard credit amounting to 80% of the nominal value of the pledged securities and up to 90 % of the currency, precious metals and obligations received by the Ministry of Finance following the transformation of the bad loans of some state enterprises into public debt. Since the beginning of February, 1992, short-term government securities auctions are carried out on a regular basis (every first and third Monday of the month). From one side, the buyers of treasury bills are the State Savings Bank and the commercial banks which used up their credit ceilings that were aimed at diversification of their credit portfolios*, and from other side - banks, willing to use Lombard credit. The purchase of 3 month treasury bills results in additional incomes from the commercial banks, despite the relatively low income that those securities seem to have and the additional increase in the price of the Lombard credit due to the margin of safety. According to our estimates, when the interest rate on non-financial enterprises is 65%, a commercial bank which, with its free resources purchases 3 month treasury bills (with an average income maturity of 14.25%) which equals a 70.38% effective annual interest rate in order to use them as a collateral against Lombard credit (with 54% interest) and the received assets (80% of the securities' nominal value) given to its clients in the form of loan, would realize income by about 14.2% higher than the one, that it would have realized if it granted those assets to the credit-reipient directly at a 65% interest rate. Based on this, in order to stimulate banks to buy

treasury bills of the Ministry of Finance and to carry out similar operations under the thus defined margin of safety, it is necessary that the income on those securities be kept at a level not lower than 8-9 points under the average interest rate on the commercial banks' credits. The tendency of lowering the basic interest rate, which leads to the realization of substantial short term incomes because of the fixed income from treasury bills, could also be a serious reason to maintain the commercial banks' interest in those auctions (as long as their income is within the above mentioned condition). After the basic interest rate was lowered two consecutive times in July, the average interest rate on credits granted by the commercial banks is about 55%. This means that the bank-credit institutions which buy securities are going to profit from them at effective annual interest rate above 47%. Of course, a lower effective interest rate does not mean a total lack of interest toward the governmental securities. Just the opposite: the lower interest rate is a consequence of the lower profitability which in turn, is due to the lower concession formed at the auction as a consequence of the significant increase in the demand for securities over their supply. However, this process has a strong opposite connection: observing the low profitability which brings losses, securities' buyers abstain from buying and the demand falls. Exactly the same

* Commercial banks have the right to purchase Government securities outside the established limits of their credit ceilings.

process was observed on the government securities market during July and August, when the lowering of the interest rate was combined with an increase in the maturity - there was a switch entirely to 6 and 9 months treasury bills. After the effective interest rate was maintained within the 47-48% limit in July (which brings a positive difference in the profit of about 1 point in advantage of the Lombard financing), in August it dropped to 42-44%, which brought about a sharp decrease in the orders by about 1/3 of the July's volume.

Unfortunately, the purchase of government securities from the commercial banks, which is regarded as a non-inflationary method of financing the budget deficit, in its nature represents an indirect financing from the Central Bank and results in an increase in money supply, which in turn creates preconditions for inflation to increase. The reason why government securities transform into inflationary financing are the Lombard credits, through which the Central Bank refinances the commercial banks on collateral of government treasury bills and obligations according to the basic interest rate. The BNB does not set limits on the total volume of the granted Lombard credit, i.e. the banks can put the whole volume of the purchased securities as collateral and receive against them credit worth up to 80% and 90% respectively of the nominal value of 3-month treasury bills and on obligations that are bad loans to other banks transformed into public debt. Thus, during the first seven months of 1992, the sales of 3 and 6 month treasury bills totaled 7556.5 min. BGL (a 2586 min. BGL Lombard credit was granted as a collateral for part of this money). After this size is netted with the actual outstanding amount from the Lombard crediting, as of July 31, 1992, the money supply increased by 1740.9 min. BGL only due to the above mentioned factor.

The transformation of the 4128 min. BGL in bad loans of state enterprises to banks into a governmental debt, at the end of the year, amounted to the same result. Commercial banks were offered long-term government bonds against the liabilities of the above enterprises. The government thus eased the debt burdens of these enterprises and guaranteed their debts to banks. However, because banks were given the opportunity to use Lombard credits as a collateral for government bonds, a big amount of financial resources were granted to these banks. This increased liquidity was at the expense of an increase in the money supply by 3672 min. BGL (this is the sum of the granted Lombard credits as a collateral of these type government bonds till July 31, 1992), thus further fueling the inflation

From a macroeconomic point of view, this way of budget financing has the same consequences as those of direct crediting by the BNB: it generates an inflationary potential by the increasing

money supply. For instance, as of the end of July, 1992, it increased by 5412.7 rln. BGL. It is reasonable here to ask the question: "What are the profits and the losses of the three parties (commercial banks, the budget, and the Central Bank) from this type of financing?"

First, the additional profit that the commercial banks make from this operation varies from -5 to 2 percentage points on annual basis, depending on the different ratios between the credit interest rate, treasury bill yield, and the basic interest rate. Therefore they can loose, as well. In order for commercial banks to earn such additional profit (at 65% interest rate on credit), the acquisition price of treasury bills should not surpass 87.91. At 55% a interest rate on credit, it should not exceed 82.48 at 100 nominal units.

Second, the budget expenditures on deficit financing increase by 1 to 5 percentage points, but this is unavoidable because it is fixed into the Budget Law limits on direct financing.

Third, the BNB has no direct financial gains out of this. Nevertheless, government bonds are a reliable guarantee on government domestic debt to the BNB. Also, the treasury bills allow the Central Bank to exercise indirect control over the money supply by handling open market operations. Pledging them as a collateral against Lombard credits means both keeping them out of the market for a period corresponding to the term of the extended credit and reducing the volume of government securities by means of which the above operations are to be handled.

The described mechanism has its negative sides. From one side, it leads to a "crowding out effect" of one part of the assets (about 9%) of the banks with unused credit ceilings for financing the budget at the expense of the industrial sector. On the other hand, these additional liquid assets, together with the net assets received during the first seven months of the year through discount loans and on the auctions for interbank deposits, could be used for covering old liabilities to the BNB (during the first quarter were liquidated debts to BNB on moratorium, conversion, and 3-month unsecured deposits worth 4736 min. BGL), and the remaining part could be deposited as profitable assets: granting credits to the non-financial sector or foreign currency operations. In our view, this would exceed (through the money multiplier) the initially defined credit ceilings by 2.35 bil. BGL, which brought inflationary pressure. This means, that banks prefer the unused assets to exceed their credit ceilings, despite the sanctions, which makes us believe that this direct instrument of credit control does not have the needed restrictive effect. However, since the basic element for increasing banks' liquidity during this period was the granted Lombard credit on obligations retransformed into government debt which were formerly bad loans to banks, t he new

issues are not expected till the end of the year, so it could be assumed that the inflationary pressure in this direction will be loosened.

At the end of 1991, the BNB introduced for the first time discount credits as a form of insured refinancing. The Central Bank granted discount credits to commercial banks against their securities - bills of exchange which were given for rediscounting. The actual residual of the discount credits (as of July 31, 1992) is 1718 min. BGL (the discount percentage, corresponding to the basic interest rate plus 1%).

3. KEY INSTRUMENTS OF THE MONETARY POLICY IN 1991

One of the prime instruments of the restrictive credit policy are the credit ceilings imposed upon the growth of the credits granted by commercial banks. This is a direct instrument employed by the BNB for immediate control over credit volumes and money supply. They are set separately for every commercial bank, as they exercise a direct control over the volume of the deposited money that could be created by the commercial banks. At the beginning they were set quarterly based on the relative share of the different banks of the total credit at the end of the last year. Since April, 1992, they are set on monthly basis. Credit ceilings largely contributed to the fall in aggregate demand, viewed as an essential part of the control exercised over money supply. Nevertheless, they had their side effects. Most influential commercial banks quickly ran out of their credit limits while vast sums of unemployed resources remained with smaller banks. As a result, credit resources were inefficiently and inadequately distributed and competition among banks was put under constraint. We can thus say that the rise in the interest rates of credits granted to quickly-consuming-credit-ceiling banks and the reallocation of their free resources to foreign currency transactions were contingent upon the above-mentioned processes. All this doubled the risk of their portfolios and led to cases of instability and abrupt fluctuations in the exchange rate of the lev in 1991. That is why, the decision to set monthly credit ceilings based on the volume of the accumulated funds in every commercial bank and for the purchase/sale of the unemployed part of the ceilings offered at BNB auctions will do away with the above-mentioned disadvantages and improve considerably the allocation of credit resources.

During the first half of 1992, the credit ceilings were strongly overdrawn. The main reason is the unlimited refinancing which injected excess liquidity in the commercial banks and led to the allocation of these additional funds into profitable assets. Thus, despite the imposed sanctions by the Central Bank on the commercial banks, the credit ceilings were significantly exceeded.

Therefore, if credit ceilings are to be an effective instrument of control, then some quantitative limits on the volume of the refinancing of the commercial banks by the BNB and stricter sanctions on overdrawing the set ceilings should be imposed.

The high nominal interest rates were meant to reduce the growth of the money supply and credit volume. They were used as a measure to counteract the anticipated headlong rate of inflation. What is more, they aimed at weakening the impact of inflation via redirection of the monetary overhang to time deposits as well as at forcing the non-lucrative businesses to restructure their production or declare bankruptcy when unable to do so. Although the task was partially fulfilled, the population was practically transformed into a net creditor and the real interest rates manifested a steady negative decreasing tendency. The real interest rates for the period April-December steadied at the negative percentage point of -8.9% even though a set of corrective anti-inflationary mechanisms were well into effect as early as February and March. This fact alone accounted for the depreciation of the savings of the population and the transfusion of resources from savings accounts into the accounts of economic agents who took on the character of a specific kind of subsidy. During the fall and winter of 1991, it resulted in a certain shrinkage of the national currency demand and the transfer of assets into foreign currency which perpetuated further devaluation of the BGL. This could be identified as the major reason for the decrease registered in the inflation tax base and together with the existing budget deficits, they both sped up the rate of inflation. The situation did not change until the first half of 1992. The real interest rate on deposits (based on the real retail price index) for the January-June period is (-11.9%). Compared to the slow rising nominal interest rates responsible both for the depreciation of the savings of the population and reductions in the domestic debt and liabilities of firms (in particular trade companies and firms producing consumer goods) in the banking sector, consumer price and retail price indexes spiralled upwards. Nevertheless, a great number of enterprises which put their production up for sale at producer prices (the latter being much slower in their rise than consumer prices in 1991) had to cope with considerably high real interest rates during certain spans of time throughout the year. The real interest rate of the credits granted to enterprises remained fixed at the 10.2% from April to December. For the first half of 1992 it was 18.3%. Along with other factors such as certain restrictions, the lack of any alternative for the restructuring of state enterprises into other forms of ownership and the continuous crediting by commercial banks, the above-mentioned tough and rigid conditions of credit prompted the accumulation of vast amounts of non-performing, bad debts and practically made the enterprises non-viable. Moreover, the high interest payments were calculated within the prices of production and thus grew into a powerful inflationary factor of threatening dimensions.

Again, along with the cutbacks made in the credit volume via credit ceilings, the high interest payments made bank financial resources inaccessible to many firms. On the other hand, they gave rise to an unexpected expansion of inter-firm crediting. The allocating function of the price mechanism was thus disrupted, and the interference of the enterprises made their distinction into "good" and "bad" ones hazy. This in turn led to microeconomic distortions in the economic processes. The lack of a reliable information system by means of which risk and solvency can be assessed and distinctions between the "good" and "bad" enterprises hindered the implementation of efficient credit management and credit policy.

All this led to evasion of the nominal credit anchor by the economic agents, which is continuing this year. In order to avoid the ineffectiveness of monetary restriction, it is necessary to apply proper legislation concerning bankrupts. This would enable banks to report liquidation of the inefficient enterprises and to cease the extension of further credits to insolvent enterprises.

Since the BNB has not yet started "open market" operations (purchase/sale of government securities from the Central Bank, leading to changes in the money base), another key instrument to regulate the money supply, created by the Central Bank is the purchase/sale of foreign exchange from the BNB. The purchase/sale of foreign exchange from the BNB is a very flexible instrument of the monetary policy, because of the possibility to affect money supply and liquidity of the banking sector on a daily basis. However, it is not very effective for achieving long-term aims. However, the use of this instrument appears to be a problem related to the fact, the foreign exchange policy of the Central Bank is directed at accomplishing another aim - stabilization of the BGL exchange rate. This forces the Central Bank to choose only one of these aims which is to be accomplished through the implementation of this instrument.

In July, 1992, the BNB lowered the basic interest rate twice, which ended at 45 %. The commercial banks in turn also lowered their interest rates. What are the expected consequences from this reduction of the basic interest rate for the economy? The latter is supposed to be set on the basis of the expected inflation rate. If we refer to the government intentions to lower the inflation rate during the second half of the year to 2% per month, this is cause for a reasonable reduction of the interest rate. An over reduction of the interest rate, if the actual inflation rate is higher would again lead to substantial negative interest rates, which would have the following effects:

First. The continuous depreciation of the savings of the population and transformation of time deposit resources into foreign currency assets.

second. When the established credit ceilings are preserved, the lower interest rate will not lead to a sharp increase in credit volume and money stock (measured by M2 or broad money), and will not turn into a strong inflationary factor.

Third. Once the money supply is brought within the limits of the credit ceilings and government expenditures are cut back or at least checked, any reductions in interest rates can be expected to have anti-inflationary effects. This, together with the deductions of 50 to 75 % of the interest payments before profits are subject to taxation, will help reduce the impact on prices through expenditure cuts. Also, it will cheapen the financing of budget deficits and thus increase the share of non-inflationary coverage of deficits while decreasing the excessive of money creation.

Fourth. The circumstances under which the lower rates of interest and credit restrictions will out credits with a higher degree of reliability and efficiency are not the Pareto-optimal conditions . On the contrary, the latter creates all the conditions necessary for the improper allocation of resources.

The ever-increasing tendencies discernible in interest rates and the continuous devaluation of the lev are simultaneous processes deserving particular attention. Anticipation, underlying the business activity of both firms and consumers, can be said to be a reason of major importance. When prices were progressively on the increase, the creditors (individuals in particular) profited from the rise in the nominal interest rates, this off-set the lower purchasing power of the BGL that was brought about by the high rates of inflation. Similarly, borrowers tended to pay high interest rates in the hope that the repayment of their loans could be completed quickly in order to take advantage of the devaluated BGL.

The preservation or even increase in the nominal BGL exchange rate during the period January-August 1992, suggest a relative independence of the foreign exchange market from the other financial markets despite the opposite dynamics of the nominal interest rate and the inflation.

4. THE RESULTS OF THE MONETARY POLICY

As Section I pointed out, inflation counteractions can be clearly identified as ranking among the prime and most decisive objectives of monetary policy in 1991. The stabilization programme pursuing the aforementioned objective requires that aggregate demand should be influenced through reductions in money supply. The comparatively consistent implementation of the

monetary policy enabled the BNB to cope with the two shocks of price liberalization quite successfully. Had the fiscal and income policy followed the same rigid line of restrictions, the results of the monetary policy would have been far better. In fact, they partially counterbalanced the positive anti-inflationary effects of monetary policy during given periods of the year.

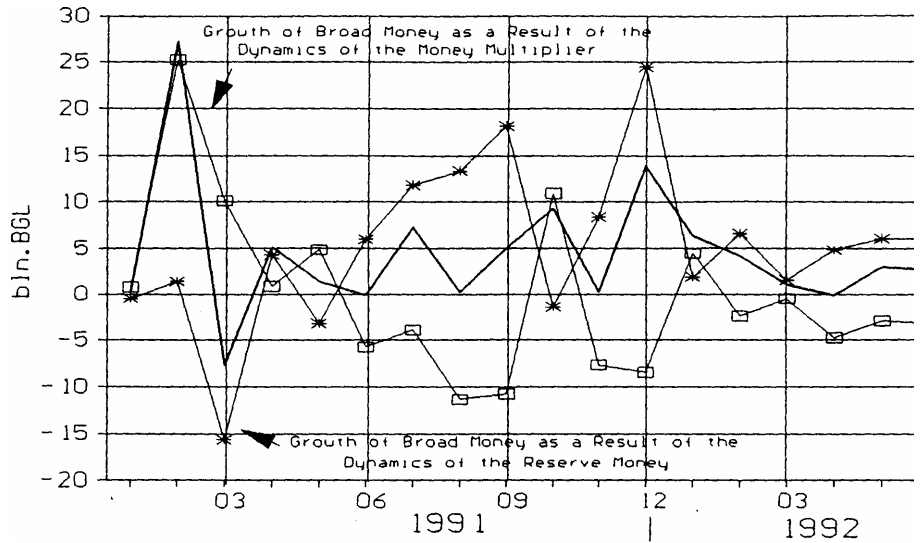
The BNB also aimed at achieving an equilibrium in the money market. It was a necessity brought about by the fact that the demand for money had to be reduced and brought into line with the reduced size of money supply thus eliminating the effects of monetary overhang in 1991. The base interest rate and credit ceilings were used as the basic instruments for fulfilling the task. The full use of the credit ceilings for the banking system as a whole amounted to approximately 100% which, in view of the different conditions of credits granted by the commercial banks, demonstrated a certain prevalence of money demand over supply. The accumulation of vast sums of reserves by the commercial banks, in a sense, was partially triggered by the fact that they had used up their credit ceilings for a given quarter. Meanwhile the BNB carried on refinancing them for the sake of improving its own liquidity and living up to its own inflation anticipations. In December there was another substantial growth in the bank reserves (21% in real terms) which could be interpreted as a case where the money supply exceeded demand. This in turn affected the interest rates strongly pushing them further downwards.

From the beginning of 1991 until the end of July 1992, domestic credit was marked by nominal growth of 121.3% but the sky-rocketing prices led to a drastic shrinkage of 60.1% in real terms. The sector structure of credits remained more or less steady. The share of credits drawn by non-financial public enterprises ranged from 64-66% and the respective shares of the state, private sector, and the population were about 28-30% and 5-6% respectively. The total amount of credits granted in BGL by the commercial banks rose by 100.3%, which was far above the 77% limit of the credit ceilings compared to 1990.

Due mainly to the devaluation of the BGL, the dynamics of money supply was characterized by a nominal rise of 169.8% in broad money and a 165% growth in money aggregate M2 throughout 1991. After eliminating the influence of the exchange rate and the price level during the period it should be noted that there was a significant real decrease in the money stock (measured with M2) of 41.3%. Within the structure of M2 the share of the money in circulation and demand deposits, i.e. M1, in July 1992, is 51.3% and is now still far above the international standards while the share of quasi-money, consisting of savings, time deposits, and a very small part of foreign currency deposits is 48.7%.

Bulgarian Financial Markets During 1991 - 1992

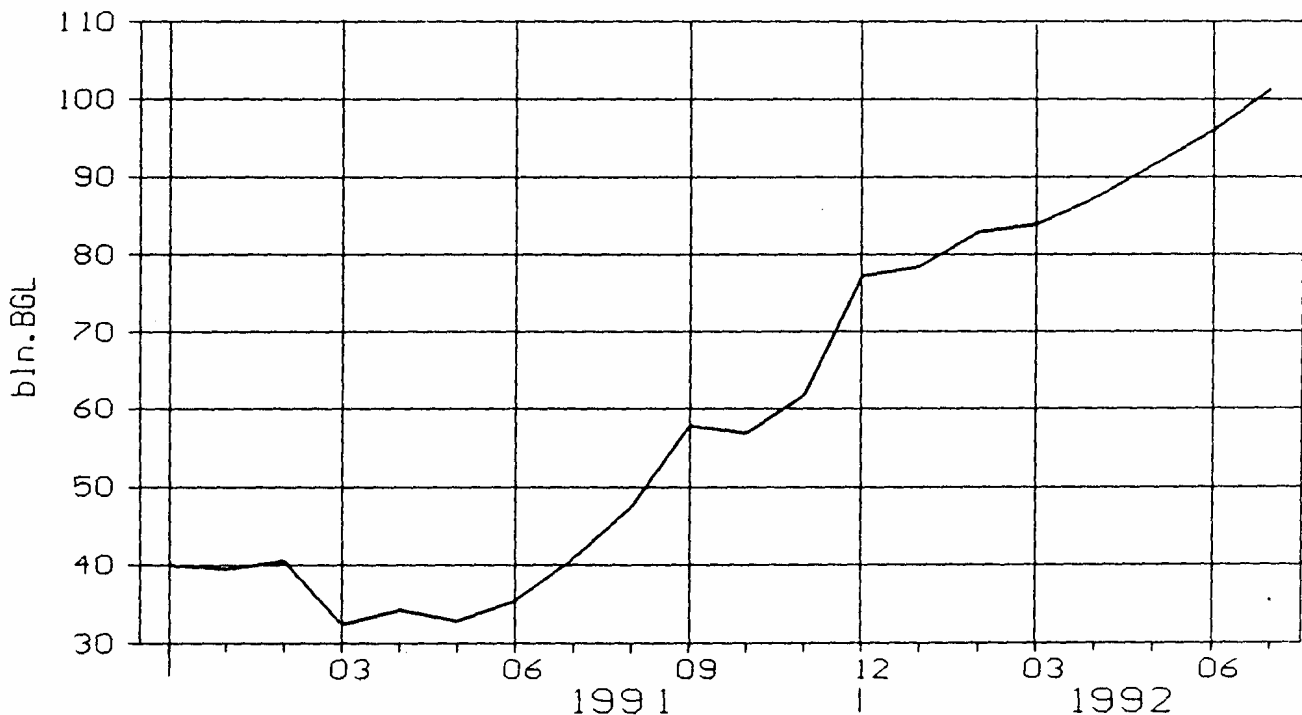
Growth Structure of Broad Money



Source: Bulgarian National Bank, Agency for Economic Coordination and Development

The dynamics of the money supply throughout 1991 reflected the adverse influences of both the money multiplier and money reserves. Inflation anticipations resulted in the reduction of the nominal money balances of the individuals effected by the purchase of real or dollar assets or the transfer of resources in national currency time deposits which further curtailed the ratio between the money in circulation and deposits. This can be considered the reason for the increases in the bank reserves and hence the upward movement of the money multiplier. The money multiplier has been marking a steady downward movement since mid 1991 when credit growth was substantially reduced through the use of the high nominal interest rates and credit ceilings. As reserve money increased, money supply marked a further growth.

Dynamics of the Reserve Money



Source: Bulgarian National Bank

CONCLUSION

The development of money market mechanisms in Bulgaria is quite encouraging. This can be said to be one of the economic fields that has benefited most from the advent of the reform processes. The gradual expansion of the instruments of contemporary monetary policy lays greater emphasis on the control exercised over the money supply through more precise and adequate open market operations rather than on a set of direct instruments. In other words, the expansion of monetary control is directed towards the implementation of an efficient monetary policy.

At the initial stages of the economic reform (February-May) the monetary policy adopted restrictive and rigid standards and the results were quite promising - inflation was checked and dropped dramatically to the desired level, the demand for local currency increased, and the initial demand for consumer goods was replaced by a demand for money. The liquidity accumulated in the national economy was done away with, which in turn relaxed the impact of inflation to some degree. However, certain unsteady and inconsistent tendencies at work during the summer months weakened the initial powerful effect of the monetary policy and kept the secondary inflation anticipations of the economic agents intact. As the end of the summer brought its quick recovery, monetary policy soon produced the desired effects.

The "soft" budget constraints applied to firms and the practically uncontrollable and chaotic growth of real incomes in the fourth quarter of 1991 transformed the interest rate from a prime instrument of regulation into an inflation-generating factor, which in turn forced the Central Bank to exploit the reductions in the interest rate for anti-inflationary purposes (by way of reducing the money supply through fiscal measures and credit ceilings). As a result, the inflation countermeasures undertaken now focused on the impact of the budget policy with all the unfavorable social and political consequences possible.