IV. Monetary Policy

1. Money Supply

Broad Money

In 1995 broad money, which includes cash outside banks and all types of deposits, rose by BGL 165.7 billion, an increase of 39.6% compared with 1994. Money supply, measured through the broadest monetary aggregate, exceeded the annual inflation rate for the first time since the start of transition from a centrally-planned to a market-driven economy. Taking into account the reported GDP growth of 2.6%, modest real growth in the money supply was recorded. Nevertheless, BNB monetary policy was restrictive during most of 1995. There is reason to assume that substantially increased real interest rates on lev deposits helped restore the confidence in the national currency and increase money demand in real terms during the first eight months of 1995. An indication of the restrictive character of the monetary policy is the slower broad money growth relative to the annual inflation rate during the first ten months of 1995. Only in November and December did the broad money growth rate exceed the inflation rate. As a result, the BNB had to refinance several commercial banks with liquidity deficiencies in order to avoid disruptions in the settlement system. The actions of the central bank, in its legal function of a lender of last resort, cannot be offset by other monetary policy tools, and the monetary restriction was relaxed.

MONETARY AGGREGATES GROWTH

Monetary aggregates	1994		1995	
	billion BGL	Dec.'93=100, %	billion BGL	Dec.'94=100, %
Broad money	183.9	78.6	165.7	39.6
BGL	95.1	51.0	143.3	50.9
foreign currency	88.8	186.5	22.4	16.4
Monetary aggregate M1	26.8	55.5	32.8	43.6
Currency outside banks	13.3	53.1	23.1	60.0
Demand deposits	13.5	58.2	9.6	26.3
Quasi-money,	152.4	83.9	129.4	38.8
including:				
Time deposits in levs	55.0	50.0	90.6	54.9
Deposits in foreign currency	84.6	193.9	21.9	17.1

Source: BNB.

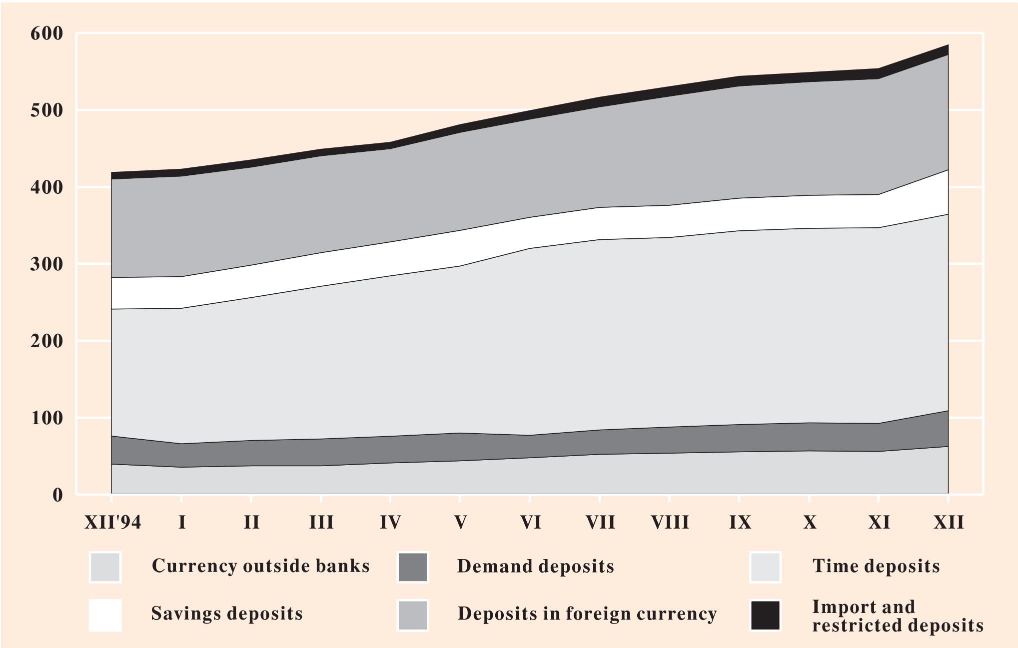
In 1994, money supply growth was predetermined by the dramatically depreciating lev and was beyond the control of the BNB. In 1995, however, an important change in the structure of money supply occurred. During this period, money supply in levs rose by BGL 143.3 billion (50.9%), accounting for 86.5% of the total money supply growth. At the same time, the foreign exchange component amounted to USD 179 million (8.7%), approaching the amount of annual interest accrued. This suggests that the process of conversion of lev funds into foreign currency deposits was halted during most of 1995.

Monetary Aggregate M1

However, the aforementioned positive trend did not couple with another trend which evolved in 1995. The monetary aggregate M1, including currency outside banks and current accounts, reached 43.6% exceeding the total money supply growth and inflation rate by 4 and 10.7 percentage points respectively. Given the high liquidity of these funds and their immediate use in settlements, the accelerated growth of these funds is inflationary and should not be overlooked. The much higher increase in money outside banks over the increase in current accounts is cause for serious concern. It was 23.7 percentage points in 1995, while in 1994 this growth lagged behind demand deposits growth by 5 percentage points. To some extent, this can be attributed to the substantially reduced inflation rate, encouraging cash holdings. At the same time, individuals and economic agents still generally prefer to make cash payments. This facilitates concealment of economic activity and tax evasion, as well as pushes inflationary pressure directly or indirectly, channeling funds to the commodity market or the forex market.

MONETARY AGGREGATES DYNAMICS IN 1995

(billion BGL)



Source: BNB.

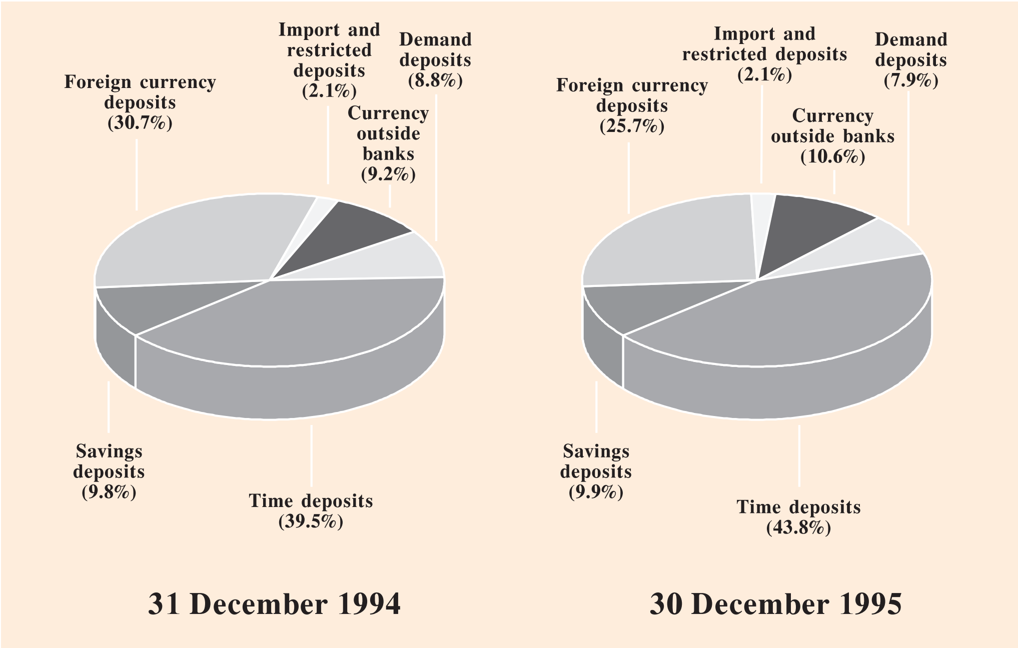
Quasi-money

In 1995 quasi-money, including time, savings and foreign currency deposits, grew by BGL 129.4 billion or 38.8%. Of this, time deposits in levs accounted for the largest increase, 54.9%. The growth in lev time deposits exceeded interest growth on one-month deposits by 13.5 percentage points. This indicates additional investment of funds in the amount of approximately BGL 22 billion. Restored confidence in the national currency was evident in the first seven months of 1995 when time deposits grew by 50%. This is 20 percentage points over the interest accrued, i.e. new investments (net) total BGL 33 billion. However, during the last five months of the year this trend gradually reversed. Between August and December, time deposits increased by only BGL 8.1 billion, or BGL 11 billion less than interest accrued. This suggests a renewed preference to invest in foreign currency, though less strong than in 1994. The reasons behind this adverse trend in monetary policy are the reduced interest rate difference between lev and foreign currency investments, negative real interest rates on lev deposits between September and December, and historically heightened expectations for devaluation of the lev in the autumn and winter.

Developments in foreign currency deposits are indicative of the degree of confidence in the national currency. Over 1995, they increased by 9.3% in dollar terms, or USD 180 million. This exceeds interest accrued by 3 percentage points, accounting for USD 60 million new investments (net). Between January and July, foreign currency deposits increased by only USD 48 million, and in the following two months, USD 157 million. In October and November they grew a mere USD 19 million, while in December they declined by USD 32 million. Data about the last three months of 1995 causes concern: declining confidence in the lev is coupled with declining confidence in the banking system due to the deteriorated liquidity of some commercial banks (private and state).

General developments in money supply may be deemed positive since the higher growth of the lev component provided additional funds to increase domestic credit and to partially offset increased government borrowing requirements consistent with the revised state budget in December 1995. At the same time, the occurrence of adverse trends in the last months of 1995, reflecting a deterioration in the banking system, may push inflationary pressure and limit the central bank's ability to conduct consistent monetary policy.

STRUCTURE OF MONETARY AGGREGATES



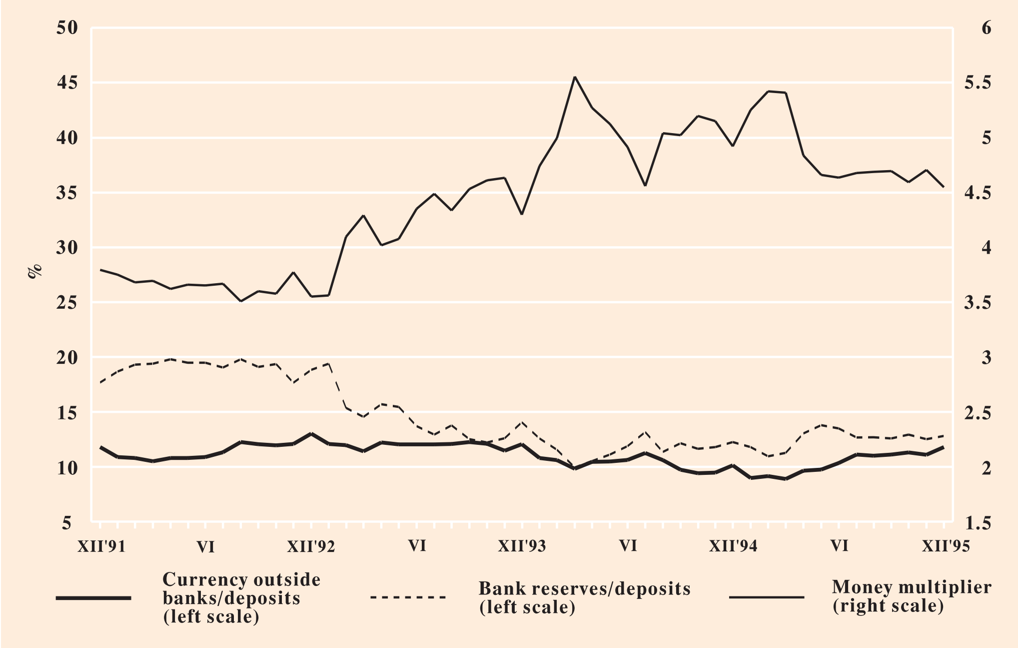
Source: BNB.

2. Reserve Money and Money Multiplier

In 1995, the BNB continued to employ reserve money as an operational target for the control of money supply. At the same time, during the reporting year several changes in minimum reserve requirements were made which affected money multiplier developments.

In 1995, reserve money rose by 51.1%, exceeding money supply growth by 11.5 percentage points. This is attributable to the raised minimum reserve requirements (from 10% to 12%) in the first half-year with a view to sterilizing the foreign currency flow. Despite the reduced minimum reserve requirements to 11% in the second half of the year, reserve money growth stood historically high at year-end. This reflects households' and companies' preferences to hold cash; compared with 1994, the ratio of currency outside banks to deposits increased from 10.1% to 11.8%. At the same time, commercial banks' behavior nearly repeated the 1994 pattern: the ratio of bank reserves to deposits rose from 11.7% to 12.8%, while the level of excess reserves remained unchanged (1.7% – 1.8%). During most of the year excess reserves were low (below 1%) due to the BNB's restrictive monetary policy aimed to regularly purge excess liquidity through purchases of foreign currency.

MONEY MULTIPLIER



Source: BNB.

RESERVE MONEY AND MONEY MULTIPLIER

Indicators	Dec.'94	March'95	May'95	June'95	Sep.'95	Dec.'95
Broad money (billion BGL)	418.0	447.8	479.8	497.9	542.9	583.7
Reserve money (billion BGL)	85.0	82.8	103.0	107.4	115.7	128.4
Money multiplier (at current exchange rate)	4.92	5.41	4.66	4.63	4.69	4.55
Currency outside banks/deposits (%)	10.1	8.9	9.8	10.3	11.1	11.8
Bank reserves/deposits (%)	11.7	11.3	13.8	13.5	12.6	12.8
Broad money change (billion BGL), including:	42.0	29.8	32.1	18.1	45.0	40.8
– reserve money	50.6	-10.6	109.0	20.8	38.2	59.6
– money multiplier	-7.6	41.4	-61.9	-2.7	6.3	-17.0
– both factors	-1.0	-1.1	-15.1	-0.1	0.5	-1.9

Source: BNB.

Reserve money growth was the major factor responsible for money supply growth in 1995. The impact of the money multiplier was stronger in the first quarter only, due to seasonally decreased ratio of currency outside banks to deposits. By the end of March, this ratio reached its lowest level of the last two years – 8.9%.

Reserve money increased more significantly in the second and fourth quarters as a result of the strong pressure to refinance several banks with liquidity deficiencies. Reserve money growth in the first five months of 1995 was predetermined mainly by the forced refinancing of the Economic Bank and Mineralbank. Later, rehabilitation of these banks, coordinated with the government, was initiated. In terms of reserve money sources, redistribution of reserve money sources occurred, rather than a change in their developments.

During the fourth quarter of 1995, reserve money growth accelerated again due to increasing tension in the banking system. Between October and December, other (mostly private) banks faced heavy liquidity problems, requiring sizable refinancing through unsecured credits. Increasing borrowing requirements of the revised state budget in December contributed to the reserve money growth.

Analysis of reserve money sources during the year reveals the effect of individual monetary policy tools employed by the BNB. If the dramatically increased BNB claims on the government[34], as a result of the newly issued government bonds for the rehabilitation of the two troubled banks is disregarded, the developments in this indicator reflect the central bank's attempts to offset, through its open market operations, injected liquidity both as a lender of last resort and a major buyer of inflowing foreign currency.

Among other monetary policy tools, unsecured loans extended to banks with liquidity deficiencies contributed most significantly to reserve money growth, and hence to money supply growth. Reserve money grew most substantially in the first quarter of 1995 due to refinancing of the two troubled banks, and in the fourth quarter when several other mostly private banks were refinanced. By the end of 1995, the amount of unsecured loans came close to that prior to the rehabilitation operation. This reveals the occurrence of new and serious problems which rapidly intensified, threatening the stability of the entire banking system.

During the first quarter, the effect of unsecured loans extended to the troubled banks on reserve money was partially offset by taking out liquidity from other banks through reduced BNB refinancing by Lombard and discount loans in levs and foreign currency. Overdrafts even declined during the reporting period. Consequently, reserve money growth was suppressed and the restrictive character of the monetary policy was sustained.

DEVELOPMENTS IN MONEY SUPPLY BY RESERVE MONEY SOURCE

(billion BGL)

Indicators	Dec.'94	March'95	May'95	June'95	Sep.'95	Dec.'95
Sources of reserve money changes	50.6	-10.6	109.0	20.8	38.2	59.6
Sources of reserve money						
claims on government	14.9	-67.5	4.5	123.4	-13.0	26.3
claims on commercial banks, including:	29.9	41.9	48.0	-132.2	-15.7	54.4
Lombard loans	37.6	-1.6	-3.3	-96.5	-1.5	2.0
discount loans	-23.7	-1.5	1.0	-0.3	3.4	1.5
overdraft	11.0	-15.1	7.0	7.1	-10.5	16.5
deposits	-0.6	44.0	13.6	-50.1	7.0	42.8
discount loans in foreign currency	-7.3	-2.8	0.7	-6.6	7.7	-6.3
other, net	5.9	15.0	56.6	29.7	67.0	-21.1

Source: BNB.

However, in the fourth quarter the possibilities to implement the monetary policy through employment of a similar set of monetary policy tools proved to be exhausted. Over the reporting period, only discount loans in foreign currency decreased, while Lombard and discount loans in levs grew, though insignificantly. Overdrafts increased more significantly, reaching the highest levels since the introduction of the settlement system. Coupled with increasingly growing unsecured refinancing, it contributed to reserve money growth and the relief of monetary restriction.

[34] Given the specificity in reporting repo-agreements, the effect of open market operations is reflected in BNB claims on the government, and not in claims on commercial banks.

3. Domestic Credit

In 1995, domestic credit growth lagged behind money supply growth by 23.9 percentage points, due to substantially increased payments on external debt service. This, combined with the foreign exchange flow significantly improved the country's net foreign exchange assets.

DOMESTIC CREDIT GROWTH

Credit aggregates	1994		1995	
	billion BGL	Dec.'93=100, %	billion BGL	Dec.'94=100, %
Domestic credit,	146.9	37.1	85.3	15.7
including:				
Government sector				
BGL	24.1	22.6	109.0	83.5
Nongovernment sector	63.8	31.5	92.6	34.8
BGL	48.2	47.6	54.7	36.7
foreign currency	15.6	15.4	37.9	32.3
Public enterprises	23.1	13.9	-20.9	-11.0
BGL	36.0	47.6	-14.1	-12.7
foreign currency	-12.9	-14.2	-6.7	-8.6
Private sector	40.6	113.0	113.5	148.1
BGL	12.1	47.7	68.9	183.5
foreign currency	28.5	270.3	44.6	114.1

Source: BNB.

Dramatic changes occurred in the structure of domestic credit in 1995: the lev component increased by 52.7%, while the forex component declined by 20.7%. If the effect of the rehabilitation of the Economic Bank and Mineralbank, in which foreign exchange claims on the government on LSNC bonds were replaced for lev claims of BGL 58 billion in newly issued government bonds, is disregarded, these changes in domestic credit structure reflected the revived confidence in the lev in most of 1995. As a result, the lev credit growth exceeded by 1.8 percentage points the lev money supply growth and by 17.8 percentage points the reported inflation rate, providing necessary lending funds for the government and real sectors.

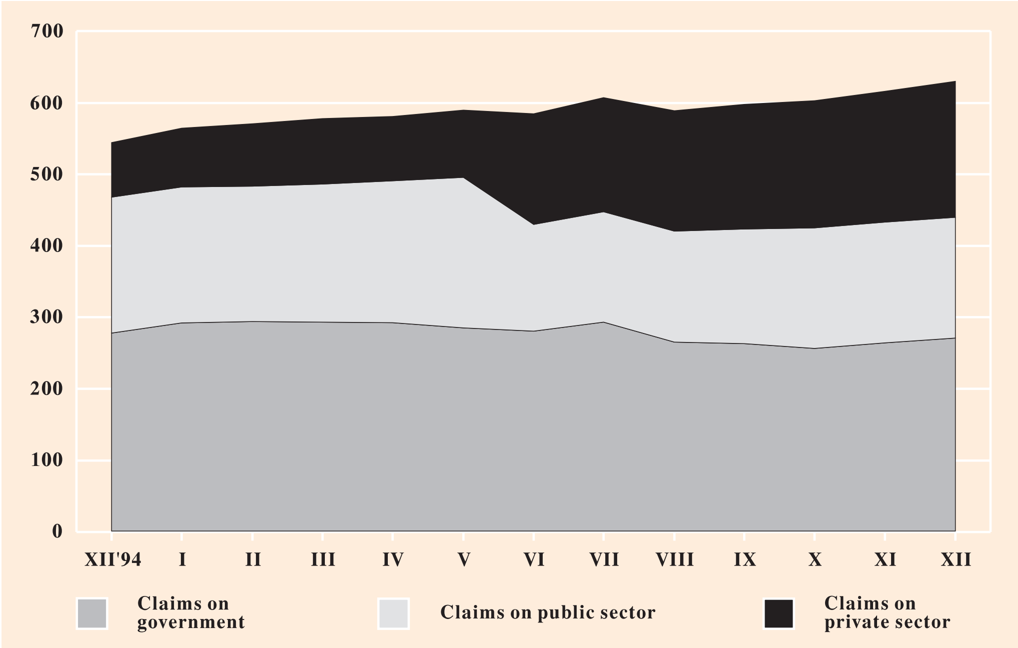
If the growth from the rehabilitation of the two troubles banks is deducted, the lev credit to the government increased by BGL 51 billion. This accounts for 48.3% of total lev credit growth and reveals continuous crowding out of the real sector from the credit market, although at a slower pace compared with recent years. This is a result of substantially increased total lev credit in real terms, reflecting revived confidence in the national currency.

Credit extended to the nongovernment sector increased by 34.8%, exceeding by 2 percentage points the inflation rate. Data indicates that the country's economy was supplied with sufficient resources for the first time after the initiation of 1991 reform, in spite of the increased government borrowing requirements. To this end, it should be noted that credit did not suppress the economic growth but even boosted it, though negligibly.

No essential structural changes occurred in the components of credit to the real sector. Lev component growth outpaced by a mere 3.6 percentage points foreign exchange component growth. In real terms, lev credit increased by approximately 3%, and the foreign exchange component, in dollar terms, increased more appreciably. Data reveals persistent demand for foreign exchange credits due both to export-oriented output and lower cost of these credits relating to the appreciation of the lev in real terms.

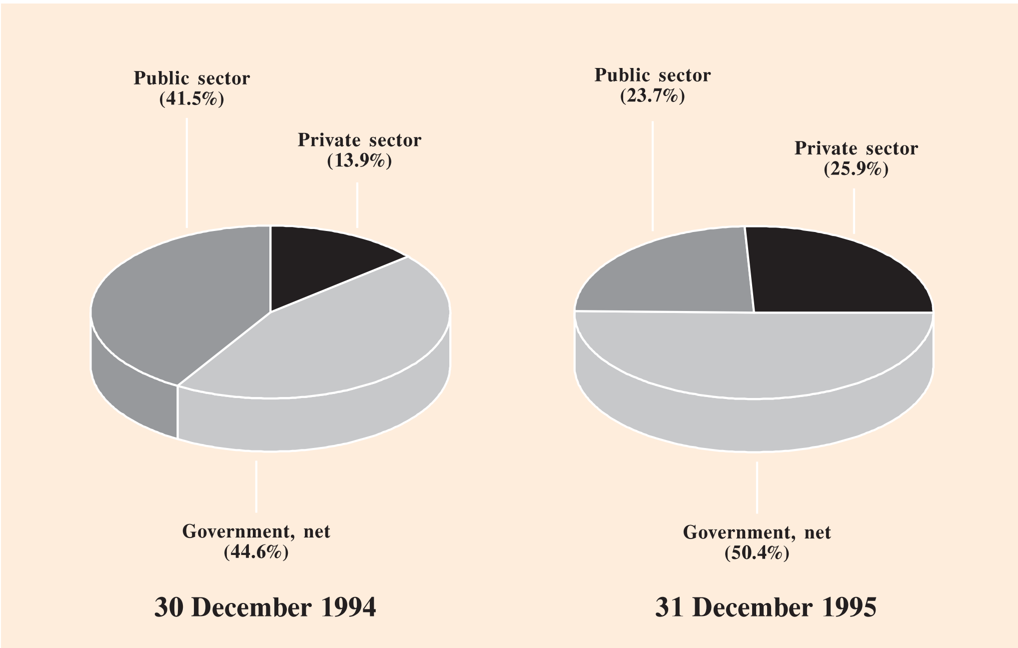
DEVELOPMENTS IN DOMESTIC CREDIT IN 1995

(billion BGL)



Source: BNB.

STRUCTURE OF DOMESTIC CREDIT
(lev component)



Source: BNB.

Changes in data, attributable to the introduction of the Uniform Chart of Accounts, render impossible precise assessment of developments in credit to the public and private sectors. Consequently, the nominal decrease in credit to nonfinancial public enterprises both in levs and in foreign currency may not be interpreted as repayment of these credits without disbursement of new credits. At the same time, the rise in credit to the private sector seems to be overestimated. There is reason to assume, however, that comparable data from the previous years about credit to the private sector exceeded credit to the public sector as well. By the end of 1995, credit to the private sector accounted for more than 52% of credit to the nongovernment sector, which significantly exceeded the private-sector share in GDP produced. Data shows that there is no ground to assume that the private sector is inadequately financed. Furthermore, intensive lending to the private sector relative to the public sector has boosted private-sector development in recent years.

4. Monetary Instruments and the Money Market

Basic Interest Rate

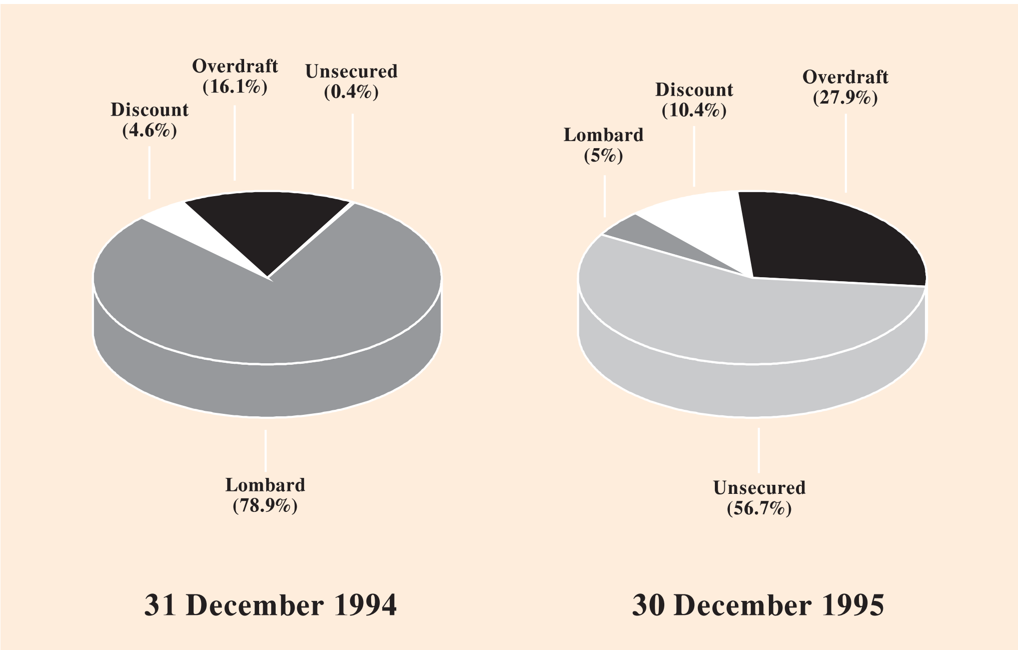
In 1995, BNB interest rate policy played a key role in reviving the confidence in the national currency and suppressing inflationary expectations. In 1994, the BNB in its attempts to tighten monetary constraints, raised the basic interest rate on several occasions to counterbalance the dramatic lev devaluation. In 1995 however, the basic interest rate was gradually decreased from 72% to 34%. The basic interest rate was gradually reduced on seven occasions between April and July. The BNB actions proved to be conservative, given the slower decrease in the basic interest rate relative to the inflation rate decline. Provision of persistently positive deposit rates was intended to enhance real money demand, and maintenance of a significant interest rate differential between deposits in national and foreign currency in most of 1995 to strengthen the lev.

Interest rates on other monetary instruments followed the changes in the basic interest rate. To fine-tune its monetary policy, the BNB changed tariffs and spreads on some monetary policy tools.

Refinancing in National Currency

By the end of 1995, funds extended by the BNB to refinance commercial banks totaled BGL 20,171 million, a decrease of BGL 8,391 million compared with 1994. By the end of June 1995, in compliance with the CM Decree on rehabilitation of the Economic Bank and Mineralbank, the obligations of these banks to the BNB were fully covered by the government against newly issued government securities of BGL 36,023 million. Taking into account the operation, refinancing of commercial banks increased appreciably.

STRUCTURE OF ACTUAL OUTSTANDING DEPOSITS AND LOANS OF COMMERCIAL BANKS



Source: BNB.

Of all 45 commercial banks, 19 banks were refinanced by the BNB, with 11 of them borrowing funds up to the permitted overdraft. Proportionally, the share of unsecured loans was the largest (56.7%), followed by overdraft (27.9%), discount loans (10.4%) and Lombard loans (5%).

Unsecured Financing

Due to serious liquidity deficiencies experienced by several banks, banking system liquidity deteriorated, particularly by year-end. The inability of these banks to normally effect payments disrupted the balance in market distribution of free monetary flows. A sizable portion of these funds were channeled from the risky interbank money market to open market operations with the BNB. Actually, commercial banks, experiencing liquidity shortfalls, had no access to the interbank market. To avoid disruptions in the settlement system, the BNB had to compensate liquidity deficiencies by extending unsecured loans under Article 30, para. 3 of the Law on the BNB. By the end of the reporting year, unsecured loans totaled BGL 11,412 million and were the major form of commercial bank refinancing. The basic interest rate plus 0.5 of a percentage point or interbank market interest rate plus 0.5 of a percentage point were applied on unsecured loans in 1995.

Lombard Loans

Significant changes occurred in the volume and structure of Lombard loans in 1995. During the first six months of the year, Lombard loans, totaling BGL 22 billion, were most extensively employed to refinance commercial banks. As a result of the measures undertaken to rehabilitate the Economic Bank and Mineralbank, Lombard loans dramatically fell over the second half of the year, reaching BGL 999 million.

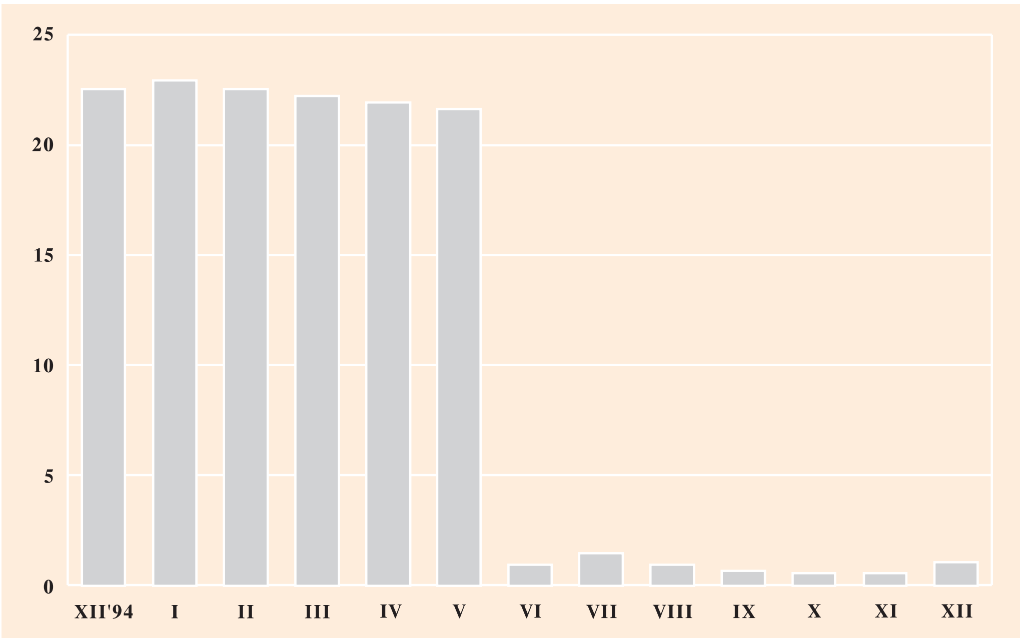
Between July and December, Lombard loans were disbursed to four banks with temporary liquidity deficiencies. Commercial banks with acute liquidity problems could not provide government securities or other acceptable collateral and had to draw only unsecured loans.

In 1995, 97 Lombard loans were extended totaling BGL 57,706 million, and 146 worth BGL 79,251 million were repaid.

By the end of 1995, Lombard loans were allocated as follows: overdue loans against a pledge of commercial paper, 30%; and loans extended against a pledge of long-term government bonds, 70%. The interest rate of the latest BNB government securities auction plus one percentage point was accrued on Lombard loans.

LOMBARD LOANS DEVELOPMENTS IN 1995

(billion BGL)



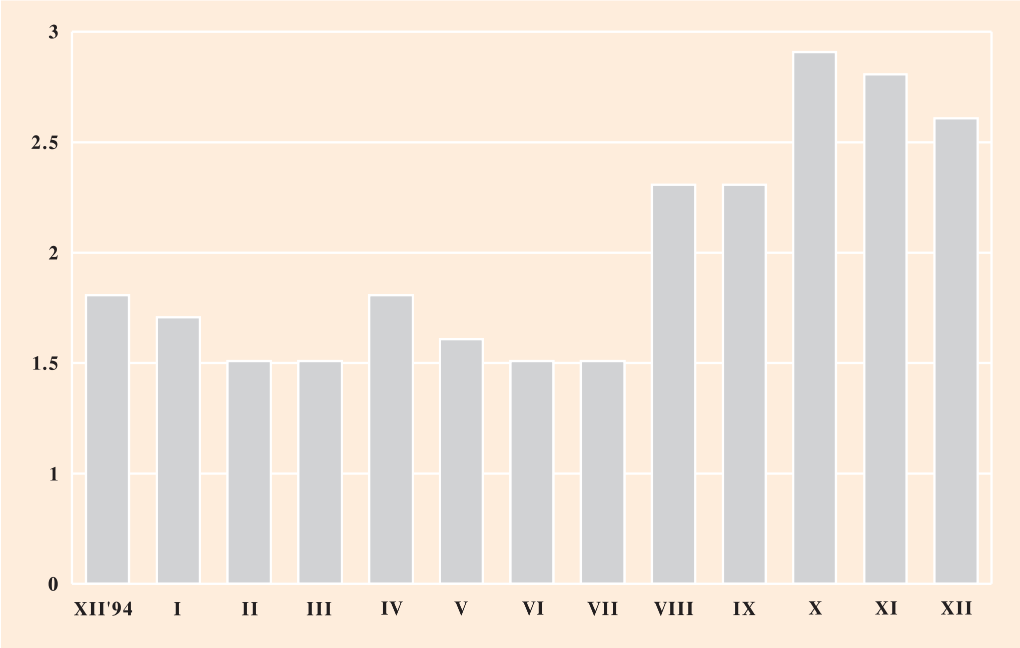
Source: BNB.

Discount Loans

Between January and December 1995, 80 promissory notes of BGL 7,852 million were discounted, including 51 promissory notes of BGL 4,266 million to finance spring sowing, 24 promissory notes of BGL 3,086 million for purchase of wheat produced in 1995, and another five promissory notes of BGL 500 million. Ninety-three promissory notes of BGL 6,984 million were repaid, including 56 promissory notes of BGL 4,549 million for agriculture and 12 promissory notes of BGL 1,341 million for wheat. Compared with 1994, the number of discount loans fell by 306 to BGL 42,603 million, including 111 loans of BGL 18,034 million for sowing.

DISCOUNT LOANS DEVELOPMENTS IN 1995

(billion BGL)



Source: BNB.

By the end of 1995, outstanding discount loans totaled BGL 2,134 million, including BGL 389 million unpaid at maturity, due to lack of funds on the current account of one commercial bank. Outstanding discount loans increased by BGL 868 million compared with 1994. The basic interest rate plus 1.5 percentage points was accrued on discount loans.

Open Market Operations

In 1995, open market operations were extensively employed by the BNB as a major monetary policy tool to regulate reserve money and liquidity in the banking system. By the end of the reporting period, the absolute amount of BNB portfolio of government securities totaled BGL 75,923 million nominal value, and its average daily amount was BGL 20,248 million. Government securities, issued to replace a portion of the LSNC bonds, accounted for the largest share, 47.5%. The remaining government securities in the BNB portfolio were allocated as follows: government securities issued under Regulations No. 5, 21.4%; government securities on the securitized government debt, 18.8%; and government securities issued under the LSNC, 12.5%.

The BNB government securities portfolio included primarily long-term issues, providing less opportunities for the conclusion of final transactions. Sales totaled BGL 5,290 million nominal value, or 0.3% of total volume of open market transactions. Repo-agreements were most extensively employed in the open market, consistent with the BNB restrictive monetary policy pursued. The employment of three interest rate levels on reverse repurchase agreements dependent on the term of the transaction resulted in an increase in their average term. On the other hand, reverse resale agreements were concluded at regular auctions with a term of 14 days and the market interest rate was applied. Interest rates on BNB repo-purchases were set by the Monetary Policy Committee, established in September 1994 as per resolution of the Managing Board of the BNB.

Refinancing of Commercial Banks in Foreign Currency

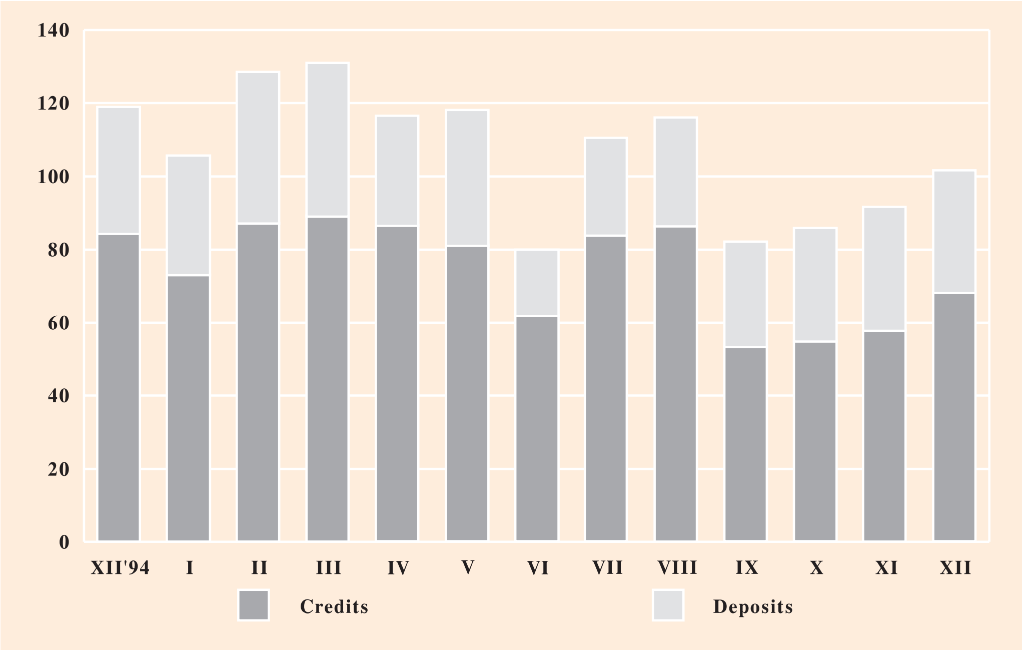
The absence of a special financial institution for funding import/export operations did not result in a significant reduction in BNB refinancing in foreign currency over 1995.

Foreign Exchange Credits

The BNB extended 3-month discount loans to commercial banks against a pledge of commercial paper (promissory notes). The volume of foreign exchange credits slightly and unevenly decreased. By the end of 1995, credits in foreign exchange extended to commercial banks totaled USD 68.2 million compared with USD 84.3 million in 1994 – a decrease of USD 16.1 million or 19.1% over 1994. Forex credits were denominated solely in US dollars and Deutschemarks, and the interest rates applied on them matched last year's level of 9%.

REFINANCING OF COMMERCIAL BANKS IN FOREIGN CURRENCY IN 1995

(million USD)



Source: BNB.

Foreign Exchange Deposits

In addition to forex credits, the BNB extended forex deposits to commercial banks. The volume of BNB forex deposits in 1995 remained unchanged, except for the relatively dramatic fall in June which was restored in the following month. By the end of the reporting period, the volume of forex deposits totaled USD 33.2 million compared with USD 34.4 million by end-1994 – a decrease by a mere USD 1.2 million or 3.5%. Forex deposits were denominated in US dollars and Deutschemarks. Interest rates on forex deposits remained unchanged from the previous year's level: between 6.5% and 8% per annum on USD-denominated deposits and 7% per annum on DEM-denominated deposits.

Minimum Reserve Requirements

In 1995, minimum reserve requirements continued to be employed by the BNB as a monetary policy tool. To offset the ease of monetary policy, consistent with the cut in the basic interest rate, the BNB included in its package of measures an increase in the minimum reserve requirements. On 6 April 1995, the minimum reserve requirements were raised from 10% to 11%, to be applied per the March regulation, and to 12% for application per the April 1995 regulation. As of 25 April 1995, government securities and commercial bank cash in foreign currency is no longer eligible for inclusion in meeting minimum reserve requirements. In compliance with the January 1995 regulation, commercial banks were permitted to hold in foreign exchange up to 50% of their reserves on attracted foreign exchange deposits. A rise in reserve requirements in foreign currency, from 20% to 50%, was permitted provided that the released funds were used for a purchase of government securities which would be blocked.

The interest accrued on minimum reserve requirements held in levs was 12% per annum, and since 8 May 1995, 10% per annum. To spur nonbank financing of the cash budget deficit, the BNB continued to accrue interest equal to 1/2 of the basic interest rate effective in the respective period on minimum required reserves in levs held by commercial banks and the SSB with the BNB, in an amount equal to the nominal value of the book-entry government securities sold by them to natural and legal persons, nonbank enterprises. Subsequently, the Board of the BNB determined the government securities sales to companies and individuals to be effected prior to the 21st of each month, i.e. reverse repurchase was not allowed for 10 days.

In July 1995, the cut in the basic interest rate was followed by a decrease in the interest rates on minimum reserve requirements from 10% to 8% per annum. Over the same month, the BNB Board decreased minimum reserve requirements by one percentage point (from 12% to 11%), aiming at reducing the spread between commercial bank lending and deposit rates which stood high irrespective of the significant cut in the basic interest rate.

By the end of 1995, minimum reserve requirements totaled BGL 55,174 million, a 37% increase from one year prior.

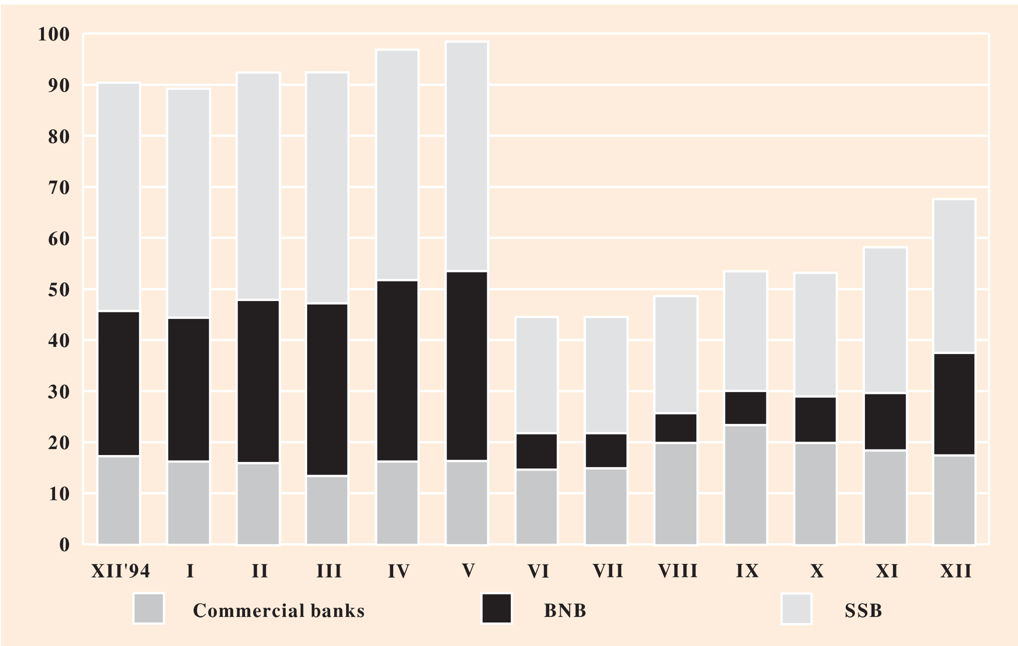
Interrelationships between Commercial Banks

Credit Resources

By the end of 1995, debt on interbank deposits was BGL 47,529 million, a decrease of BGL 14,376 million (23.2%) compared with end-1994 when it was BGL 61,905 million.

VOLUME OF THE MONEY MARKET IN 1995

(billion BGL)



Source: BNB.

This was mainly the result of the measures undertaken to rehabilitate the Economic Bank and Mineralbank, whereby they repaid their obligations of BGL 22,292 million to the SSB by the end of June 1995. If the above reduction is disregarded, the debt on interbank deposits increased by BGL 7,646 million or 12.3%. Despite the significant reduction by the end of the year, the debt on resources provided by the SSB made up the largest share, BGL 29,956 million or 63%.

Interbank Market Interest Rate

The average interest rate on credit extended in the interbank market was 50.8%. Analysis of the interbank market interest rate indicates a persistently high cost of credits in levs over the whole year. The spread moved within the range of 3 to 3.5 percentage points over the year, irrespective of the changing basic interest rate in absolute terms, and in January alone it displayed even a higher value (approximately 4 percentage points). Some commercial banks exchanged mostly short-term resources at a rate below the average basic interest rate for the respective period.

Despite the high spread, by the end of the year free monetary resources of commercial banks were channeled to repo-agreements with the BNB, given the deteriorated banking system liquidity and real risks of delayed repayment of credits exchanged between commercial banks.

5. Interest Rates on Commercial Bank Operations

Deposit Rates

During 1995, commercial bank rates on time deposits in levs which prevailed followed the changes in the basic interest rate. Over the first quarter, despite the insignificant nominal change, interest rates deflated by the consumer price index became positive, and savers' real profit approximated 3%. The new real deposit rates exceeded those registered in the first and fourth quarters of 1994 when the real losses were 3% – 4%. As a result, savers' preferences dramatically changed, opting for investment in time deposits in national currency.

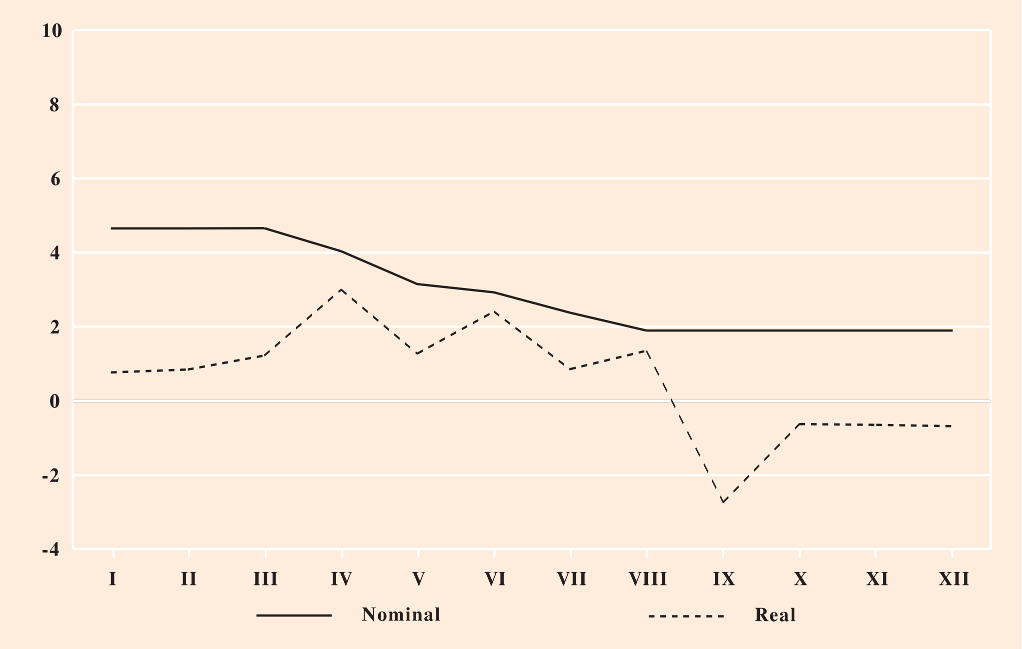
Over the following five months, interest rates on time deposits declined, consistent with the cut in the basic interest rate, but stood positive in real terms. Between January and August 1995, cumulative positive real savers' profit in levs exceeded 12% and halved the losses sustained in 1994. This contributed to the revived confidence in the national currency. In addition, the significant differential between deposits in levs and in foreign currency, coupled with a seasonally positive trade balance, encouraged the inflow of foreign currency and supported the balance of payments.

During the last four months of the year, the above trends were reversed. Deposit rate decline halted, since the basic interest rate was sustained at its lowest level after liberalization. Despite the lower inflation rate compared with the corresponding period in 1994, real deposit rates became negative. Between September and December 1995, the savers' losses accounted for around 5% in real terms.

The annual real interest rate of over 7% proved to be significant relative to the losses sustained in 1994. Nevertheless, a possible new erosion of real money demand, and consequently the deposit base, is cause for concern. Declining confidence in the lev and the progressively deteriorating banking system, having begun by end-1995 and strengthened in early 1996, also contributed to this effect.

MONTHLY INTEREST RATES ON ONE-MONTH DEPOSITS IN 1995

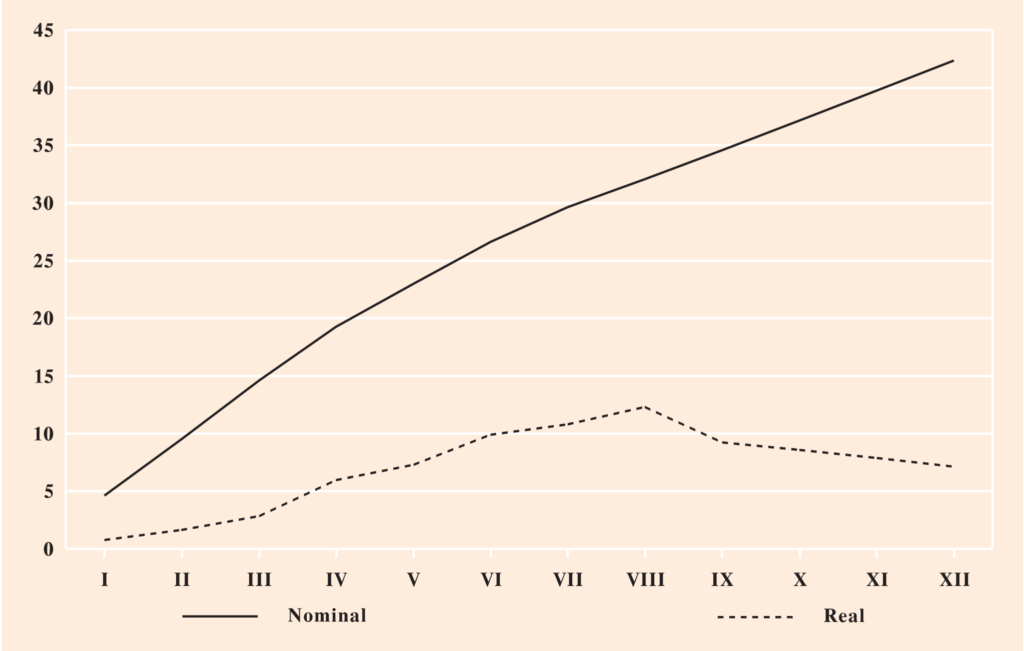
(%)



Source: BNB.

INTEREST RATES ON ONE-MONTH DEPOSITS IN 1995
(cumulative as of January 1995)

(%)



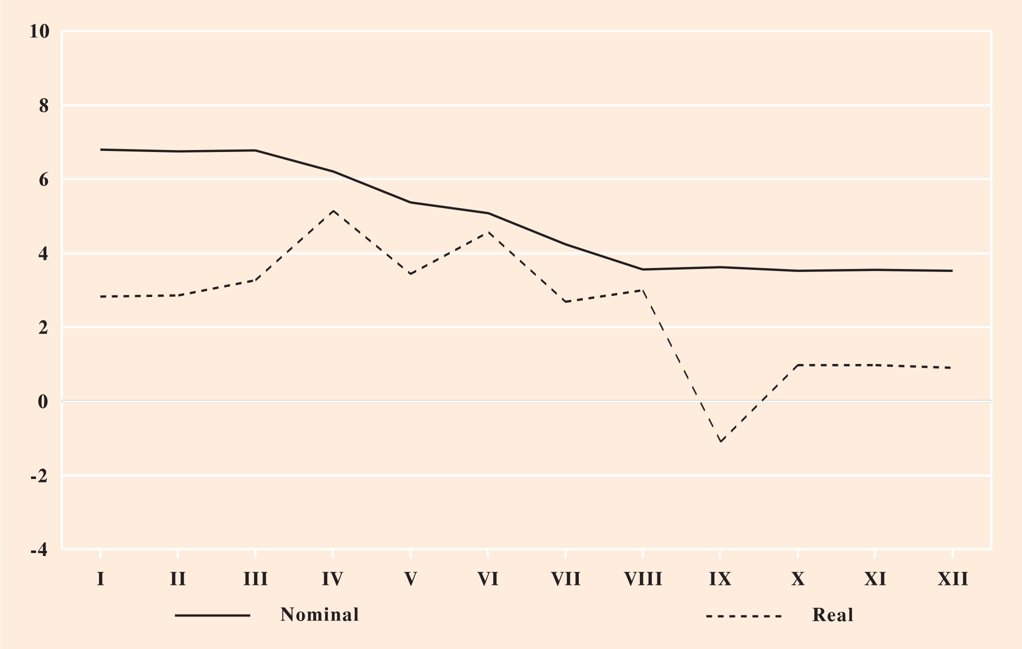
Source: BNB.

Lending Rates

In 1995, significant changes occurred in commercial bank interest rates on short-term credits extended to companies of the real sector. In most of 1994, lending rates were negative in real terms (approximately 9% per annum), though too high in nominal terms. In 1995, they fell nominally but became positive in real terms.

MONTHLY INTEREST RATES ON SHORT-TERM CREDITS IN 1995

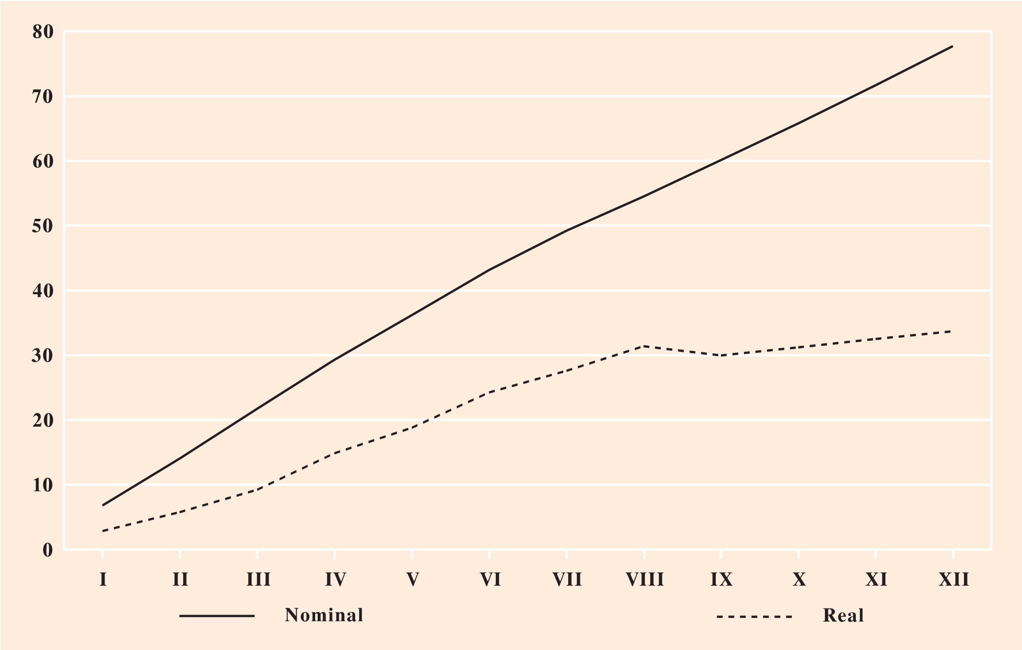
(%)



Source: BNB.

INTEREST RATES ON SHORT-TERM CREDITS IN 1995
(cumulative as of January 1995)

(%)



Source: BNB.

As a result, the interest rate burden increased dramatically, and despite the recovery which occurred in the real sector, it shifted almost entirely to the banking system due to scarcity of loanable funds. The decline in nominal lending rates was consistent with the cut in the basic interest rate, but the spread was sustained in nominal terms. The real monthly rate moved in the range of 2% to 5%, and cumulative real interest rate exceeded 31% in the first eight months of the year. In the following months, the monthly rate fell below 1% and in September was negative.

However, the real annual interest rate burden increased to about 34%. This suggests that the heavy interest burden placed on the debtors may be unbearable for most of them, resulting in an accumulation of new losses irrespective of the slight improvement in economic conditions in the country. At the same time, a number of commercial banks should be criticized about the disbursed credits, the repayment of which was uncertain given the interest rate levels. Under these conditions, despite the signs of recovery in the real sector, credit expansion is inconsistent with the BNB monetary policy goals.

Interest Rate Differential

In spite of the significant reduction in the basic interest rate in 1995, the interest rate differential between lending and deposit rates was sustained in nominal terms. The prime reason behind this adverse for the real sector trend is the deteriorating quality of the portfolios of a number of banks. In addition to bonds issued under the LSNC, the number and amount of classified loans, subject to provisioning, increased in banks' portfolios as well. However, the possibilities to improve commercial banks' efficiency by reducing their current and investment costs should not be overlooked.

Under these circumstances, deposit rates should be maintained at a positive level to strengthen savers' confidence in order to provide sufficient loanable funds for the government and nongovernment sectors by increasing money demand. At the same time, only strict financial discipline both in companies and in banks will help improve the quality of banks' credit portfolios. This will lead to a reduction in the interest rate differential between lending and deposit rates which will relieve the interest burden on the country's economy. Thus, the economic recovery would be boosted despite the ongoing crowding out of the real sector from the credit market.

6. Issuing Activities

Volume of Issues

By the end of 1995, currency in circulation outside the BNB vaults totaled BGL 68.6 billion, an increase of BGL 25.5 billion, or 59.2% compared with 1994 year-end. By end of the first half of 1995, currency in circulation increased by BGL 8.3 billion, or 19.3%.

As in previous years, the BNB was more active in issuing currency during the second half of the year.

The share of currency in circulation in the total money supply rose from 10.3% at 1994 year-end to 11.8% at 1995 year-end.

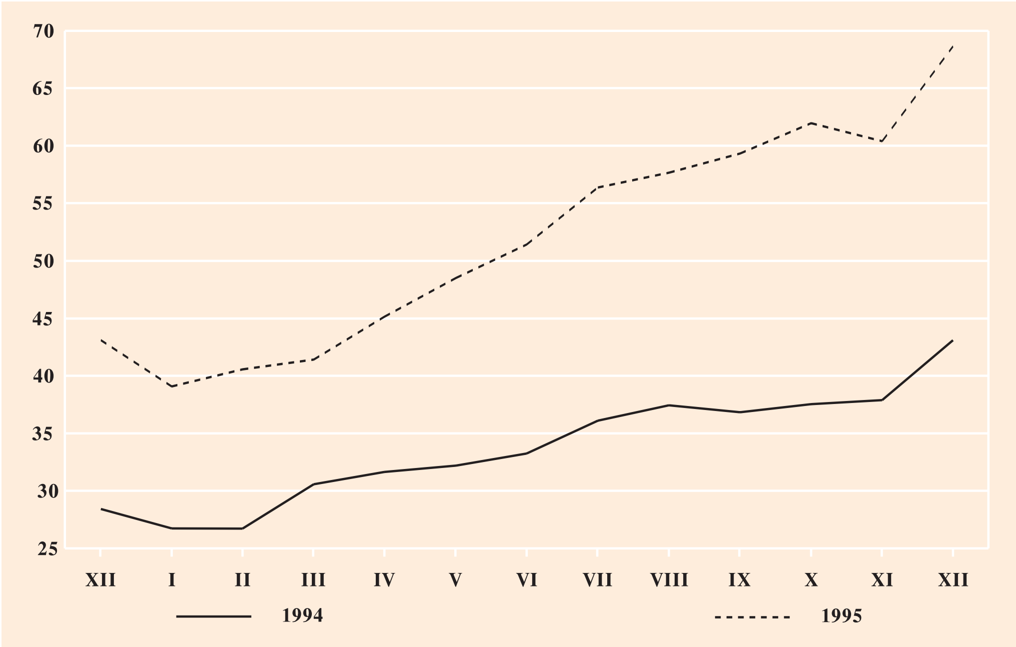
No significant changes occurred in the factors directly or indirectly affecting the currency supply: moderately high inflation, nominal income growth, peculiarities in the country's payments system, corporate indebtedness, and underdeveloped money market.

An analysis of currency in circulation outside BNB vaults in 1995 indicates a decline from the end of 1994 through January 1995. In the following months, currency outside BNB vaults increased slightly and by the end of the first quarter it reached BGL 41.4 billion, or a BGL 1.7 billion decrease from end-1994. In the next three months, currency in circulation grew by BGL 10 billion in total, or by 24.1%. The high growth rate of currency outside BNB vaults during the second quarter is basically due to increased incomes of individuals, caused by Council of Ministers' decrees raising the levels of social pensions, setting a new minimum wage, and increasing compensation of certain incomes of the population in 1995. Another factor behind this growth was the introduction in the banking system of the new Chart of Accounts which forced a number of banks and bank branches to increase their cash holdings to be able to normally effect payments in the transition period. During the following three months, currency outside BNB vaults continued to grow, posting a BGL 7.9 billion increase compared with end-1994's level, or increasing 15.4%. During the last quarter of 1995, currency in circulation displayed the typical of this period movement. In October and November, currency outside BNB vaults rose by BGL 1.1 billion, or 1.8%, and in December alone by BGL 8.3 billion, or 13.7%.

Growth in currency outside BNB vaults in December matched that in 1994, due mainly to increased money demand by individuals for Christmas and New Year spending, payment of extra remuneration, rising incomes of the population pertaining to the advance payment of wages, cash payments effected by companies, and growing cash holdings in commercial bank vaults.

CURRENCY OUTSIDE BNB VAULTS

(billion BGL)



Source: BNB.

Another factor responsible for the increased cash in hand was the liquidity squeeze faced by some banks, prompted by massive withdrawals of individuals' deposits from one bank and depositing them in another bank or investing the withdrawn funds in government securities.

Cash in the vaults of commercial banks increased considerably, from BGL 4.6 billion at 1994 year-end (increasing by BGL 0.2 billion at the end of the half-year) to BGL 7 billion by the end of 1995. This amounts to growth of BGL 2.4 billion, or 52.2%. Enhanced cash liquidity of commercial banks at the end of 1995 was due to expected withdrawal of deposit funds by individuals for the Christmas holidays, the long distances money had to travel between commercial bank branches and BNB branches, technological peculiarities of processing money, and inconveniencies regarding its immediate deposit in BNB branches.

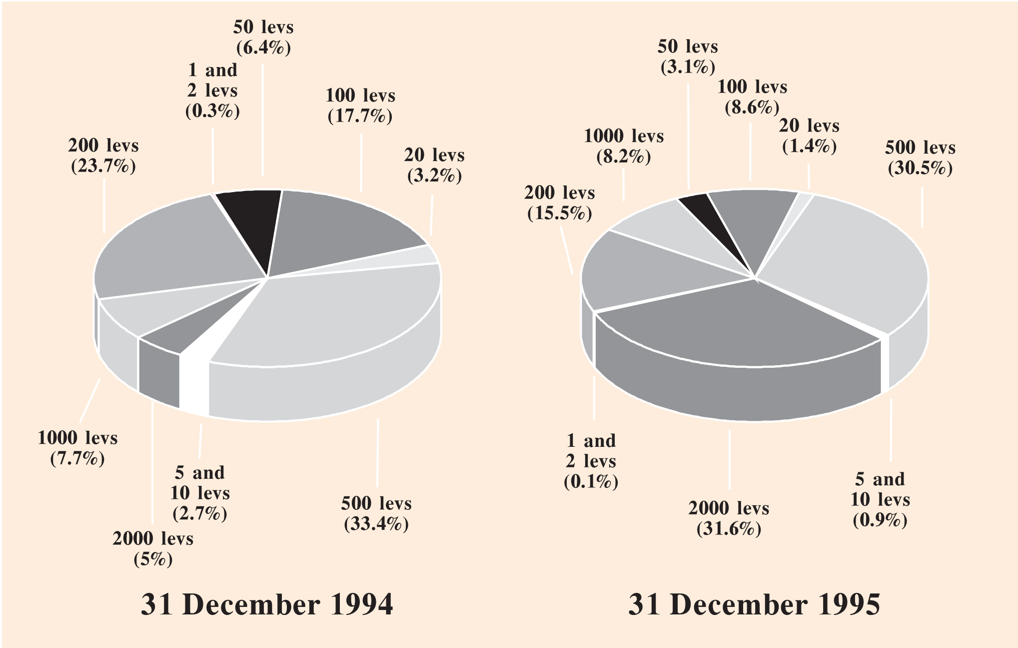
As a result of BNB issuing activities and commercial bank policy concerning cash holdings, currency outside banks reached BGL 61.6 billion by the end of 1995, a growth of BGL 23.1 billion from 1994 year-end, or 60%. At the end of the half-year, currency outside banks rose by BGL 8.1 billion, or 21%.

Denomination Composition

Changes occurred in the composition of currency denominations during 1995 compared with end-1994. Banknotes of higher denominations (BGL 100, 200, 500, 1000 and 2000) proved to be a more convenient form of currency. By the end of the period in review, high denomination banknotes accounted for 94.4% of the total value of denominations, against 87.5% in 1994 year-end, and 74.6% in 1993. The share of these denominations in the total amount of banknotes comprised 41.4% at 1995 year-end, against 30.9% at 1994 year-end, and 19.6% in 1993.

The BNB continued to gradually withdraw old-design banknotes after normal wear. In this regard and with the goals of improving denomination composition of banknotes in circulation, creating better conditions for the service of bank clients, maintaining clear money circulation, the BNB made payments primarily with banknotes of the new issues. The needs of lower-denomination banknotes were satisfied by coins, issued in 1992. Banknotes of 1, 2, 5 and 10 levs (issues 1962 and 1974) will be legal tender until 31 December 1996 and after their normal wear they will be withdrawn more extensively from circulation and will be exchanged until the end of 1998 only at BNB cash-desks.

DENOMINATION COMPOSITION IN THE BANKNOTE ISSUE*



* The share of denominations is based on values.

Source: BNB.

The "average" banknote in circulation in 1995 had a face value of BGL 128 versus BGL 93 in the first half of 1995 and BGL 76 at 1994 year-end. The increase in the face value of the "average" banknote in circulation was a result of higher denominations in circulation in 1995, on the one hand, and the smaller number of banknotes in circulation in 1995, on the other hand. Compared with 1994 year-end, their number fell by some BGL 32 million during the reporting period with the withdrawal of normally worn banknotes of lower denominations.

Coin Issues

In 1995, the BNB continued to issue commemorative coins in compliance with established practice. In January 1995, the Artistic Design Committee to the BNB Managing Board approved the projects of the following coins: "Rozhen Peak Astronomical Observatory," commemorating Bulgaria's association with the European Community, "100 Years Olympic Games," dedicated to the Olympic Games in 1996, "110 Years of the Union of Eastern Rumelia with the Bulgarian Principality" and "50 Years FAO," celebrating the 50th anniversary of the establishment of the Organization on Food and Agriculture to the UN. By a Board resolution, the BNB developed and motioned for approval to the Council of Ministers the face value, subject, form and design of the four commemorative coins, issue 1995, which were then put into circulation.

In compliance with a BNB Board resolution, the work on the development of projects of four silver commemorative coins, issue 1996, started in 1995: one on an Olympic subject, two on historic subjects, and one of the ECU series of coins, celebrating Bulgaria's association with the European Community.

Pursuant to a BNB Board Resolution of 1992, circulating coins of 1, 2 and 5 stotinkas (issues 1962, 1974, 1981, 1988, 1989 and 1990) ceased being legal tender as of 1 January 1996. After this date until 31 December 1997 they will be exchanged at the cash-desks of the BNB and its branches.

Precious Metals

By the end of 1995, the BNB gold reserves were 1,031,222 troy ounces.

Over the reporting period, the increase in BNB circulating gold in the Main Depository continued. As in the previous two years, growth in gold reserves was effected chiefly through purchases of bullion from domestic producers and coins from individuals.

At the end of 1995, circulating silver in the Main Depository of the BNB decreased compared to 1994 due to conclusion of domestic and foreign transactions.

Platinum increased due to purchases from abroad. The purchases were made in order to recover the metal used for the minting of the platinum coins.

In 1995, precious metals sales to domestic producers increased compared to 1994. The prime reason for this was enhanced demand from licensed private companies for the making of jewelry.

PRECIOUS METAL STOCK IN THE BNB

(in troy ounces)[1]

Indicators	31 December 1994	31 December 1995
Gold reserves of the BNB[2]	1,031,222	1,031,222
Circulating precious metals[3]		
Gold	41,160	51,000
Silver	617,589	530,548
Platinum	5,351	11,949

[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.

7. Foreign Exchange Policy

In 1995, the BNB's foreign exchange policy was designed and operated under relatively favorable economic conditions. Its major objective was to restore and strengthen confidence in the Bulgarian lev, because a confidence problem in the autumn of 1994 had prompted a dramatic rise in interest rates. Turnaround in the real sector and significantly subdued inflation contributed for much of the year to the achievement of this goal. However, despite the return to growth in the economy, the pre-crisis levels of the real GDP were still distant, and real gross investments remained still inconsistent with long-term growth. Moreover, a considerable portion of the surplus on the balance of payments current account was offset by large repayments on the country's foreign debt. Under such conditions, the foreign exchange policy was seen as a major tool of economic adjustment and a means to control the rate of internal and external devaluation of the lev. In 1995, the BNB employed this instrument to support the monetary policy tools, responding to changes in the national economy and the external environment.

Throughout 1995, the gradual lowering of the basic interest rate was repeatedly "proved" by pressure exerted both on internal prices and the exchange rate – less significant in June and August and more strong in November and December. With the BNB seeking to gradually establish a new equilibrium level, the role of its forex operations increased.

Forex Market

Foreign currency in the banking system and in the forex market was supplied mainly by the chemical and metallurgical industries, machine building, metal processing, light and food industries, and tourism. Final buyers of foreign currency were enterprises of the oil processing and energy sector, the printing industry, as well as importers of automobiles, metals and sugar, among others. Foreign currency was demanded and supplied by the tobacco and footwear industries, construction, transport and telecommunications, and travel agencies.

The real sector supplied and demanded foreign currencies in the interbank forex market. In addition to spot transactions, made on the second working day following the operation, which traditionally dominated the forex market, a new type of transaction, tom value, was introduced at the end of 1994 and used more extensively in 1995.

FOREIGN CURRENCY SPOT AND TOM VALUE TRANSACTIONS

(million USD)

Volume	A. Bought	B. Sold	C. Balance
1. BNB with customers	98.9	629.7	-530.8
2. Fully licensed commercial banks with customers	4,165.0	3,559.9	605.1
3. Interbank, fully licensed commercial banks	1,049.1	1,072.9	-[1]
4. Interbank, BNB included (3+6B)	1,435.2	1,459.0	-[1]
5. BNB, total (1+6)	1,205.7	1,015.8	189.9
6. BNB with fully licensed commercial banks	1,106.8	386.1	720.7
7. Intercorporate[2]	14.8	14.8	-
8. Total with customers (1+2+7)	4,278.7	4,204.4	74.3

[1] Some imperfections in reporting lead to a minimum difference between purchases and sales which are identical in the interbank market.
[2] The data is for the minimum volume of the market as currently monitored.

Source: BNB.

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

(%)

Interbank turnover/forex bought from customers (commercial banks)	25.8
Interbank turnover/forex sold to customers (commercial banks)	30.1
Interbank turnover/forex bought from customers (commercial banks and BNB)	34.2
Interbank turnover/forex sold to customers (commercial banks and BNB)	34.8
Net BNB purchases/total purchases to customers	4.5
Net BNB purchases/balance of banks with customers	255.6

Source: BNB.

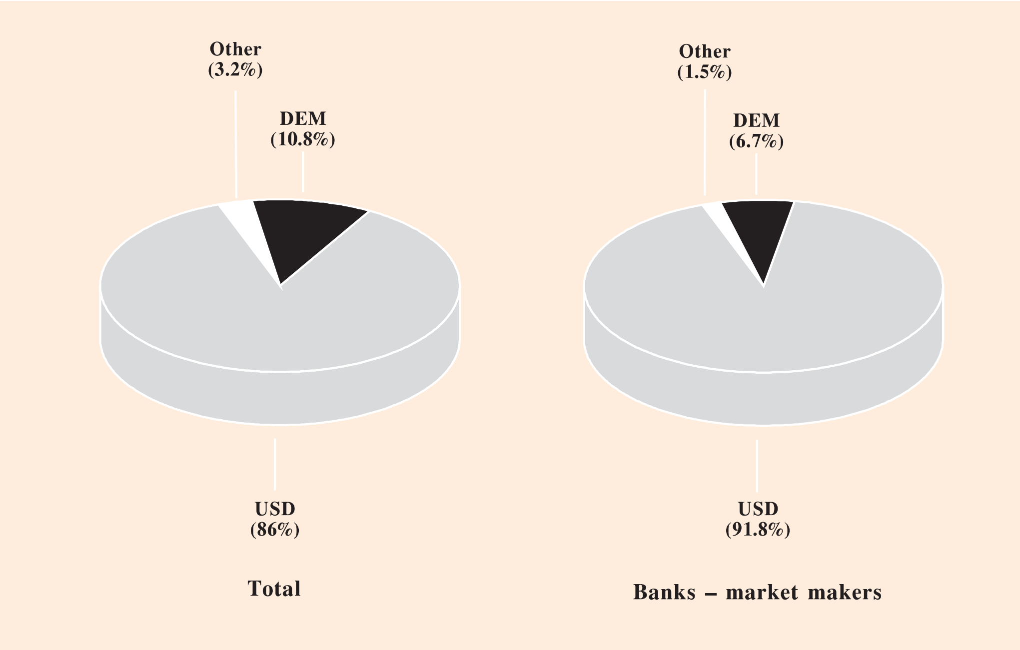
The total volume of foreign exchange transactions, including double reporting of some transactions, recorded by the BNB totaled USD 6.8 billion in purchases and USD 6.8 billion in sales, a twofold increase compared to 1994. To some extent, this increase is purely technical: the number of banks reporting their operations daily in the BNB for the central exchange rate fixing rose. Exporting customers of fully licensed banks were the major source of foreign currency inflow in the forex market, contributing USD 4,165 million, an 83.5% increase from 1994. The volume of foreign currency rechanneled to customers grew by 61.1% or USD 3,559.9 million. The surplus of USD 605.1 million was entirely sold through the BNB. Forex sales of fully licensed commercial banks exceeded this surplus, reaching USD 720.7 million. Foreign currency was most actively traded in the interbank market whose volume increased by 119.5%, accounting or not for the two-way exchange of foreign currency between the BNB and fully licensed commercial banks.[35]

The BNB net foreign currency purchases (USD 189.9 million) were less than the surplus realized by the fully licensed commercial banks, a result of the excess of sales to customers over purchases by customers. This reflected dollar sales for foreign debt payments and for energy sector needs. BNB operations with domestically

[35] The group of "fully licensed commercial banks" includes banks submitting information required for the daily central exchange rate fixing. The group of "customers" includes firms, budget-supported organizations, financial houses and domestically licensed banks, including branches of foreign banks. Classification of domestically licensed banks and financial houses as customers is conditional, since they act as intermediaries both of firms and interbank market participants. Operations with customers both in sales and purchases involve partially resales in the interbank market. Annual data also reflects inclusion of new fully licensed banks submitting information for the calculation of the central exchange rate fixing during the second half-year. Consequently, the operations reflecting transactions of those banks as counterparties during the first half-year were assigned to the group of fully licensed commercial banks whereby a difference, though insignificant, between the section on the first half-year of the present report and that in the semiannual report has appeared.

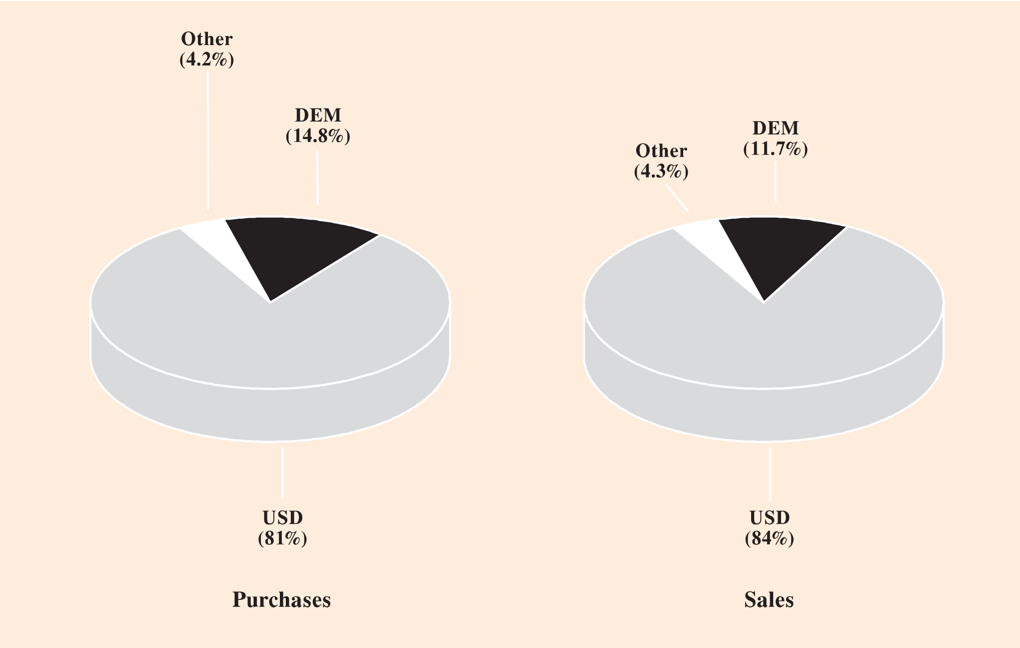
licensed banks resulted in a surplus for the BNB. The BNB purchases totaled USD 1,205.7 million. Of these, USD 1,106.8 million (91.8%) was purchased from fully licensed banks, USD 97.2 million (8.1%) from domestically licensed banks, and USD 1.7 million (0.1%) from companies. The BNB sales totaled USD 1,015.8 million. Of these, USD 386.1 million (38%) was sold to fully licensed commercial banks, USD 48.6 million (4.8%) to domestically licensed banks, and USD 2.2 million (0.2%) to financial and brokerage houses (one intervention in early January), USD 97.4 million (9.6%) to the energy sector, USD 73.5 million (7.2%) to budget-supported organizations (this group includes hospitals, national electronic media, municipal administration), and USD 408 million (40.2%) for foreign debt service.

STRUCTURE OF FOREIGN EXCHANGE MARKET IN 1995



Source: BNB.

PURCHASES FROM AND SALES TO CUSTOMERS IN 1995



Source: BNB.

The US dollar retained its dominant position in the domestic forex market since it plays a key role in foreign trade turnover, which was also evident in the interventions in the forex market and foreign debt repayments.

The US dollar was the preferred currency in the corporate exchange of foreign currency for Bulgarian levs in the commercial banks; less so was the Deutschemark. French, Swiss and Belgium francs, British pounds, Italian lire and Austrian shillings were also traded. Generally, transactions had a daily character. The most active participants in the forex market were foreign trade companies, financial houses, and sole proprietors, while enterprises from light and heavy industries participated only sporadically. Intercorporate market quotations were mostly pegged to the central exchange rate, rarely to the bid and offer quotations of servicing banks, or to the average exchange rate of bid and offer quotations. Sometimes forex transactions were made at a mutually agreed upon rate – usually an average exchange rate between the bank's bid and offer quotations.

Exchange Rate

Bilateral Exchange Rate[36]. As the US dollar plays a key role in Bulgaria's international settlements and foreign currency trade, as well as in assessing prices for foreign trade, the bilateral BGL/USD exchange rate is the benchmark rate in the domestic forex market. In practice, the BNB defines its operating forex policies in regard to the movements in the central USD/BGL exchange rate. On 29 December 1995 the Bulgarian lev had lost 6.52% against the US dollar compared with 30 December 1994, estimated at the central exchange rate quotations. The average nonweighted value of the central BGL/USD[37] exchange rate over the year was BGL 67.168 per one USD. The average weighted[38] value of the exchange rate of all BNB transactions and fully licensed banks was BGL 67.207 per one USD.

Effective Exchange Rate. The BNB estimates of lev movements are based on indirect calculation of so-called effective exchange rate – the lev rate to major reserve currencies. The empirical measure of the *nominal* effective exchange rate to the IMF basket of currencies consisting of the special drawing rights (SDR), much like the basket of currencies composing the former "foreign exchange lev"[39], indicated an 8.2% nominal devaluation of the lev against the SDR in 1995. As inflation in the country (based on consumer price index and industrial output producer price index) was fourfold higher, the *real* effective exchange rate of the national currency exhibited a sizable appreciation. Such movements in the real effective exchange rate, adversely affecting the competitiveness of Bulgarian exports, had a depressive effect on the otherwise high growth rate of exports during the year.

Along with the effective exchange rate, movements in the exchange rates of the lev to the currencies of Bulgaria's major trading partners were also essential indicators. Most of these currencies are not reserve currencies and not all of them are used for settlements with these countries. Consequently, changes in the balance of payments with any particular country generated pressure first on the reserve currencies, which only then was passed through the individual exchange rates of these currencies to one another. The lev devalued against most currencies of the above ten countries (14.5% to the French franc, 13.7% to the Deutschemark, 13.3% to the Macedonian denar, 8.9% to the Italian lire, 7.9% to the Greek drachma, 6.5% to the US dollar, 5.8% to the British pound). Against the remaining of the above ten currencies, the lev rallied (54.7% to Ukrainian karbovanets, 48.9% to the Turkish lira, 20.3% to the Russian rouble). The rally was big enough to amount to an overall appreciation of the lev to the above ten currencies of 4.97% as weighted by the country's foreign trade volume in the period January – September 1995 (4.94%

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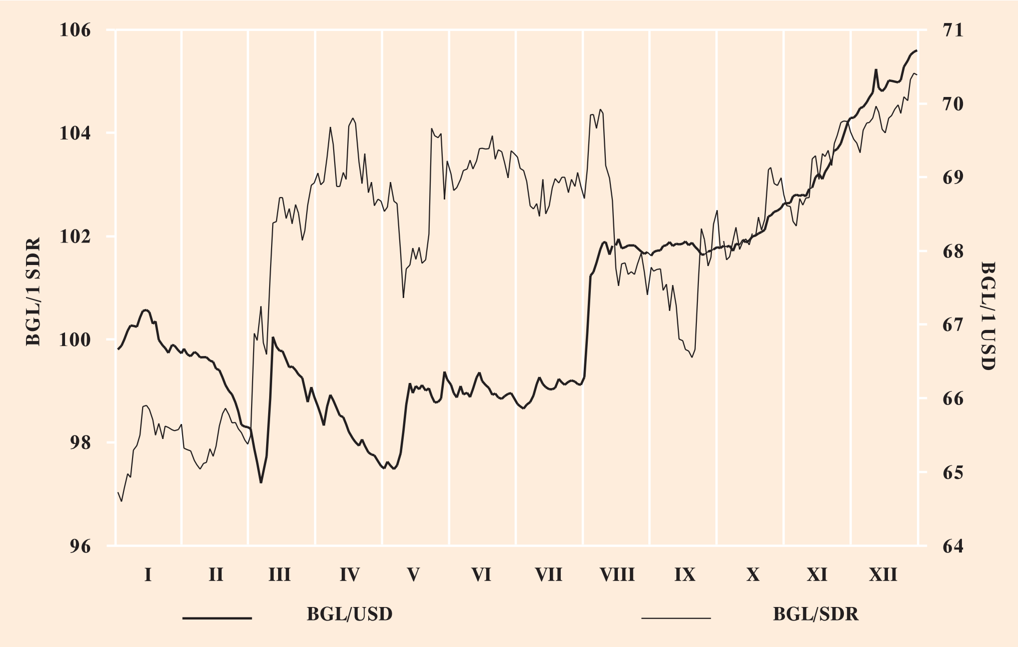
[36] The rate at which the Bulgarian currency is exchanged for the currency of a particular country.
[37] Equal to the arithmetic mean of the valid central exchange rates over the year.
[38] Transactions in volumes are used.
[39] The SDR is composed of five international currencies with different weights: US dollar, Deutschemark, Japanese yen, French franc, and British pound.

weighted by volume of Bulgaria's exports, and 5% weighted by volume of its imports). Appreciation of the Bulgarian lev to the latter three currencies refers primarily to their devaluation to the US dollar, which was later evidenced in their devaluation to the lev. These currencies, including the denar, are not reserve currencies and are not traded in the Bulgarian interbank market. However, pressure from exporters and importers on a change in the BGL/USD exchange rate and on the lev rate to the major currencies, and this to be commensurate with the rates of the latter currencies to the currencies of Bulgaria's major trading partners, can indirectly impact the forex market.

CENTRAL EXCHANGE RATE OF SDR AND US DOLLAR IN 1995



Source: BNB.

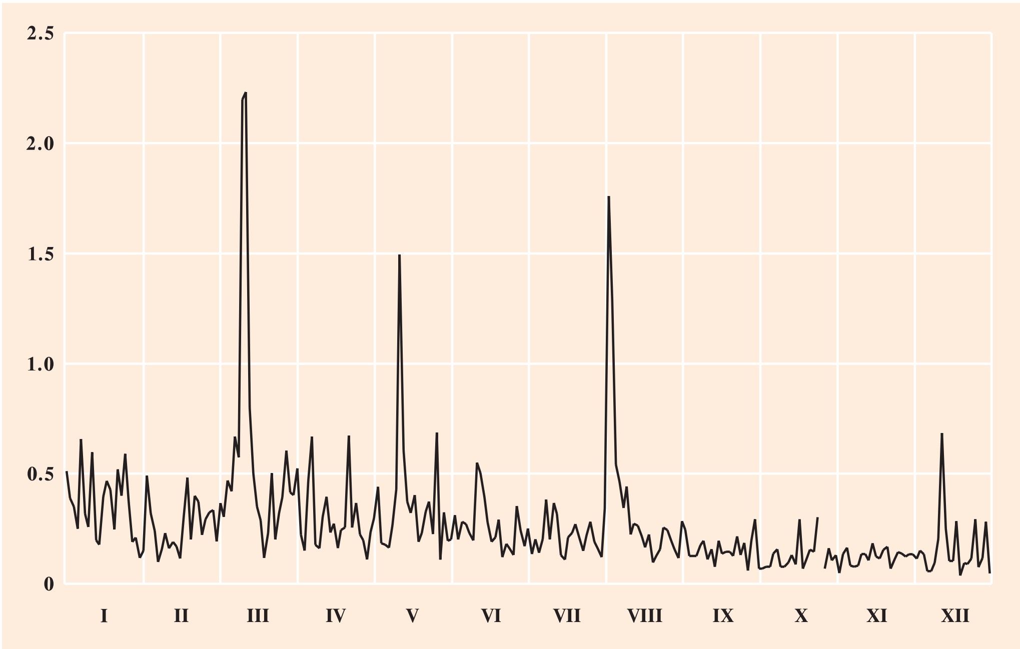
Actually, lev movements against the US dollar indirectly affected the effective exchange rate, even though the US dollar is the benchmark currency used in defining the exchange rate policy in the country. This role of the US dollar is also displayed in the smoother curve of movement of the lev exchange rate to the US dollar. Diversification of bank capital made it possible for an unpegged movement of the lev to any individual currency, including to the benchmark currency. For example, US dollar devaluation against other major currencies, during certain periods, was coupled with lev devaluation against those currencies but to a much lesser extent. Thus, both the lev and the above currencies gained against the US dollar. The seasonal pressure on the lev in winter and spring was reflected in the SDR exchange rate as well. However, a weaker US dollar in the international markets put the lev in a stronger position, but a trend generally assessed as atypical of this period evolved. That is any temporary gain in the US dollar in international markets was accompanied by a pressure for a sharp appreciation of the dollar rate to the lev in the domestic market.

The seasonal pattern of a lev increase in summer and gradual downward pressure on the lev at the end of it was once again more clearly seen in the effective exchange rate when the modest rally in the US dollar in international markets reflected on the bilateral BGL/USD exchange rate. Since autumn 1995, the lev continued to gradually decrease against the US dollar both in effective and bilateral terms. In addition to seasonal factors, a reduction in the basic interest rate was made in a series of steps in the spring and summer which also contributed to this decrease. On 1 August, the basic interest rate was lowered to 34% thus equaling the 1995 forecast for the consumer price index. Although the two indicators did not refer to one and the same period – the second involved January – December 1995, while the first covered the twelve-month period beginning August 1995 – the coincidence had a psychological effect. Thus, pressure on the forex market – the typical autumn tension in the forex market was brought forward to August – signaled that reduction in interest rates should be halted.

When interest rates hit their breaking point in August, shock waves passed through the entire banking system and the economy. The first intervention of the BNB in support of the lev and the new interest rate level was undertaken at the beginning of August. Subsequent attempts to put the lev under continued pressure due to expectations about its gradual devaluation resulted in substantial drain on the official foreign exchange reserves. On the other hand, BNB's interventions in the forex market could only prevent a more dramatic "plunge" of the lev, without being able to counteract the long-term trend evolving with regard to fundamental and rate-formating factors.

VOLATILITY OF THE BGL/USD EXCHANGE RATE IN 1995

(%)



Source: BNB.

Volatility of the BGL/USD exchange rate in the interbank market was relatively low and even. On an average monthly basis, it ranged from 0.12% to 0.57%: 0.36% on average over the first half-year, 0.19% in the second half-year, and 0.28% for the whole 12-month period[40]. The peaks reflected the strong impact of the international market on the Bulgarian market (2.23% on 14 March and 1.5% on 15 May), pressure on the lev consistent with equally low basic interest rate and the estimates for the annual consumer price index (1.76% on 3 August), and seasonal pressure traditionally exerted at year-end (0.68% on 8 December).

The market experienced difficulties related to the introduction of the new Chart of Accounts, but the dollar did not appreciate strongly during this period (end-May – early June) – this was anticipated in the forward transactions as well – a result mainly of the negligible pressure in covering open positions on these transactions.

[40] Since chronological registration of quotations became a fact in 1995, the volatility formula has been applied without modification where in the comparisons with the previous day the close rate is used instead of the central rate; the latter rate is only used to convert lev amounts to dollar amounts.

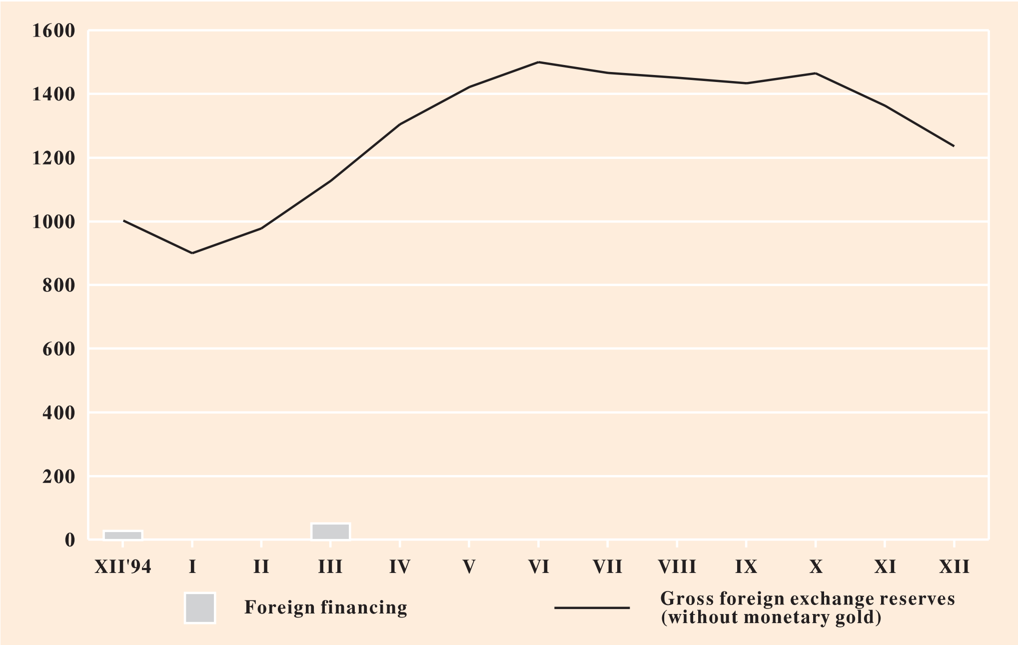
The BNB participated in the interbank market both to balance the effects on the exchange rate and as an internal source for accumulation of reserves needed for the foreign debt service. In early January, the central bank intervened to subdue the seasonal pressure on the lev and in mid-March and May to temper dramatic volatility. During the first half-year, its purchases prevailed over sales. During the second half-year, however, the amount of foreign currency sold by the BNB to banks (both fully and domestically licensed banks, the latter reported in the table in the group of "customers"), including for interventions in support of the lev in August and during the last three months, totaled USD 337.1 million. BNB sales comprised 80% of the foreign currency bought from banks during the second half-year (USD 423.9 million). This level of sales of foreign currency to meet foreign debt service, energy sector needs and budget-supported organizations almost matched the volume of sales during the first half-year. Thus, BNB became a net seller of foreign currency during the second half-year and reduced the volume of BNB net purchases during the whole year. As a result, the official foreign exchange reserves decreased.

Foreign Exchange Reserves

Foreign exchange reserves were used as the ultimate resource to balance payments on the current account and foreign debt service. The BNB's participation in the domestic forex market was determined by the amount and dynamics of foreign exchange reserves.

GROSS FOREIGN EXCHANGE RESERVES AND FOREIGN FINANCING IN 1995

(million USD)



Source: BNB.

From February 1995, sustainable foreign exchange reserves growth reached USD 1.5 billion by end-June due to the prevalence of foreign currency supply over demand in the interbank market. As this was not reversed in March and May when payments on foreign obligations were settled, it was an essential factor in the strengthening of the lev exchange rate. This period was historically determined by a drop in reserves in January and July when more sizable repayments on the foreign debt were made. The drop in reserves in January was stronger, while that in July was less so but continued in August, though more slowly. This is broadly a result of a reduction in the lev equivalent amount of reserves due to a stronger US dollar rather than a real decline. The decrease continued in September due to payments to creditors, even though the BNB remained a net buyer of foreign currency. The combination of internal speculative pressure following a temporary limit on the reduction of the basic interest rate and seasonal pressure on the balance of payments made the BNB a net seller of foreign currency during the last quarter of 1995. During this period, interventions in the forex market became the major tool for controlling the exchange rate. The drop in foreign exchange reserves, following a short-lived reversal in October due to reduced commercial bank refinancing in foreign currency by the BNB, deteriorated further. From USD 1,465.4 million at the end of October, it declined to USD 1,236.4 million by year-end.

After repayments on BNB external obligations, the sale of USD 408 million to the MF for settling obligations to foreign creditors, and service of BNB customers are taken into account, gross foreign exchange reserves had increased by USD 234.6 million by the end of 1995 from the previous year-end's level (USD 1,001.8 million). This increase was larger than the only source of foreign financing, the second tranche of the loan agreement in support of the balance of payments, received from Japan in March, totaling USD 48.5 million. Thus in 1995, net growth in reserves occurred as a result of BNB's operations in the domestic forex market. However, this increase was offset quickly in early 1996 to ensure regular settlements abroad and as a result of the stabilizing interventions of the central bank in the forex market.

V. Bank Supervision

The state of commercial banks deteriorated further in 1995. The increased share of nonperforming loans proved to be the major factor responsible for this. The Law on Settlement of Nonperforming Credits did not produce the expected results, that is the cleansing of banks' portfolios. Worsened credit portfolios of banks is a direct result of ineffective bank management: inadequate assessment of existing environment, nonobservance of the "prudence" principle, inadequate assessment of credit, liquidity and foreign exchange risks, overexposure to unviable sectors in the economy, and some problematic clients. Another factor responsible for the poor structuring of credit portfolios is the current ineffective legislation for defaulted debtors.

General improvement in economic conditions did not affect the state of banks, however. In such an environment, the central bank could not achieve the needed stabilization of the banking system through the conduct of its legally defined control function.

In 1995, the BNB undertook rehabilitation of two ailing state-owned commercial banks – Mineralbank and the Economic Bank. Even though the current legislation does not allow for bank bankruptcies, urgent measures were taken against the permanent and acute illiquidity of Agrobusinessbank, Plovdiv.

Considering the situation in the country, the bank supervision department developed a parallel system for monitoring (current control) commercial banks and the banking system as a whole while continuing its on-site inspections.

The system of off-site inspections involves monitoring and analysis of trends in the financial performance of banks, based on monthly, quarterly and annual reports furnished by banks. Efficient bank supervision requires an improved and accurate database to ensure proper and timely identification of noncompliance with established norms. Entirely new conditions in the transition to a market economy and reorganization in the banking system called for the creation of unified reporting standards and performance criteria. Financial statements and return forms of bank regulators formed the database of the off-site inspection system. By the middle of 1995, all banks had to implement the National Chart of Bank Accounts, which was to ensure comparability in assessing individual bank performance and reduce the time for processing and analysis.

Methods for assessing bank performance based on ratios, accepted and applied worldwide, were introduced. A system for assessment based on the US CAMEL system is being developed and tested. An early warning system is in the process of preparation, which would allow a more profound, detailed and accurate analysis of banks to reflect changes in legal regulation. In addition to off-site supervision, data on the financial status of banks is verified through thorough examinations in which all assessment criteria are employed, and on-site examinations. Reports of certified public accountants were also helpful. The combination of the European model of auditors performing basic on-site inspections and the US experience in supervisory examinations produced better and more reliable results. Improvement of certified public accountants' work and definition of their responsibilities are essential for improved bank supervision.

Experience gained over the past few years revealed the necessity to amend and supplement current legislation regulating bank activities and supervision. In 1995, the Managing Board of the BNB adopted Regulations No. 17 on bank investments as per Article 29 of the LBCA. Regulations No. 7 and No. 8 were also amended and supplemented. For a more complete analysis, additional reports were required from banks concerning the state of their credit portfolio, attracted funds, off-balance-sheet commitments, and investment in fixed assets.

1. Licenses

In accordance with recommendations, in 1995 issuance of licenses for bank institutions was limited. Applications were filed for obtaining a bank license from nine banks and two branches of foreign banks. The BNB Board granted licenses for bank operations to: Bulgarian-Russian Investment Bank Ltd., Sofia; Trakia United Private Commercial Bank Ltd., Plovdiv; Agricultural and Industrial Bank Ltd., Sofia; a branch of the Ionion and Popular Bank of Greece; a branch of the Beirische-Bulgarien Commercial Bank Plc., Munich, Germany.

One hundred and forty-six applications were filed to obtain a license for a financial house, and 66 for brokers. During 1995, no licenses were granted to financial and brokerage houses. As of 31 December 1995, newly licensed financial houses numbered 149, of which 27 were not authorized to conduct operations. The newly licensed brokers numbered 30, of which 18 were not authorized to conduct operations. Compared with 1994, due to revocation of licenses, the number of financial houses decreased by 14, and that of brokers by four. New licenses were granted to 288 exchange bureaus.

2. Off-site Inspection

In 1995, off-site supervision of banks was carried out along the following lines:

• Periodical examination of commercial bank reports submitted to the BNB to ascertain whether they are complete, comply with legal regulations and instructions for their enactment and whether the deadlines are being observed. Upon discovery of a violation, the banks were required in writing to rectify the inaccuracies. Throughout the year, information received from on-site inspections was used more often. Examiners not only demanded a response to their written findings in examinations, but also organized meetings with chief accountants and auditors of commercial banks where the problems of accounting methods and methods for reporting on bank regulators were discussed. In the cases when off-site control uncovered violations, temporary restrictions were imposed on the defaulted banks until the infringements were eliminated. Similar restrictions were imposed in regard to commercial banks' claims to the BNB – for example, in lev and foreign currency refinancing, and extension of a license. Adopted measures proved efficient for timely provision and accuracy of reports.

• Impaired liquidity of some banks required analysis based upon monthly information. The decisions for refinancing and restrictions were based on this information. As a result of these restrictions, some banks reduced their credit expansion compared to 1994. Additionally, a drop in the growth rate of banks' investment in financial and nonfinancial institutions was seen.

• Additionally, commercial banks had to furnish periodical information concerning the state of their credit portfolio, the attracted funds and their long-term assets. For that purpose a program was designed accompanied by instructions for its implementation.

• In 1995, work on developing an early warning system began. For this purpose, a consultant from the Central Bank of Netherlands was appointed under PHARE auspices. In addition, a group of experts working on the project was able to draw on the Dutch experience. Taking account of the consultant's opinion and drawing experience from the central banks of Netherlands, the Czech Republic and Hungary, the first stage of the project was completed to be discussed in May 1996 and entered for approval by the BNB Board.

• A quarterly detailed analysis of commercial bank performance was completed. In this respect, periodical meetings with the management of banks facing liquidity shortages were held. Concrete programs for their rehabilitation and elimination of existing problems were demanded. Implementation of the programs was monitored by examiners from the Bank Supervision Department; upon nonobservance of the programs, measures to restrict BNB refinancing to these banks were offered.

• Basic measures undertaken by bank supervision involved actions to restrict credit activity, reduce investment so that the ratios prescribed by Article 29 of the LBCA were observed, cut banks' overhead expenses, and improve the structure of management.

3. On-site Inspection

In accordance with the program for on-site inspections, thorough inspections (all assessment criteria employed) of 12 banks were made during 1995. Target examinations were made in 19 banks with deteriorating financial performance.

On-site inspections and examinations targeted: establishing whether the banks' activities were in compliance with the provisions of the LBCA and whether the reports submitted under bank supervision regulations were correct and realistic; detailed assessment of the credit portfolio status; assets and liabilities management in terms of liquidity; efficiency of internal control systems, analysis of return on investment, and decapitalization factors. Analysis of banks' reports indicated greater differentiation of banks in terms of their financial performance. One group of banks showed relative stability and improvement in their financial performance, while the other group was characterized by deterioration. This trend may be reversed only by sizable investments, restrictions and changes in management structure.

On-site examination findings point to several important issues. First, an inadequate stance of the management in designing and implementing the rehabilitation programs or lack of such programs for banks with worsened financial performance; internal control on lending activities and expenses is almost absent. Second, a high percentage of renegotiated, rescheduled and unserviced loans; a large percentage of big loans; concentration of big internal loans to economically related persons or shareholders of the bank (i.e. loans were made to customers who were reported to be overexposed to other banks); insufficient provisioning against potential loan losses. There is a great difference between a bank's classification of credits and that of the BNB examiners.

A number of banks have not defined their credit policy:

• Short-term credits are extended for long-term investment to borrowers who are unable to meet their obligations within such short period of time; promissory notes are often accepted as security on loans, which exceed many times the value of the borrower's and the guarantor's assets or their business's potential to repay the loan; inadequate analysis of the financial state of the borrowers and the guarantors and their ability to repay the loan; no credit limits are established according to management lines of responsibility and type of borrowers; credits are renegotiated without being serviced at all, for compounding interest.

• Maturity mismatches occur in which short-term liabilities are funded with long-term assets. This is poor management of assets and liabilities. The term risk of assets and liabilities is directly related to the liquidity risk and results in liquidity deficiencies.

High interest margins, significant interest expenses, a low-quality credit portfolio, a sizable share of noninterest-bearing assets, as well as excess of noninterest expenses over earnings altogether produced negative financial results and subsequent decapitalization of banks. Accounting entries are made to reflect nonexisting incomes. These include interest on the LBCA and Brady bonds, revaluation of fixed tangible assets and foreign currency, and accounting compounded interest as income. Also of note is nonaccrued interest on expenses for attracted funds.

• Bad management is witnessed in striving for fast growth, poor credit policy, weak or nonexistent internal controls, and absence of planning. Deviation from reasonable limits on lending, accelerated development of a branch network, uncontrollable diversification of risk, speculative behavior, as well as lack of professional expertise and education of bank officials may ultimately result in impaired liquidity and subsequent insolvency. Management does not look for strategic solutions to concrete problems but applies only temporary measures.

It has become a practice with some banks not to reflect and account for off-balance commitments, avals, and promissory notes, which was discovered in counter examinations in other banks.

Foreign Exchange Control

In 1995, 37 examinations in 22 financial institutions were carried out, targeted to assess whether the foreign exchange regime is observed. Experts from BNB participated in examinations of "pyramid schemes" and other nonlicensed institutions. The following violations of the foreign exchange regime were found: transfers made without adequate reason, attraction of foreign currency for trust management, conduct of bank operations without a bank license, receipt of bank funds for free by financial and brokerage houses for participation in the forex market, and unlawful refinancing on discounted promissory notes.

4. State of the Banking System

Data from commercial bank balance sheets and reports as of 31 December 1995 is displayed in the Appendix to the BNB Annual Report. Data reported for 1995 is preliminary, and data for 1994 is based on final reports. It should be noted that data based on preliminary estimates and final data for 1994 differ in terms of value of some indicators by more than 10%.

The general conclusions based on the summarized information are as follows:

Group I includes banks whose balance sheet figure as of 31 December 1995 totals BGL 30 billion – the big banks. This group is comprised of nine banks and makes up 74.9% of the banking system. The SSB is excluded.

Group II includes banks whose balance sheet figure as of 31 December 1995 totals less than BGL 30 billion – the medium and small banks. They are the remainder of banks in the country and constitute 25.1% of banks in the banking system. All newly licensed banks also belong to Group II.

Group I includes Bulbank Ltd. The severalfold higher values of this bank's results in comparison to the other commercial banks distort the picture for the entire banking system.

Consolidated Report of Commercial Banks

Total balance sheet figure for all commercial banks as of 31 December 1995 amounted to BGL 911 billion, a 7.03% increase from 1994.

Group I – balance sheet figure totaled BGL 682 billion, a 4% decrease from 1994. This was a result of more than a BGL 100 billion decrease in balance sheet figure due to restructuring and rehabilitation in some banks.

Group II – balance sheet figure totaled BGL 229 billion, a 63.1% increase from 1994. The group increased its share of the market by 8.6 percentage points. The latter was due to both operations of newly licensed banks, 16% of the increase, and increased balance sheet figure of existing banks.

The **capital** of commercial banks was BGL 64.3 billion, a 44% increase, reaching 7.1% of the balance sheet figure. This was due to both increased capital of some banks and inclusion of newly established banks. Supplementary capital decreased by 0.8%.

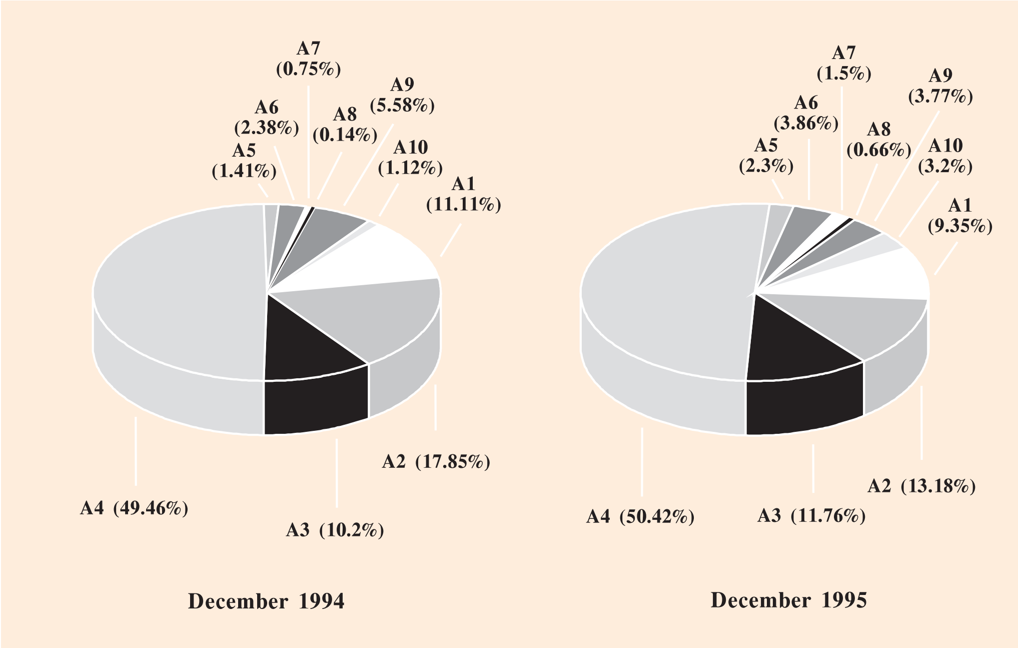
Group I – capital of the banks in this group was BGL 39.4 billion, a 9.4% increase, comprising 5.8% of the balance sheet figure. It makes up 61.3% of the total bank capital. Supplementary capital of this bank group decreased by 5.5% due to its transformation into equity capital.

Group II – capital of this group was BGL 24.9 billion, a 187.6% increase, reaching 10.9% of the balance sheet figure. It should be noted that 24% of this capital has not been paid in. Supplementary capital rose by 100.1% to BGL 2.8 billion.

On the Chart "Capital of Commercial Banks" the indicator "Capital (adjusted)" is derived by subtracting the loss from rights to equity subscription from the capital base (own funds).

Despite the 37% increase in the capital base, attributable to "Capital," taking into account banks' losses and rights to equity subscription, the value of "Capital (adjusted)" increased by 6%. If the latter is considered in terms of the 7% increase in the balance sheet figure, it becomes clear that the process of decapitalization continued. If the other components of the capital base (determined as per Regulations No. 8 on the capital adequacy) are taken into account, this process becomes more pronounced – a 47% decrease of the total capital adequacy ratio.

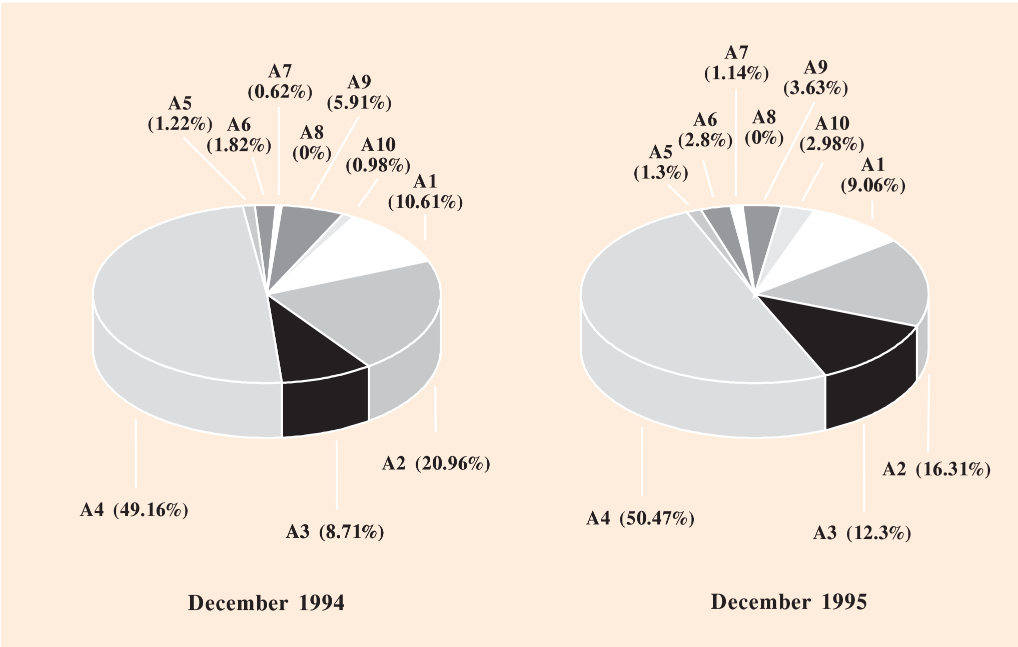
STRUCTURE OF THE CONSOLIDATED ASSETS OF COMMERCIAL BANKS, TOTAL



A1 – money resources, A2 – government securities, A3 – claims on banks and other financial institutions, A4 – claims on nonfinancial institutions and other customers, A5 – other financial assets, A6 – nonfinancial assets, A7 – expenditures for future periods, A8 – rights to equity subscription, A9 – other assets, A10 – losses for the reporting period

Source: BNB.

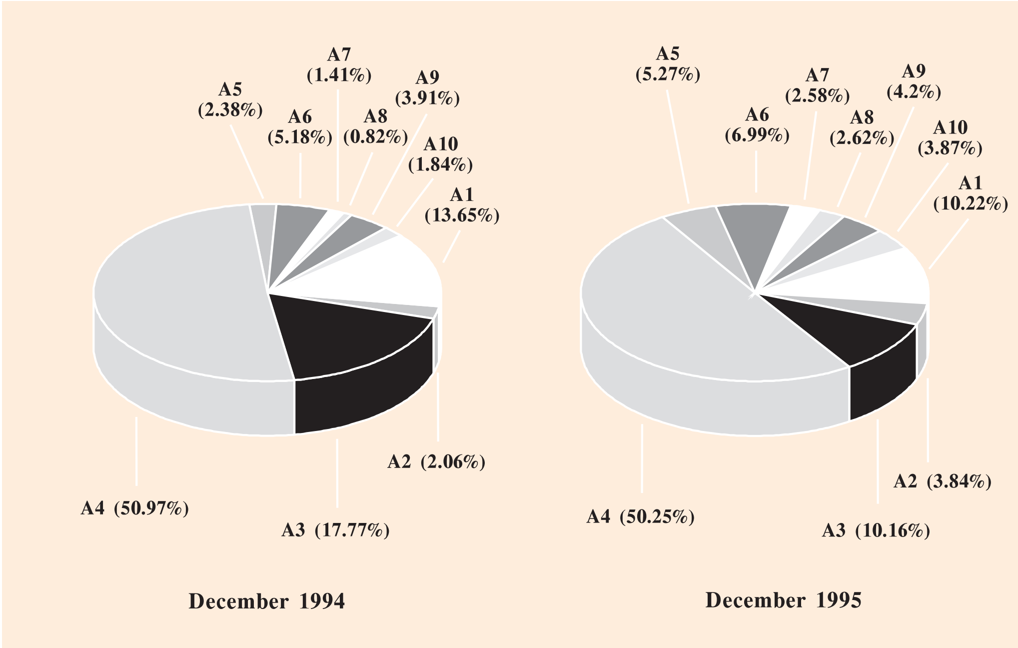
STRUCTURE OF THE CONSOLIDATED ASSETS OF COMMERCIAL BANKS, GROUP I



A1 – money resources, A2 – government securities, A3 – claims on banks and other financial institutions, A4 – claims on nonfinancial institutions and other customers, A5 – other financial assets, A6 – nonfinancial assets, A7 – expenditures for future periods, A8 – rights to equity subscription, A9 – other assets, A10 – losses for the reporting period

Source: BNB.

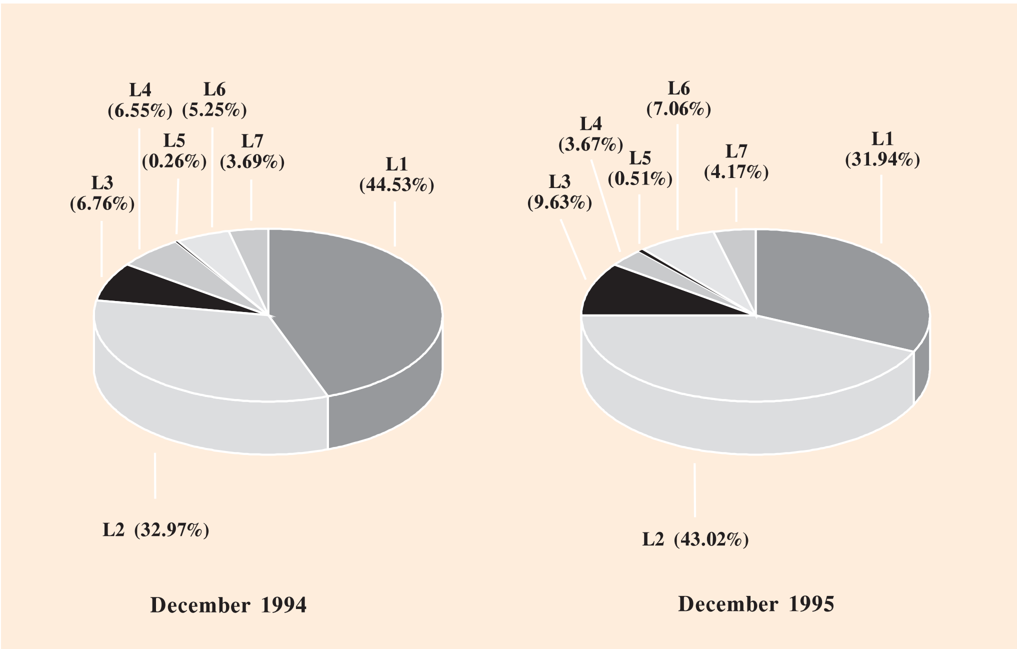
STRUCTURE OF THE CONSOLIDATED ASSETS OF COMMERCIAL BANKS, GROUP II



A1 – money resources, A2 – government securities, A3 – claims on banks and other financial institutions, A4 – claims on nonfinancial institutions and other customers, A5 – other financial assets, A6 – nonfinancial assets, A7 – expenditures for future periods, A8 – rights to equity subscription, A9 – other assets, A10 – losses for the reporting period

Source: BNB.

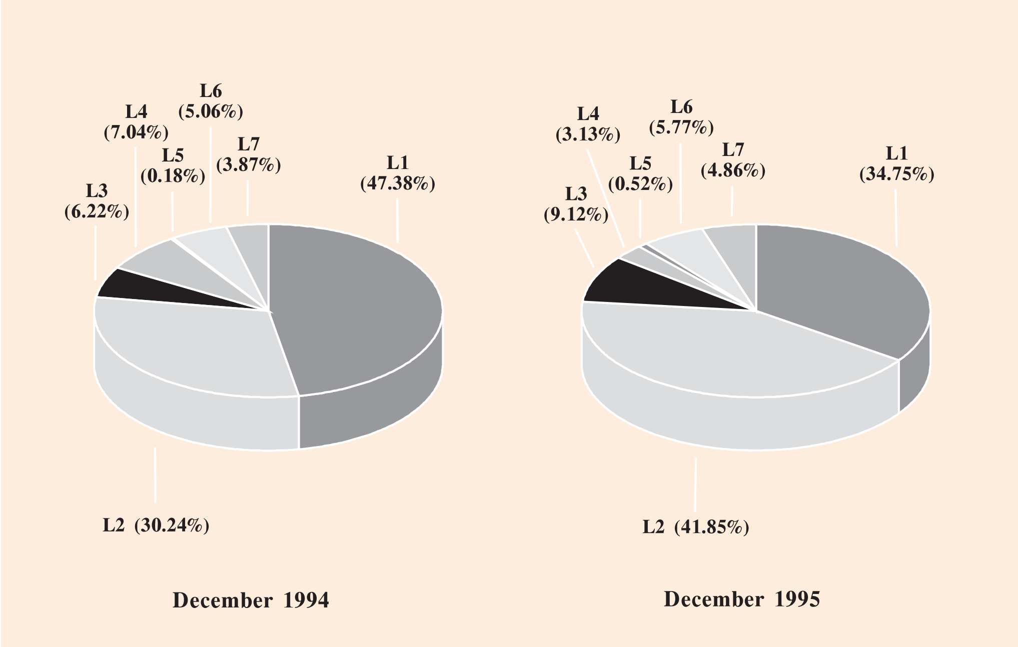
STRUCTURE OF THE CONSOLIDATED LIABILITIES OF COMMERCIAL BANKS, TOTAL



L1 – attracted funds from banks and financial institutions, L2 – attracted funds from nonfinancial institutions and other customers, L3 – revenue for future period, L4 – other liabilities, L5 – profit, L6 – capital, L7 – reserves

Source: BNB.

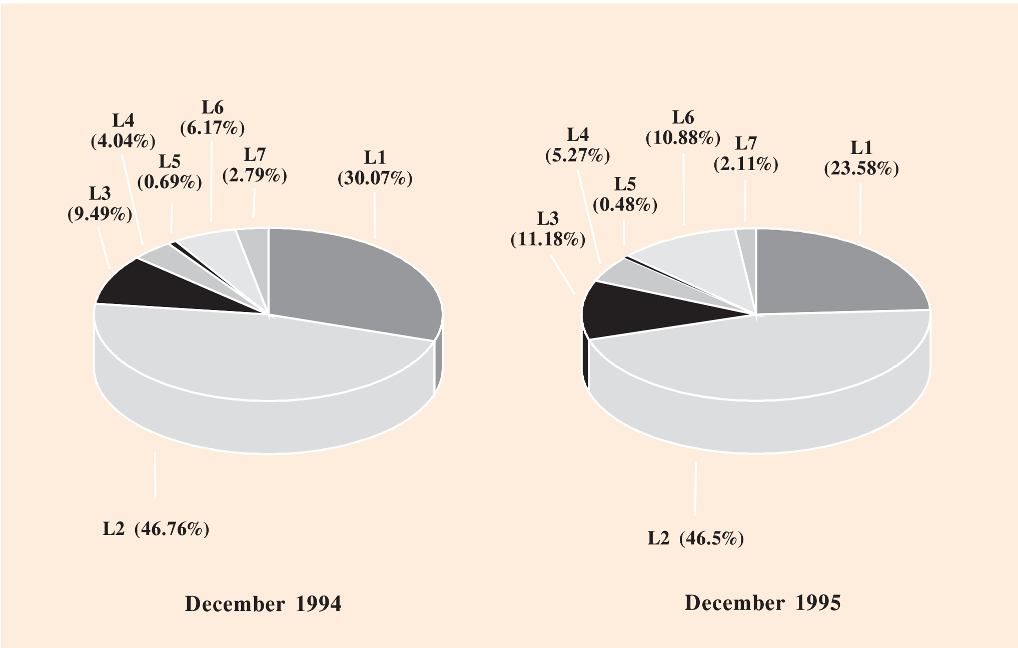
STRUCTURE OF THE CONSOLIDATED LIABILITIES OF COMMERCIAL BANKS, GROUP I



L1 – attracted funds from banks and financial institutions, L2 – attracted funds from nonfinancial institutions and other customers, L3 – revenue for future period, L4 – other liabilities, L5 – profit, L6 – capital, L7 – reserves

Source: BNB.

STRUCTURE OF THE CONSOLIDATED LIABILITIES OF COMMERCIAL BANKS, GROUP II



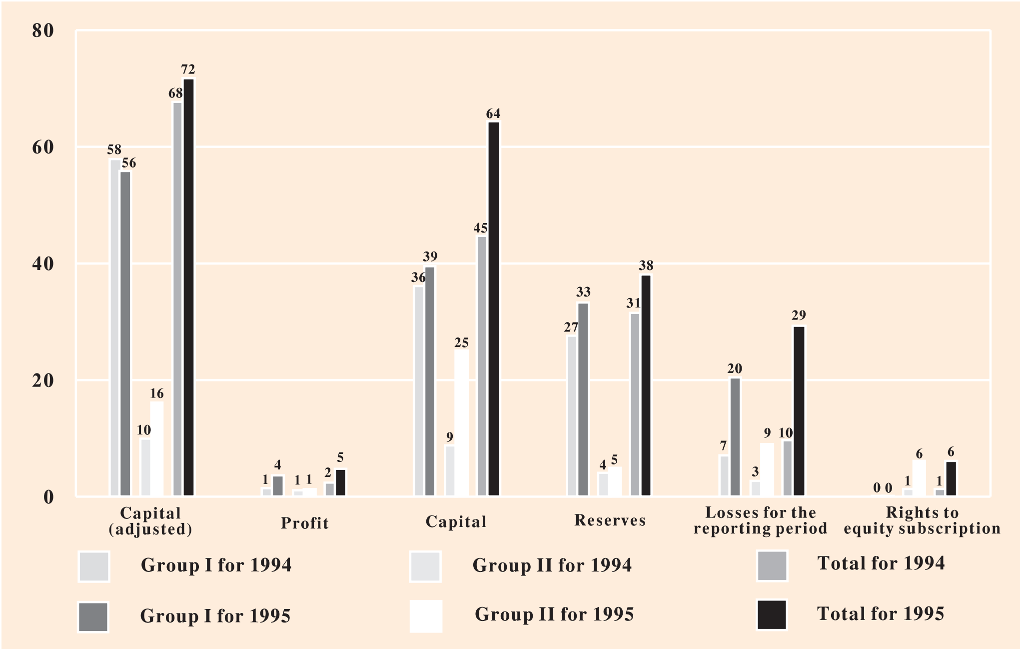
L1 – attracted funds from banks and financial institutions, L2 – attracted funds from nonfinancial institutions and other customers, L3 – revenue for future period, L4 – other liabilities, L5 – profit, L6 – capital, L7 – reserves

Source: BNB.

Reserves in the banking system, totaling BGL 40 billion, increased by 21% and accounted for 4.2% of the balance sheet figure. Reserves in Group I comprised 87% of total banking system reserves.

CAPITAL OF COMMERCIAL BANKS

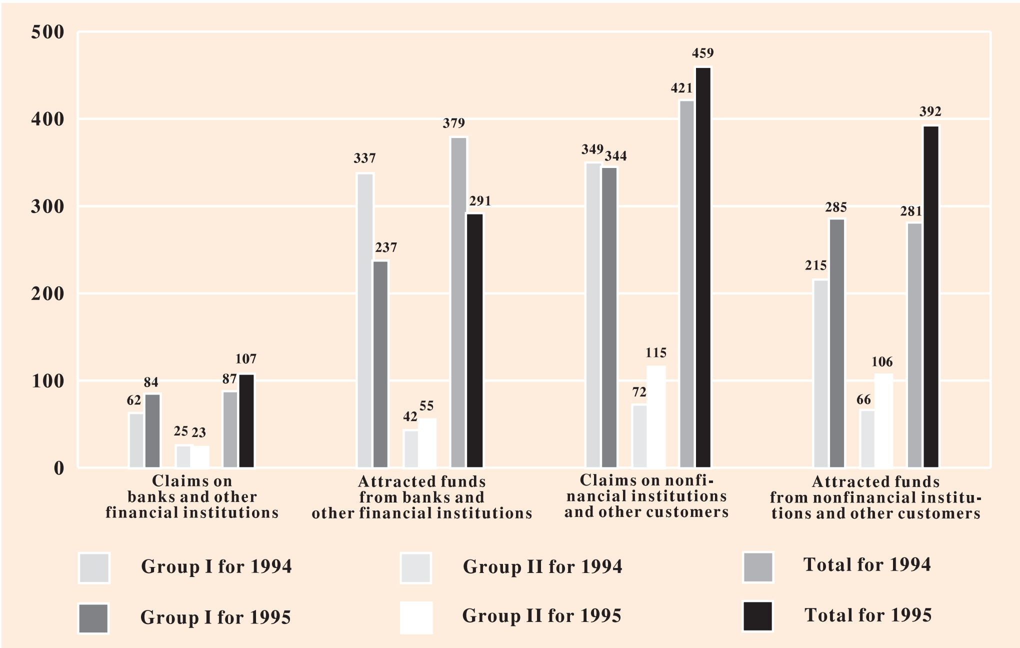
(billion BGL)



Source: BNB.

SELECTED INDICATORS OF THE CONSOLIDATED BALANCE SHEET OF COMMERCIAL BANKS

(billion BGL)



Source: BNB.

Attracted funds, totaling BGL 683 billion, rose by 3.5%. As a result, the share of attracted funds in liabilities fell to 75% against 77% in 1994 due to the increased balance sheet figure. Attracted funds increased by 40% due to the increase in "Attracted funds from nonfinancial institutions." "Attracted funds from banks and other financial institutions" dropped by 23%. This suggests commercial banks' efforts to attract more core resources.

Group I – Attracted funds dropped by 5.3% due to decreased "Attracted funds from banks and other financial institutions" by 29.6% (BGL 99.7 billion), a result of rehabilitation of some state-owned banks. "Attracted funds from nonfinancial institutions" increased by 32.8% which signals an improvement in the structure of attracted funds.

Group II – Attracted funds increased by 48.7%, with "Funds attracted from nonfinancial institutions" growing more significantly, by 62.2%.

The need for resources forced most banks to offer high interest rates. This led to sizable expenditures, which is one of the reasons behind the losses sustained. Investing expensive resources in risky ventures which subsequently became uncollectible claims spelled greater losses.

Claims totaled BGL 566 billion, increasing by 11.6%. They made up 62.2% of the balance sheet figure, against 59.7% in 1994. This adverse trend is attributable to the increased "Claims on banks and other financial institutions" (23.4%), and the increased "Claims on nonfinancial institutions" (9.11%).

In *Group I* the overall growth in claims (4%) was due to the increased amount of claims on financial institutions, rising by 35.6%. Claims on nonfinancial institutions declined.

Group II displays the reverse trend. A 43% increase in claims was the result of the increased claims on nonfinancial institutions (61%), while the claims on financial institutions declined. Significantly increased claims on nonfinancial institutions due to credit expansion prompted a more marked growth in the total risk component.

During 1995, commercial banks reported an increased amount of credits, which were later classified as doubtful or uncollectible credits as per Regulations No. 9. This is the major reason for the progressive decapitalization of the banking system.

The sizable amount of attracted funds from banks and other financial institutions and their transformation into claims on nonfinancial institutions makes banks closely interdependent, which may lead to chain failures.

In 1995, **cash balances and government securities** declined by 10% and 21% respectively against 1994, reaching BGL 85 billion and BGL 120 billion. This decline compared with the total balance sheet figure increase reflected a significant decrease in the shares of both items in total assets, indicating an erosion of liquidity in the banking system as a whole. The latter refers to banks included in Group I. An increase in the absolute values of both items was registered in Group II, but it is inconsistent with the total balance sheet figure increase of the group, that is liquidity of this group has eroded as well.

Investment in *financial long-term assets* rose by 79%, to BGL 12.8 billion. This was entirely a result of Group II banks which make up 99% of this increase. Exchange of stocks between banks and other financial institutions occurred.

Commercial bank investment in *nonfinancial assets* grew by 74% to BGL 35 billion. A 3.9% increase in the share of commercial bank investment in nonfinancial assets reflected their greater increase compared with the total balance sheet figure. This trend is more pronounced in Group II.

Increased commercial bank investment in financial fixed assets and nonfinancial assets additionally reduced the amount of the capital base.

Future revenues increased by 53% to BGL 88 billion. Given the sizable increase in future revenues, they accounted for 9.6% of total liabilities. This adverse trend is a result of the increased bad and doubtful loans, and interest accrued but unpaid on them.

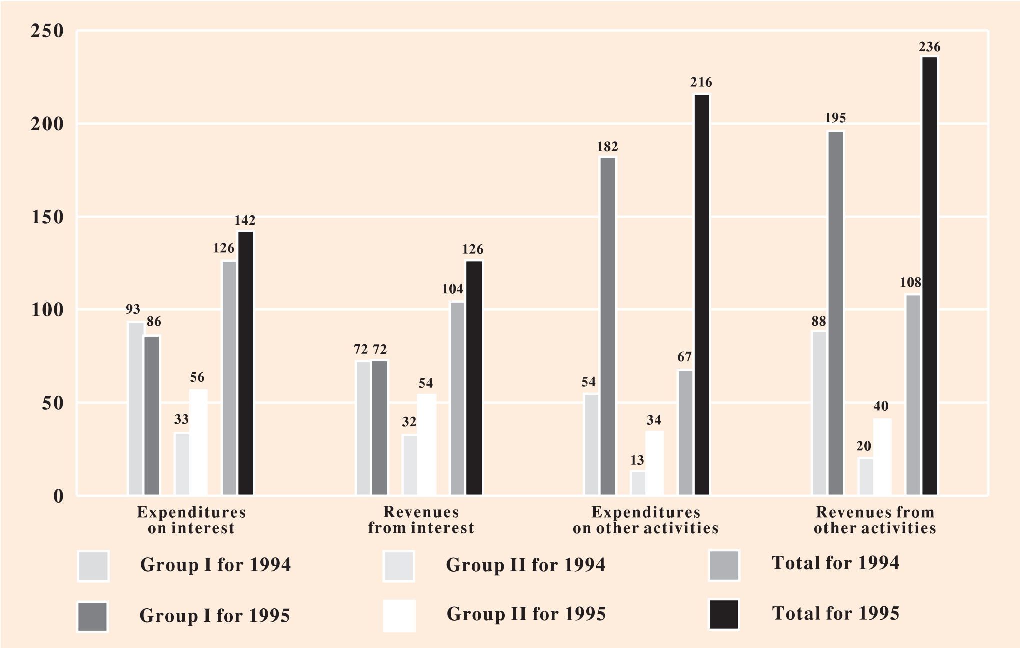
Off-balance sheet commitments increased by 239% to BGL 554 billion. This led to increased commercial bank exposure but was also an opportunity for banks to gain substantial revenue from these operations.

Income statement analysis shows that expenditures rose by 73% and revenues by 65%, resulting in a negative financial performance of BGL 23.2 billion. The balance between revenues from other activities and expenditures on these activities (BGL 20 billion) completely covers the negative balance of BGL 16 billion from banks' major activity, i.e. revenues and expenditures on interest. Moreover, in contrast to 1994 banks' revenues (expenditures) from other activities significantly exceeded the corresponding items from banks' major activity. This is due particularly to banks included in Group I. An increase in the total revenue/balance sheet figure ratio occurred: by 40% in 1995 and by 25% in 1994. The negative financial performance was a result of significantly increased expenditures by economic elements (79.3%).

The negative financial performance limited commercial banks' ability to allocate provisions. In 1995, allocated provisions totaled BGL 6.6 billion against BGL 17.3 billion in 1994.

SELECTED INDICATORS FROM THE INCOME STATEMENT

(billion BGL)

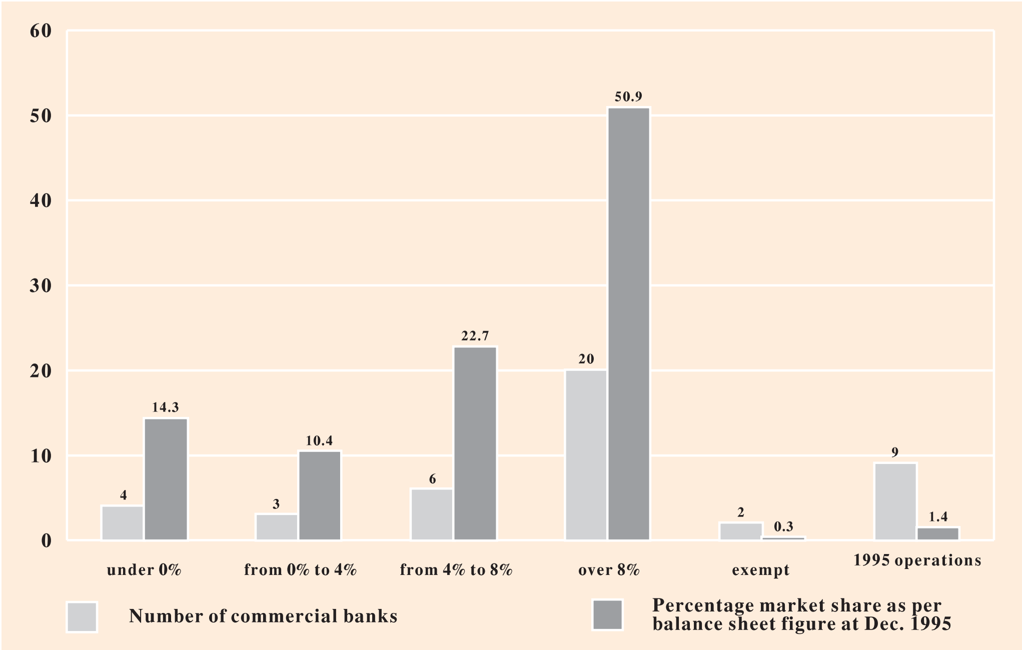


Source: BNB.

Capital Adequacy (as per Regulations No. 8)

The total capital adequacy ratio is 4.6%, against 8.6% in 1994. The change in this ratio reflected a reduction in the capital base (36%) and an increase in the total risk component (18%). Besides losses, the capital base decline is attributable to banks' participation in financial and nonfinancial institutions.

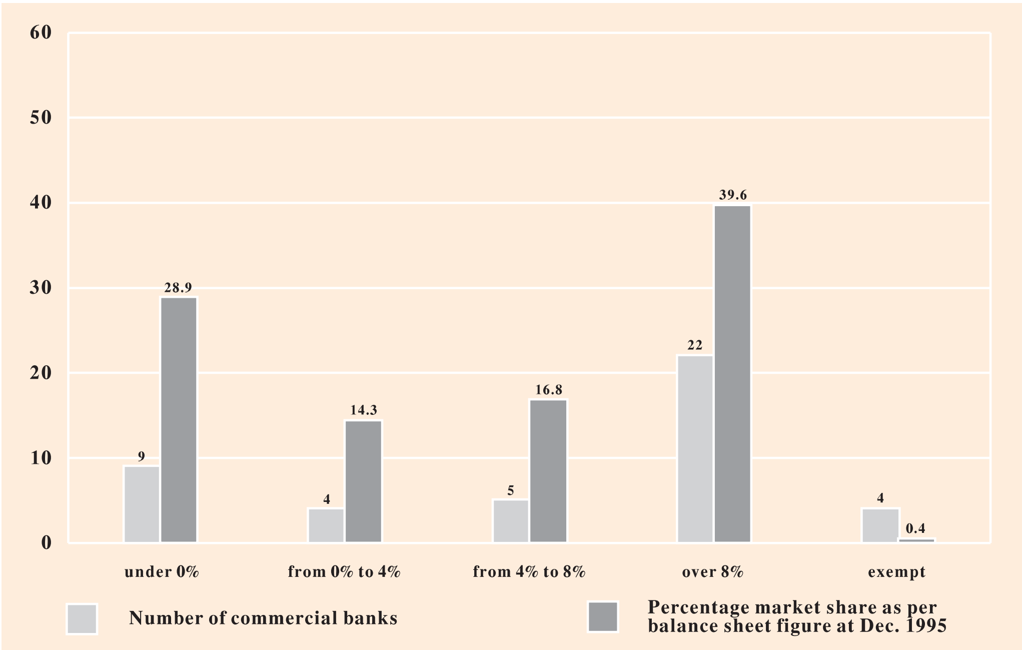
TOTAL CAPITAL ADEQUACY IN 1994



Source: BNB.

If the impact of Bulbank and some newly established banks is disregarded, the total capital base and the general capital adequacy ratio is negative. It should be taken into account that current calculation of the capital base does not include the shortage of mandatory statutory provisions.

TOTAL CAPITAL ADEQUACY IN 1995

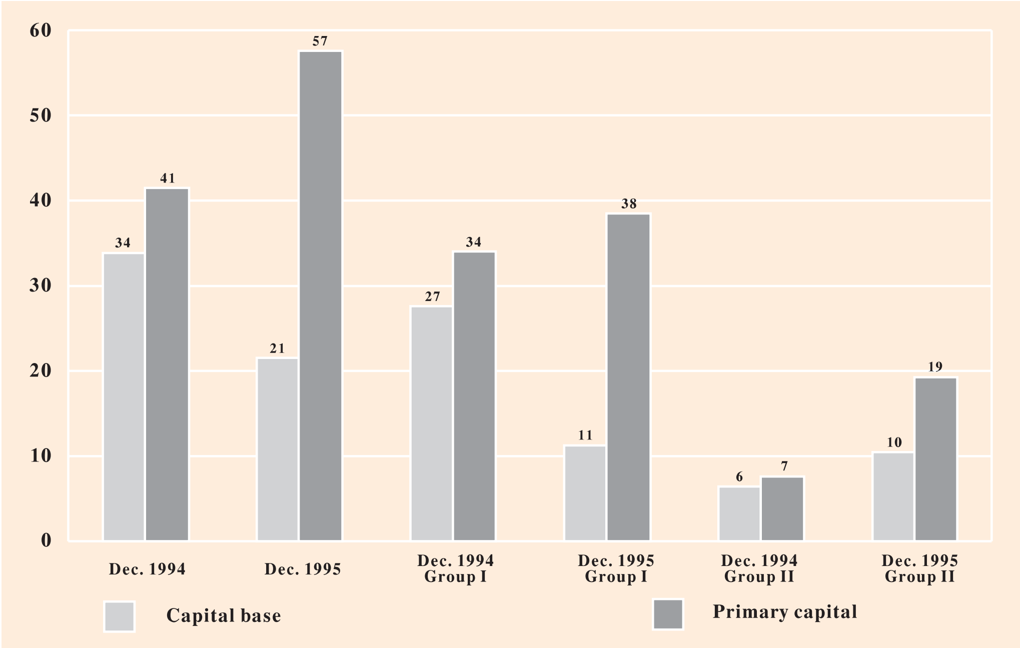


Source: BNB.

The required total capital adequacy ratio of 8% was achieved by 22 banks, having a market share of 40%. A negative capital base was reported by nine banks, having a market share of 29%.

CAPITAL BASE AND PRIMARY CAPITAL

(billion BGL)



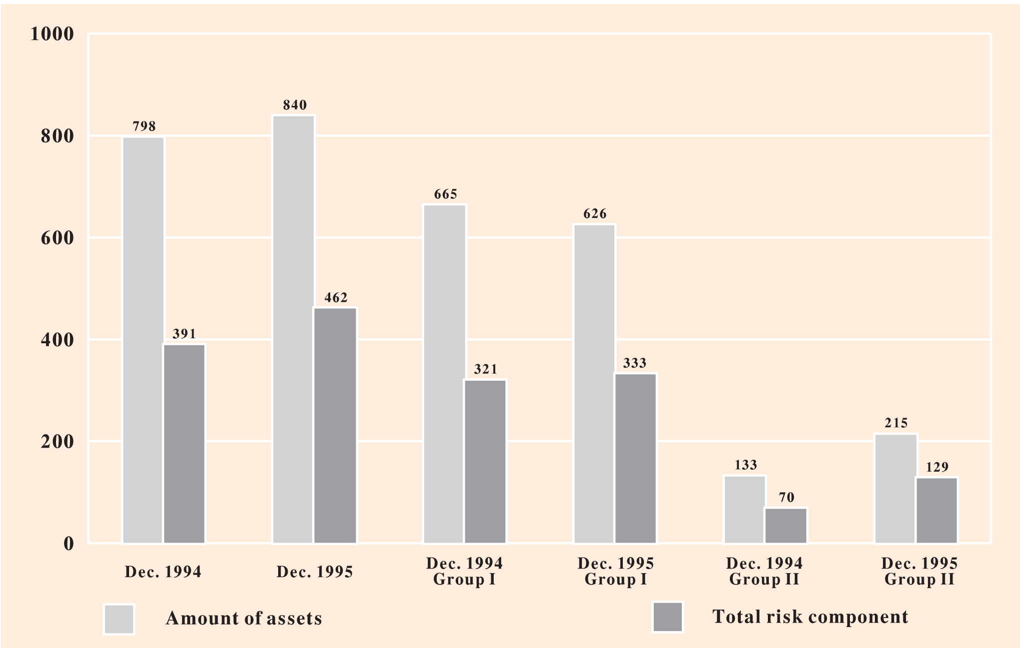
Source: BNB.

Group I – The capital adequacy ratio is 3.3% against 8.6% in 1994. This is mainly due to the decrease in the capital base by BGL 16.3 billion (60%).

Group II – The capital adequacy ratio is 7.97% against 8.9% in 1994. This was the result of the substantially increased total risk component (85%) which cannot be offset by a 64.9% growth in the capital base.

AMOUNT OF ASSETS AND TOTAL RISK COMPONENT

(billion BGL)



Source: BNB.

The "Amount of assets" under Regulations No. 8 increased by 5%, while "The total risk component" increased by 18%. This worsened the "Degree of risk of the assets", or the structure of the banking system portfolio. This trend was seen in both groups, Group II performing worse.

Reduced capital base and increased amount of assets affected the "Degree of assets coverage" which fell from 4.2% in 1994 to 2.5% in 1995. In Group II, this indicator is improved, though insignificantly, as a result of an increased capital base.

The pending inclusion of the shortage of mandatory special reserves (statutory provisions) in the calculation of the capital base would have additionally eroded the total capital adequacy ratio. As per the reported statutory provisions of December 1995, the total capital base of the banking system is negative. Given the level of the total risk component by 31 December 1995, the deficiency of capital up to the non-negative capital base is BGL 79 billion, and up to an 8% required capital adequacy ratio, BGL 116 billion.

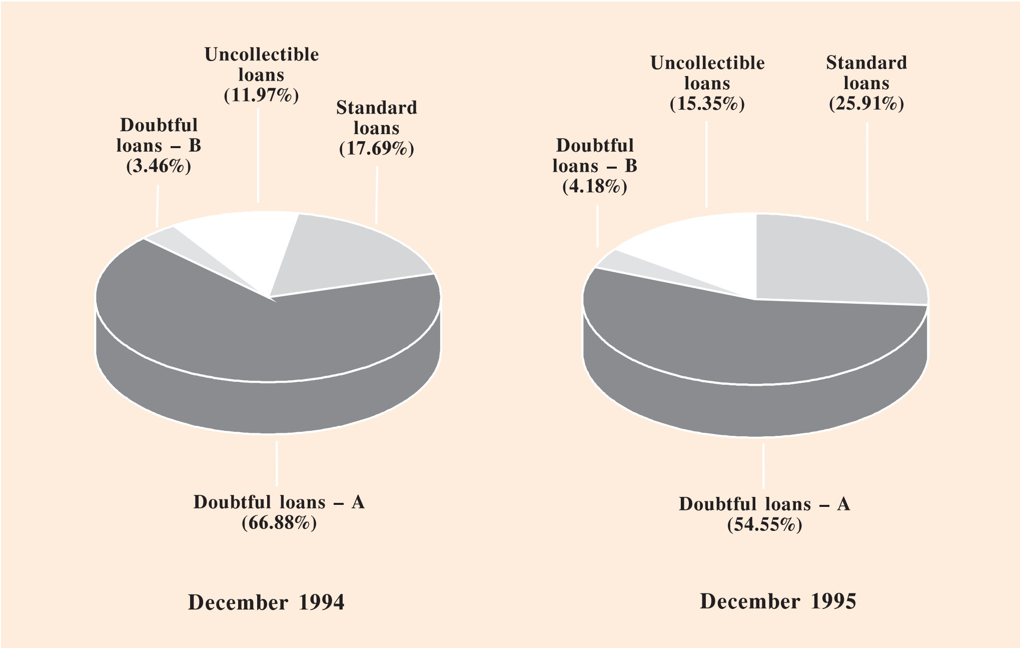
Loan Classification and Formation of Mandatory Special Reserves (as per Regulations No. 9)

Banks' loans rose by 18% in 1995 to BGL 463 billion. The ratio of loans to the balance sheet figure increased by five percentage points to 51%, a result of the smaller growth in the balance sheet figure. Standard loans increased most significantly (73%) followed by uncollectible loans (52%). Doubtful loans, Group A, dropped by 3.5%. Given the faster growth in standard loans, the share of classified loans fell by eight percentage points to 74%. However, this does not imply a decrease in the share of doubtful and uncollectible loans which instead grew significantly. Doubtful loans, Group A, accounted for the largest share (54.6%), a result of classification of foreign exchange holdings in this group.

Group I – A 7.3% increase in loans significantly lagged behind the growth in the whole banking system. The largest share of classified loans (82.7%) is attributable to doubtful loans, Group A.

Group II – A 63.3% increase in loans substantially exceeded the increase in loans in the whole banking system. The latter signals increased credit expansion in this group. Standard loans comprise a significant share (49%), while the share of doubtful loans, Group A, is relatively small.

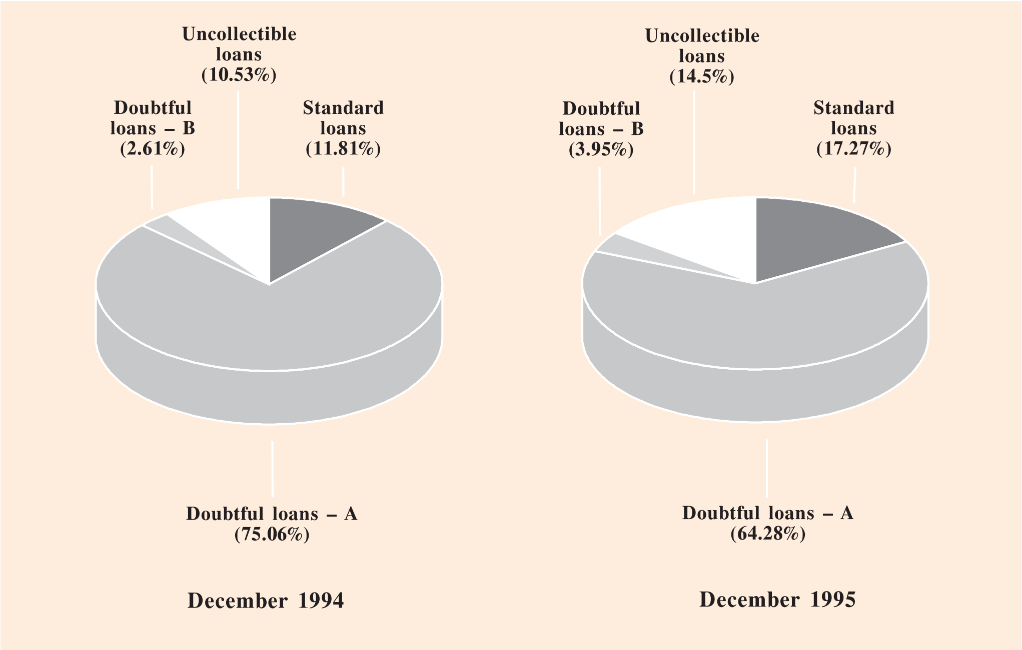
LOAN CLASSIFICATION OF COMMERCIAL BANKS, TOTAL



Source: BNB.

Substantially increased uncollectible loans eroded the "Uncollectible loans to own capital ratio", reduced with the loss and rights to equity subscriptions, to 99% versus 69% in 1994. This indicator is 88% for banks included in Group I versus 57% in 1994 and 139% for the banks included in Group II versus 140% in 1994.

LOAN CLASSIFICATION OF COMMERCIAL BANKS, GROUP I

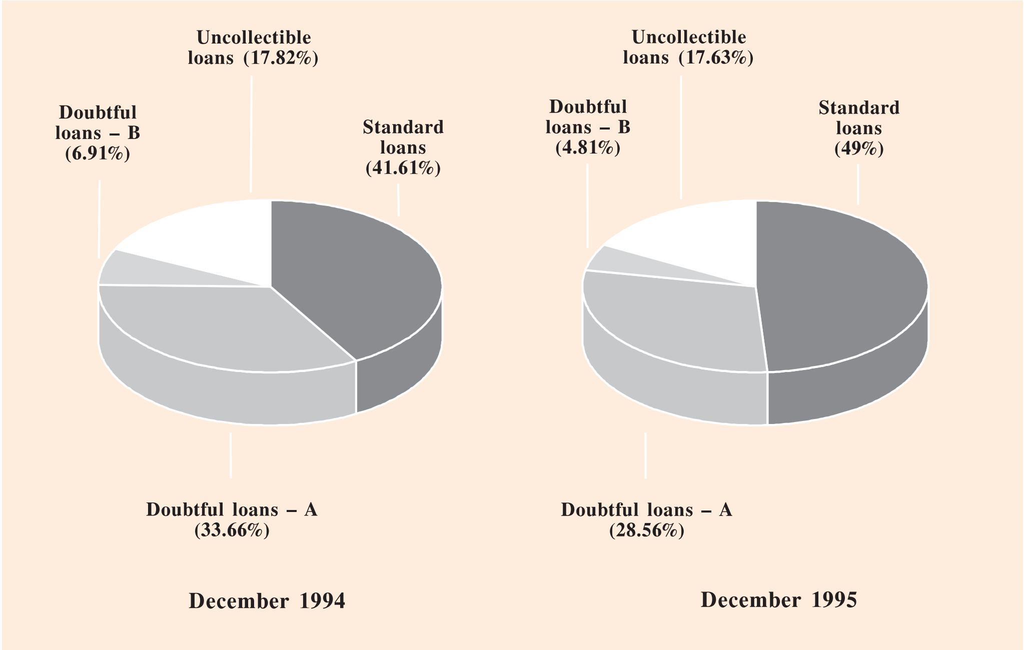


Source: BNB.

Reported provisions rose by 24.9% to BGL 31.1 billion, and required provisions by 24.1% to BGL 131 billion. In Group I, reported provisions increased by 25.4% and required by 17.1%, and in Group II by 22.4% and 51.2% respectively.

The greater increase in the reported provisions slightly improved, the "Reported to required provisions ratio" from 23.6% in 1994 to 23.7% in 1995. However, this indicator remains far below the required norms. In Group II this indicator deteriorated as a result of increased classified loans and banks' inability to allocate provisions due to negative financial performance.

LOAN CLASSIFICATION OF COMMERCIAL BANKS, GROUP II



Source: BNB.

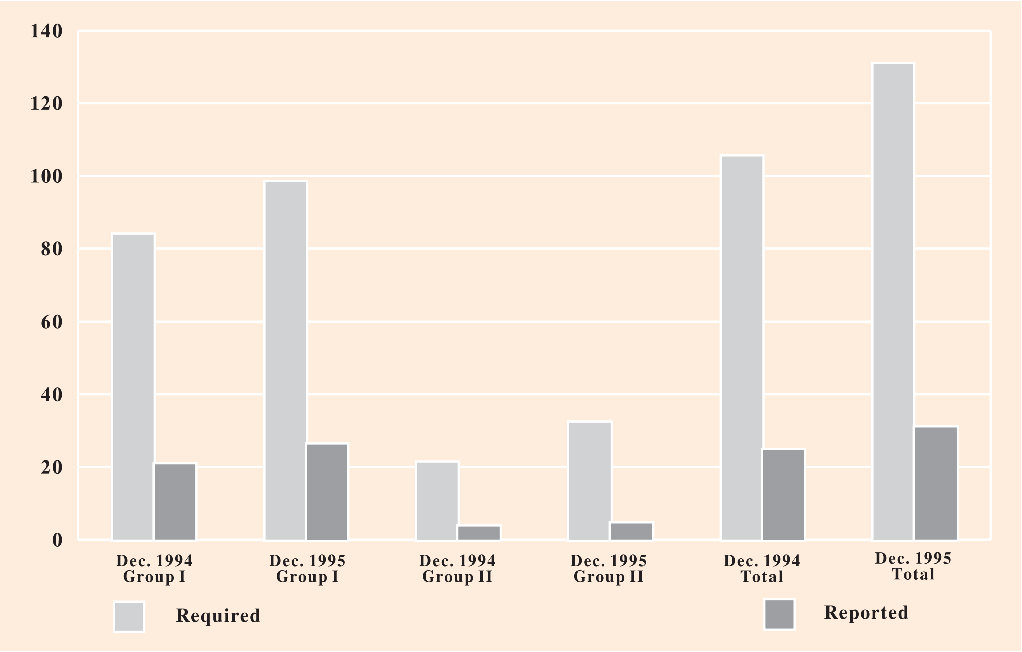
Big Loans (as per Regulations No. 7)

Big loans grew by 129% to BGL 165 billion, reflecting an increase in the general exposure to individual clients and a reduction in the capital base. Moreover, credit portfolios of banks which have reported a negative capital base qualify as big loans. This trend occurred in both groups. The ratio of big loans to the capital base is 7.7 times, against 2.4 times in 1994. For Group I, this ratio is 7.98 times versus 1.24 times in 1994, and for Group II, 7.4 times versus 6.1 times in 1994.

Big loans extended by banks included in Group II accounted for more than 45% of all big loans against a market share of this group of less than 25%.

STATUTORY PROVISIONS OF COMMERCIAL BANKS

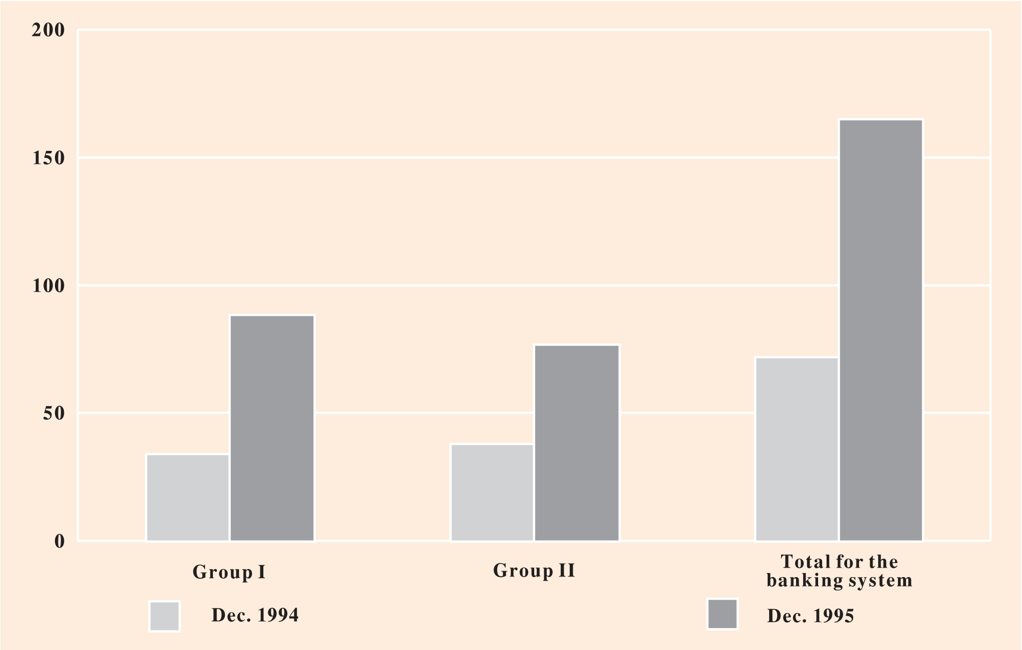
(billion BGL)



Source: BNB.

BIG LOANS EXTENDED BY COMMERCIAL BANKS

(billion BGL)



Source: BNB.

VI. Financial Results of BNB Activities

The BNB annual balance sheet was done after the closing of the state budget and conversion of foreign exchange assets and liabilities in levs at the effective exchange rate as of 31 December 1995. The revaluation of precious metals was done by quarter based on the average price of gold in the respective period, as specified in the BNB *Monthly Bulletin*.

The BNB's fixed capital is BGL 200 million in compliance with Article 7 of the Law on the BNB. The reserve fund built up from the excess of revenue over expenditure was used mainly for the purchase of foreign currency to replenish the foreign exchange reserves.

DISTRIBUTION OF BNB ANNUAL BALANCE OF REVENUE OVER EXPENDITURE IN 1995

(thousand BGL)

I. BNB revenue	153,935,554
II. BNB expenditure	135,476,631
III. Balance of revenue over expenditure (I–II)	18,458,923
Amount to be distributed:	
1. Reserve fund (25%)	4,614,731
2. Other special reserves (0.95%)	175,360
3. Social support fund (0.05%)	9,229
4. Balance to be paid in the budget	13,659,603
IV. Amount paid in the state budget	14,768,864

Source: BNB.

In accordance with §3 of the transitional and final provisions of the State Budget Law, the BNB pays in advance every month the surplus of revenue over expenditure in the state budget, which exceeded the required amount by BGL 1,109,261,000 at the end of the year. This amount is to cover the contribution for January 1996.

In 1995, the BNB made interim credits to the MF, totaling BGL 19 billion. During the year, a portion of BNB's long-term credits to the MF were replaced by book-entry government securities amounting to BGL 10,021,960,000. In addition, the MF made regular monthly repayments, totaling BGL 2,990 million, whereby its debt to the BNB at the end of 1995 was reduced by that same amount. By year-end, the MF's debt to the BNB amounted to BGL 26,052 million.

Equity participation of Bulgaria in international financial institutions totaled BGL 16,237,553,841, with equal shares of the BNB and the MF in the IMF, the EBRD, and the International Financial Corporation. These institutions are as follows:

(BGL)

Bank for International Settlements	955,577
European Bank for Reconstruction and Development	1,500,947,070
International Monetary Fund	11,591,481,450
International Financial Corporation	126,489,456
National Numbering Agencies Association	1,171,608
Multilateral Agency for Investment Guarantees	27,923,130
World Bank	258,335,639
International Bank for Economic Cooperation	881,641,833
International Investment Bank	1,848,608,076

Source: BNB.

BNB equity participation in the Bank Consolidation Company was BGL 1,469,008,000 and in other companies BGL 280,179,353 (including BORICA Ltd., BGL 145,000,000; Bankservice Ltd., BGL 114,290,000; Bulgarian Mint Ltd., BGL 14,528,000, among others).

Financial Revenue

In 1995, interest revenue amounted to BGL 40,790,180,000. The largest portion of interest revenue was generated from short-term credits extended to the MF (45.22%), followed by interest revenue from commercial banks' deposits (44.50%), interest from foreign exchange operations (10.19%), and interest on unduly transferred minimum reserves (0.09%).

Revenue from interest on credits extended to the MF decreased in 1995 compared with 1994, due to the large share of MF securitized indebtedness to the BNB and the continual reduction in the basic interest rate.

Revenue from operations in government securities totaled BGL 112,119,788,000, or 72.83% of total financial revenue. This compares with 44.6% in 1994 and results from the BNB's restrictive monetary policy which intended to reduce commercial bank refinancing.

Financial Expenditure

The BNB's expenditure on interest repayments in 1995 totaled BGL 12,602,428,000, compared with BGL 10,642,161,000 in 1994. This results mainly from higher interest repayments on foreign exchange operations (BGL 3,395,607,000 versus BGL 2,440,444,000 in 1994), interest repayments on current accounts of the MF (BGL 1,131,797,000 versus BGL 685,690,000 in 1994), and interest repaid on the State Fund for Reconstruction and Development (BGL 845,149,000 compared with BGL 476,672,000 in 1994). In structural terms, interest repayments are distributed:

(thousand BGL)

on current accounts of the Ministry of Finance	1,131,797
on forex operations	3,395,607
on deposits	2,496,768
on minimum reserves	4,656,478
on the State Fund for Reconstruction and Development	845,149

Source: BNB.

Expenditure for government securities operations amounted to BGL 120,512,069,000, compared with BGL 34,918,480,000 in 1994. The overall result of BNB's operations in government securities was negative, totaling some BGL 8,392 million. This is the price paid by the BNB for the conduct of its open market repo-operations to avoid excessive liquidity growth and easing of monetary policy.

Expenditures on currency in circulation totaled BGL 903,493,000, compared with BGL 370,734,000 in 1994. The higher cost of currency in circulation was mainly a result of both the utilization of letters of credit for the printing of banknotes negotiated in 1994 and provided in the first half of 1995, and the increased amount of newly minted coins replacing the 1, 2, and 5 lev banknotes.

Overall administrative expenditures totaled BGL 1,581,275,000, or 1.17% of total expenditures.

Budget of the BNB

By resolution of the Plenary Council of the BNB, the 1995 budget of the BNB was adopted, in the amount of BGL 2,143,550,000 for support of its current activity, and BGL 3,108,176,000 for investment in tangible and intangible fixed assets.

PERFORMANCE OF THE 1995 BUDGET OF THE BNB

Indicators	Budget (thousand BGL)	Budget performance (thousand BGL)	(%)
Section I			
Expenditure for support of current activity	2,143,550	1,581,275	73.77
Expenditure on currency in circulation	1,089,250	903,493	82.95
Expenditure on labor and social securities	451,062	326,611	72.41
Expenditure on material services	570,501	323,021	56.62
Expenditure on social activity in the BNB	32,737	28,150	85.99
Section II			
Investment in tangible and intangible fixed assets	3,108,176	3,274,079	105.34

Source: BNB.

The 1995 capital investment program of the BNB included construction of the BNB branch in the town of Rousse, step-by-step construction of the banknote printing center of the BNB, purchase of the equipment for the lev operations dealing office at the BNB, and the introduction of security systems at the BNB. The general surplus in Section II is due to advances made under an agreement for the equipment of the printing center, to be delivered in 1996.

During the year, expenditures were made for the improvement of security, computerization, and the purchase of machines and equipment.

Balance Sheet of the Bulgarian National Bank

million BGL

	1994	1995
ASSETS		
Holdings in Bulgarian coins	343	**660**
Holdings in foreign exchange	109	**93**
Participation in international institutions	12,075	**16,238**
Holdings in foreign securities	50,391	**50,522**
Deposits and loans extended to commercial banks	89,946	**111,022**
Loans extended to the government	40,087	**26,052**
Securities	14,767	**52,307**
Other assets	33,606	**45,950**
Total	241,324	**302,844**
LIABILITIES		
Statutory fund	200	**200**
Reserve and other funds	91,094	**102,047**
Banknotes in circulation	45,935	**68,146**
Current and deposit accounts	86,361	**125,969**
Other liabilities	17,734	**6,482**
Total	241,324	**302,844**

VII. Development of the Banking and Settlement System

1. Development of the Settlement System

During the first half of 1995, significant changes not seen in recent decades occurred in banking.

Over a relatively short period of time, Bulgarian commercial banks, especially their accounting units and software servicing companies, had to design and introduce bank automation systems meeting the new requirements of the MF's National Chart of Accounts (NCA), and the National Chart of Bank Accounts (NCBA), based on the Uniform National Chart of Accounts. This was done to introduce a unified methodology of accounting for bank operations as well as to meet international standards.

Besides the NCBA, developed by the Commission on Unification and Bank Standards (CUBS) in 1991 – 92 and adopted by the Managing Board of the BNB, the following new bank unified standards (BUS) were designed and introduced:

• BUS 6094 "Standard for Making Payments by Budget Entities";

• BUS 9094 "Electronic Access and Exchange of Data through BISERA";

• BUS 3095 "Structure of Codes Identifying Banks and Bank Branches," as well as the whole set of standards, BUS 5194, 5294, 5494, 5594, defining in detail various forms of payment – virement, letter of credit, checks, and bulk payments. The new standards prepared the ground for designing new bank products and improved services for bank clients.

The task was further complicated by the ongoing process of restructuring in the banking system. This included establishment of a number of new banks and consolidation of banks with majority state holding.

In designing the software for automation of bank operations, besides compliance with the requirements of the NCA and NCBA, the peculiarities of individual banks, in some cases even branches and head offices, must be considered because they employ different and specific charts of accounts. Various computer platforms and means of telecommunications were used in combination with sizable investment for the purchase of technical equipment and software products.

In view of these difficulties, the BNB developed a number of methodological instructions to facilitate the transition, to be able to prevent disruptions in the banking system and to ensure the smooth introduction of the new standards. The deadline for compliance with the new requirements was changed on several occasions. The final date for meeting the new requirements was set to be 1 June 1995. Following difficulties in the first week, the settlement system became functional, which is evident in June transactions levels. Unfortunately, some banks were unprepared for the gradual introduction of the NCBA within the required deadlines and instead of making the best of the new standards, many banks used modified versions of existing software or deferred introduction of the new standards because they did not prepare the ground for the new software. The phase-in period to introduce a unified system operating under the new chart of accounts has not been completed yet at some banks.

During the reporting period, the number of settlement inputs increased, from 746 on 1 January 1995 to 878 on 31 December 1995. By the end of the period, the threshold of 10,000 persons per one input was exceeded. According to this indicator, Bulgaria has lagged far behind developed countries, where one input services from 742 (Belgium) to 2,330 persons (USA).

The number of interbank transfers effected through the BISERA (the system for electronic interbank transfer) was 10,103,225, totaling BGL 2,150 billion, with a daily average volume of BGL 8.465 billion. Despite significantly increased settlement system inputs and interbank transactions, electronic transfers in lev terms did not match the expected level.

2. Legal Regulation of Bank Activities

During the period under review, the BNB continued its legislative activity aimed at improving the banking by-law regulatory framework in the country.

Regulations No. 16 of 2 March 1995 on payments initiated by bank cards (State Gazette, issue 28 of 1995) of the Managing Board of the BNB form the legal basis for the establishment of a nationwide system for payment by bank cards. Participants in this system are banks, issuers of bank cards, persons who have concluded contracts for use of bank cards, traders who have agreed to accept payments by bank cards, and the national operator which approves interbank payments. By resolution of the BNB Board, BORICA Ltd., Sofia, is the national operator. In compliance with the adopted regulations, payments by bank cards may be made for up to the amount on the card holder's account balance, i.e. only debit cards are allowed. Bank cards may be issued only by banks licensed by the BNB Board.

Regulations No. 17 of 8 November 1995 on the enforcement of Article 29 of the Law on Banks and Credit Activity (State Gazette, issue 102 of 1995) determine the manner for the establishment and accounting of banks' investments in real estate, equipment, shares and interest in nonfinancial enterprises and of their own capital, and the measures for removing any violations on Article 29 of the LBCA, where the amount of these investments exceeds the bank's own funds.

Regulations No. 1 of 21 December 1995 on bank deposit insurance (State Gazette, issue 6 of 1996) determine the establishment and operation of a system for insurance of bank deposits of physical persons, the amount to which these deposits shall be insured and the terms and procedures for reimbursement of deposits up to the amount guaranteed. In compliance with the proposed system for insurance of bank deposits of physical persons, reimbursement of funds up to the guaranteed amount, BGL 250,000, shall be made only in levs from a specifically created fund, to which banks make initial and annual premium contributions. Obligations to recover funds arise when a particular bank is insolvent which makes it incapable of making payments due to its clients, and upon ascertaining this fact the Managing Board of the BNB revokes its license to conduct bank transactions, or where applicable to effective law, the bank is declared insolvent by a court of law.

The amendments made to *Regulations No. 7* on the big and internal loans of banks are intended to clarify the definition of "a big loan" as well as to improve banks' reports on extended big and internal loans.

Significant amendments were made to *Regulations No. 8* on the capital adequacy of banks. They are aimed at improving the criteria for the establishment of the capital base and the risk component of balance sheet items, which is essential for the establishment of the capital adequacy ratios. The capital requirements for banks were significantly increased. According to the latest changes made, a bank may be incorporated with a minimum paid-in capital of BGL 800 million, or BGL 1,200 million for an international license. Existing banks must also meet the new requirements for minimum own funds within the deadlines set.

As the BNB abandoned the practice of holding auctions for short-term interbank deposits in levs, *Regulations No. 4* of 1991 on holding auctions of interbank deposits were repealed.

3. Relations with International Financial Institutions

International Monetary Fund

Given the noncompliance with the performance criteria established in the letter of intent to the third stand-by agreement with IMF, the country has not received the last tranches of this agreement. The importance of a new agreement with the IMF is due primarily to the role of this institution as a center of the financial community rather than to funds which will be extended in support of the country's balance of payments. A new agreement with the IMF will become a factor of stability, indicating enhanced financial discipline and improved credit rating of the country.

Regular visits of IMF missions in the country continued. Negotiations on a fourth stand-by agreement with the IMF are in progress.

Bulgaria is a regular payer to the IMF. Obligations on interest and principals extended by the IMF are duly repaid.

World Bank

In 1995, the BNB acted as a government agent on the World Bank credit line for small and medium enterprises in agriculture (ADP project), totaling USD 55 million. The loan became effective on 14 July 1995 thanks to well coordinated actions. Three banks had access to the funds under this credit line agreement: First Private Bank Ltd., Dobrudza Commercial Bank Ltd., and Raiffeisenbank – Bulgaria, Ltd. No loan agreements under this project have been approved yet because the projects submitted were insufficient in number and did not meet the requirements of the Bank. On the other hand, the World Bank is not inclined to increase the number of the mediating banks.

Work on the credit line for Private Investment and Export Financing of small and medium enterprises (PIEF), totaling USD 55 million, continued. Funds extended under this loan agreement totaled USD 5 million. The number of mediator banks was increased to two: First Private Bank Ltd. and Raiffeisenbank – Bulgaria, Ltd. Twenty-one projects, totaling USD 15.9 million, were approved. The term of the credit line was extended until the end of 1997.

European Bank for Reconstruction and Development

During the first half of 1995, the EBRD Board of Directors approved projects for Bulgaria, totaling more than ECU 10 million.

An investment agreement was signed for the establishment of wholesale markets for vegetables and other agricultural products in 12 towns throughout the country in the amount of ECU 28 million.

The Bulgarian Investment Bank, in which the EBRD holds a stake, began to carry out its activities.

An investment agreement of ECU 36.4 million for the reconstruction of the Bulgarian Railways was signed.

Of 15 projects worth ECU 192 million approved in 1995, the bank concluded four contracts for ECU 66 million.

European Investment Bank

The work on the credit line for small and medium enterprises (APEX project), totaling ECU 30 million (USD 40 million), continued in 1995. The mediator on this project is First Private Bank Ltd. The BNB, in cooperation with the EIB, has considered three other banks for mediation on the credit line. In 1995, three projects, totaling ECU 3.1 million (USD 4 million), were approved, of which USD 3.8 million was utilized.

Technical Assistance for Restructuring of the Banking System

In 1995, the BNB intensified its coordination of the technical assistance rendered to the BNB and the banking system by international financial institutions as well as the 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 the fields of rehabilitation of the banking system, monetary policy, and economic and monetary policy analysis.

The work on the most significant projects under the PHARE program continued in 1995. All projects for international diagnostic and financial audits in some large commercial banks (i.e. Sofiabank Ltd., Mineralbank, Economic Bank Ltd., Post Bank Ltd., Biochim Ltd., and Balkanbank Ltd.) were completed. Another important project on rendering technical assistance for the restructuring and development of the SSB is in progress. In October 1995, the International Banking Institute launched a training program in banking developed in cooperation with the Manchester Business School.

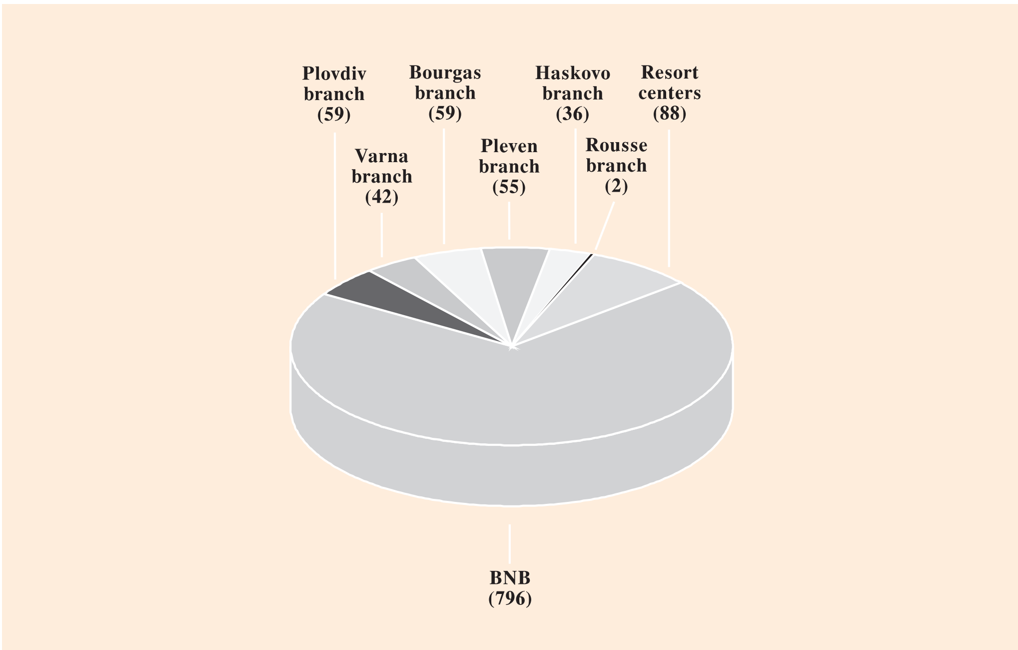
4. Personnel and Qualification

The total number of BNB personnel was 1,137 persons as of 31 December 1995.

Throughout the year, the BNB continued to pursue an open policy in selecting and recruiting its personnel. The major criteria adopted were expertise and professional experience of the applicants.

PERSONNEL OF THE BULGARIAN NATIONAL BANK

(number of persons)



Source: BNB.

In 1995, a PHARE financed project on human resources management in the BNB was completed. Over the course of two years, the following essential issues were executed: design of a system for job classification based on job description characteristics; methods in recruiting bank personnel – tests, interviews, etc.; and a payroll system. The entire work on the project and resultant systems were very helpful for the introduction of modern methods in personnel management at the BNB.

The BNB, in order to meet the new requirements and trends in the development of the banking system in Bulgaria, continued to invest funds for training.

The trend of increasing contacts with other central banks, institutes and centers for bank training from western Europe, the USA and Japan continued, reflected in the increased number of employees participating in various forms of training abroad. In 1995, their number rose to 110, a 40% increase compared with 1994. Training covered the following areas: monetary policy, economic and monetary analysis, foreign exchange operations, bank supervision, bank management, information technologies, and bank accounting.

VIII. Major Trends in Monetary Policy in 1996 and 1997

Significant progress was made in curbing inflation in 1995. In annual terms, the inflation rate decreased from 122% to 33% – two percentage points less than the target range (35% – 40%). The major reasons behind this success relate to the generally restrictive monetary policy pursued throughout the second half of 1994 and most of 1995, and the enhanced real demand for money, primarily the national currency.

Exchange rate stability was the major factor responsible for the low inflation rate in 1995. The real lev appreciation against the benchmark international currencies had a suppressive effect on domestic prices but it did not affect the trade balance. At the same time, the BNB interest rate differential between lev investments and foreign currency investments resulted in a substantial capital inflow which helped replenish the country's forex reserves and thus ensure foreign debt servicing. The supply of foreign exchange through most of 1995 was sterilized by the BNB to avoid money supply growth over the real demand.

In 1995, the BNB succeeded in gradually decreasing the basic interest rate, consistent with the achievement of its anti-inflationary goal. For the first time after the initiation of the reforms, the seasonal pattern of higher interest rates in the autumn and winter and lower interest rates in the summer changed. In 1995, the BNB pursued a conservative interest rate policy. That is, positive deposit and lending rates were maintained over the year. This helped to strengthen the real demand for money and to expand credit resources, though at a high cost: an unmanageable interest rate burden for a number of borrowers and the deterioration of the financial state of many banks.

However, relatively improved macroeconomic conditions did not accelerate the structural changes in the real sector and the banking system which would have radically changed inflationary expectations. Delayed privatization and strict financial discipline imposed on all economic agents did not permit the resolution of long existing, fundamental problems. A number of state-owned enterprises continued to accumulate losses and transfer them to the banking system through the existing lending system. The high real lending rates and BNB's efforts to sterilize foreign exchange inflow in the country had an additional depressive effect on banks and their clients.

During the latter part of 1995 and early 1996, financial stability has been fragile. The financial state of some banks (private and state) has rapidly deteriorated thus threatening not only the solvency of the troubled banks but also that of the entire banking system. In 1995, these banks failed to adjust to the new conditions of lower inflation and a stable exchange rate and continued their credit expansion. Currently, they face sustained and dire liquidity problems. To support the payments system, the BNB had to refinance these banks through unsecured loans in its capacity of lender of last resort. Given the lack of an effective mechanism for the forced collection of claims, including that of bankruptcy and the absence of political will, the BNB's actions may only postpone the problems. As the liquidity problems continue to intensify, without radical changes, bank insolvency is the result.

A liquidity squeeze at some banks in conjunction with other factors, including political problems, prompted a sizable withdrawal of deposits from these troubled banks. As a result, they were refinanced by the BNB. In order to save the two banks and to restore confidence in the banking system, the BNB became a major shareholder in these banks. However, these steps have a temporary effect and cannot resolve the underlying problem given the further delay in structural reform.

The BNB's increasing role as lender of last resort heavily contradicts the general anti-inflationary orientation of central bank's monetary policy and exerts pressure on its relief. Increasingly growing unsecured refinancing of commercial banks with liquidity deficiencies cannot be fully sterilized through open market operations, and free funds have been channeled to the forex market where in early 1996 the lev began to depreciate in real terms. This erodes the confidence in the national currency and disruptions in the banking system undermine banks' credibility. In this situation, the real money demand decreases and a trend of investing in foreign currency in cash evolves which impedes the pursuance of an anti-inflationary monetary policy.

With regard to preserving the forex reserve necessary to service the country's foreign debt, liquidity should be taken out primarily through the lev market. Since early 1996, daily repo-operations have been introduced to expand the lev market. In order to make the lev more attractive, the BNB had to increase interest rates. As a result, the central bank raised the basic interest rate on two occasions – from 34% to 41%, and then to 49%. However, these measures have a temporary effect. They cannot eliminate the reasons for the increasing financial instability and the growing interest rate burden on borrowers given the lack of structural changes. Thus they exacerbate further the banking system crisis. Evidence of this is the sustained growth in interest rates on repo-agreements in the open market which prompts a new increase in the basic interest rate.

Problems of the banking system reflect the problems of the country's economy which cannot be resolved within the framework of BNB monetary policy. The close coordination and decisive actions of the government and the central bank on a joint program for rehabilitation of the real sector and banking system is the only remedy for the deteriorating macroeconomic and financial situation. Given the exclusive importance and political responsibility for the implementation of the program, it should be approved by the legislative powers. Within the framework of the comprehensive development of the program, the Plenary Council of the BNB, at its two consecutive sessions at the end of 1995 and early 1996, determined the major trends in the BNB monetary policy in 1996. The Plenary Council will regularly discuss and clarify the program, consistent with the initiated restructuring and rehabilitation of the banking system.

In 1996 and 1997, BNB monetary policy will be aimed at strengthening the internal and external stability of the national currency. The major monetary policy goal in 1996 will be to maintain the inflation rate within the projections of the state budget macroeconomic framework. Consistency in BNB monetary policy and fiscal and income policies in the ensuing year is needed for provision of financial stability in the country at an acceptable social cost. At the same time, monetary policy alone cannot compensate for the delay in structural reform, an indispensable condition for anti-inflationary economic growth.

Accelerated structural reform and pursuance of an adequate macroeconomic policy in 1997 will further subdue inflation. The BNB will continue to pursue its major monetary policy goal by employing monetary policy tools in such a way as to avoid additional pressure on economic growth.

BNB foreign exchange policy will support the overall anti-inflationary character of the monetary policy. Foreign exchange policy goals include relative exchange rate stability resulting from the effects of the fundamental factors and reduction of fluctuations on the selected trajectory, as well as maintenance of an adequate level of forex reserves. A modest real depreciation of the lev to the benchmark international currencies may occur in 1996. It will partially offset the 1995 lev ascendancy in order to avoid decreases in the positive trade balance and a decline in the forex reserves to a level threatening the implementation of a comprehensive foreign exchange policy and servicing of the foreign debt.

Determination of the 1997 foreign exchange policy goals is challenging. The situation by the end of 1996 and the balance of payments performance will determine whether or not it will be possible to modestly appreciate the lev, which would have an anti-inflationary effect. At the same time, the amount of forex reserves and access to international capital markets will be the key factors influencing foreign exchange policy in 1997.

BNB interest rate policy in 1996 will be instrumental in controlling inflation. The interest rate burden on borrowers needs to be decreased as much as possible in 1996. To this end, a decrease in interest rates may be expected both on deposits and credits. The interest rate difference between deposits in levs and foreign exchange also should fall but remain positive. Given the situation in early 1996, the BNB will not be able to follow a one-way path of change in the interest rate as in 1995. Despite the two increases, the interest rate level of 49% is far from the average interest rate used in calculating the 1996 state budget expenditure. Nevertheless, BNB interest rate policy in 1996 will remain conservative. The BNB will resist external pressures to cut interest rates until the necessary conditions are in place. These conditions involve an appropriate reduction in the inflation rate, as well as the start and resolve to carry out structural reforms which are to change overall expectations.

The BNB's efforts will be aimed at creating conditions for a decrease in the spread between interest rates on credits and deposits. The main factor to achieve this is to improve the quality of the banks' credit portfolio through effective collection of claims, by all possible means, including debt-for-equity swaps and initiating bankruptcy procedures against insolvent borrowers. Strengthening of financial discipline in all sectors of the economy should be carried out jointly by the BNB and the government.

To maintain confidence in the national currency and strengthen money demand, it will be reasonable to keep real interest rates slightly positive in 1997. A dramatic decrease in the spread between deposit and lending rates resulting from rehabilitation measures in the real sector and the banking system will help relieve the interest rate burden on borrowers and will not have a depressive effect on economic growth. Moreover, maintenance of a slightly positive interest rate difference between deposits in levs and foreign exchange will attract additional funds for the development of the country's economy.

The BNB will continue to limit the money supply in order to achieve its anti-inflationary target. After the registered decline in the money demand at the beginning of 1996, the broadest monetary aggregate, including currency outside banks and all types of deposits may be inflationary, given the inflation rate. In this respect, a tightening of monetary policy is needed and the money supply will lag behind the inflation rate by four to five percentage points consistent with the expected real growth in GDP.

Should the real money demand strengthen, as a result of adequate measures undertaken by the government and the BNB, a nominal increase in the broadest monetary aggregate by several percentage points over the inflation rate would be admissible in 1997. In this situation, the BNB monetary policy will be determined by real GDP growth and the increase in real money demand. However, BNB monetary policy should remain restrictive, though less than in 1996.

The control over money supply will continue to be implemented by reserve money management. The BNB will use different monetary instruments to keep the reserve money growth along a predefined path. The refinancing of troubled banks with uncollateralized credits by the central bank will be compensated by defensive open market operations so that the overall liquidity in the banking system remains under control. To preserve foreign exchange reserves, it will be necessary to take out liquidity on a true market principle, freeing interest rates, so as to clear the money market and the primary auctions of government securities. Under such a scenario, the exchange rate will be used as an additional aggregate indicator to fine-tune monetary policy: pressure for a speedy depreciation of the lev will mean that further tightening is needed and relief on foreign exchange will leave room for adequate easing.

Reporting minimum reserve requirements on an average monthly basis, introduced in February 1996, will be of essential importance for reserve money management. Commercial banks may use up to 50% of their minimum reserve requirements on a given day but they should be restored to the average monthly required minimum by the end of the regulation period by depositing excess reserves on other days. This step is aimed at eliminating overdraft, which is practically beyond BNB control, and encouraging more flexible daily liquidity regulation by banks. However, it is clear that banks with sustained liquidity deficiencies will not be able to abide by this requirement. It is reasonable that these banks be gradually deprived of the right to use a portion of their minimum reserve requirements and the necessary funds to maintain their liquidity shall be extended by the BNB in the form of uncollateralized credits. As a result, the number of monetary policy tools employed will decrease and the monetary policy will be more transparent.

If decisive rehabilitation measures are taken in 1996, it is expected that the role of the BNB as a lender of last resort will diminish dramatically. This would help limit the number of monetary policy tools employed to open market operations. Open market operations will regulate liquidity in the banking system and help keep control over reserve money and money supply respectively. This will allow a more transparent and more effective central bank monetary policy, since banking system stability will facilitate forecasting and make the estimates on the money multiplier more reliable.

In 1996 and 1997, the trend toward an increase in the net foreign assets in the banking system, evolving through most of 1995, is expected to continue. This reflects Bulgaria's position of a net payer on its foreign debt in the ensuing years. In 1996, the banks' net foreign debt is estimated at approximately USD 250 million. Given this, the increase in domestic credit will lag behind the money supply growth by approximately three percentage points.

The growth in the money supply, consistent with the decrease in inflation, as well as the need to set aside sufficient resources for the growing real sector, limit bank financing earmarked to cover the cash budget deficit and maturing principal payments on the foreign debt. Within the overall framework of a feasible financial program, this financing cannot exceed 4% of GDP. To avoid any loosening of the monetary policy, the BNB and the government have to look for additional sources by promoting nonbank financing, cash privatization and foreign investment.

An important requirement for monetary policy in 1996 is to finance the budget deficit only by issuing government securities to be sold at market prices. As the domestic debt burden is heavy, the BNB together with the government should look for possibilities and means to limit its further growth and cut the expenditures on its service. At present, this cannot be done through administrative interest rates. Only decisive and radical structural changes can prepare the ground for a substantial decline in interest rates to free the budget of one of its heaviest burdens and to relieve the fiscal pressure on monetary policy.

Credit to the real sector represents a difference between the domestic credit and credit to the government. Provided that in 1996 the budget borrowing requirements are reduced to 4% of GDP, overall credit to the nongovernment sector will fall by approximately 9% in real terms. If foreign currency credits decrease to around USD 200 million (10%), the real cut in the lev credit would approximate 13%. This credit will be sufficient to promote economic growth in the real sector, since the rehabilitation of the country's economy will provide necessary conditions to channel credit resources to viable enterprises.

The BNB will intensify its supervision over the commercial banks and its activity will be aimed not only at limiting the volume of nonperforming loans but also at addressing the reason for their appearance. A program for weekly and monthly control over monetary flows in banks will be introduced. Measures provided by bank supervision will be applied on the basis of analyzed data and outlined trends. A project for synchronization of reports required as per the bank supervision regulations and a unified report on all regulations will be introduced. Work on a system of early warning, which includes a system of indicators for monthly control of commercial banks and unified system for assessment of the state of banks, is in progress.

The BNB will perform its function of lender of last resort only upon assessment of the viability of the troubled bank and after approval of a jointly developed program for the bank's rehabilitation. Such programs will involve measures to increase the collectability of extended loans, to reduce the amount of new loans and to decrease current and investment expenses. The banks will be temporarily refinanced by the BNB through uncollateralized loans, provided they strictly implement the rehabilitation program. Any deviation from it should lead to more severe measures, including closure of the bank. Under the existing complex situation, such an act may have a much stronger confidence and liquidity effects than the usual increase in the interest rates.

Further decapitalization of the commercial banks not only would limit the enactment of anti-inflationary monetary policy but also might seriously threaten the stability of the entire banking system. This problem cannot be solved solely within current BNB bank supervision. A comprehensive program for the rehabilitation of the entire banking system has to be implemented jointly by the BNB and the government. Delays and inconsistent actions lead only to further financial destabilization with heavy economic, social and political consequences. The necessary financial resources for the rehabilitation of the banking system cannot be supplied from the BNB because it will have a clear inflationary effect. Such measures should be provided by a separate structural government budget which should be financed by additional resources: nonbank financing, receipts from cash privatization, and external financing.

The BNB will support the establishment and operation of an agency for collection of claims as a part of the rehabilitation program in the banking system. The biggest loss-making state-owned enterprises should be isolated from banks through the agency, thereby preventing the transfer of losses to the banks. The nonperforming loans of loss-making enterprises should be transferred for collection to the agency, and government securities with market yields should be extended to commercial banks. In this manner, progress in solving existing problems in order to improve the quality of commercial banks' credit portfolio could be made.

Further development of the legal framework of banking will be of essential importance for the banking system. The BNB will actively participate in expanding and improving the legal framework, intending to create legal conditions for the real restructuring of the banking system. The central bank will make propositions as to the simplification and efficiency enhancement of the legal procedures for declaring insolvency, receipt and realization of pledges and securities, as well as other procedures for forcible collection of claims. The BNB will improve a number of by-laws regulating bank activity: Regulations No. 3 on payments, Regulations No. 7 on the big and internal loans of banks, Regulations No. 8 on the capital adequacy of banks, Regulations No. 9 on the loan classification and formation of mandatory special reserves (statutory provisions) by banks, Regulations No. 10 on the internal control in banks, Regulations No. 11 on the liquidity of banks. The BNB will take part in developing a law on deposit insurance which will replace the operative regulations on deposit insurance.

To support its monetary policy, the BNB will also cooperate in putting in place and enforcing the legal framework for the development of primary and secondary capital markets based on the Law on Securities, Stock Exchanges and Investment Funds. This will help to speed up privatization and is expected to reinforce the market principles in the banking system.

In 1996 and 1997, the BNB policy will aim to establish adequate conditions for the conclusion of agreements with the International Monetary Fund and the World Bank. The need to sign new agreements with the international financial institutions arises to a large extent from the present difficulties in servicing the foreign debt in the face of a lack of foreign financing. Estimates for major macroeconomic parameters in 1996 do not suggest that the inflow of short-term capital will continue. In such an environment, the balance of payments support from official sources in 1996 as well as in the next one to two years will play a decisive role in preserving foreign exchange reserves at a satisfactory level to meet foreign debt obligations.

At the same time, the agreements with the international financial institutions will have a more important structural effect. They will mobilize the whole country to strictly and rapidly follow an overall rehabilitation program which will provide the necessary environment for effective functioning of enterprises and banks for cutting inflation to a single digit and for sustainable export-oriented economic growth in the medium term. Such measures will help to improve the country's image, regain access to international capital markets, and attract more foreign direct investment. These resources will finance the import of more advanced technology investment equipment, which will have additional positive effect on the national economy, in its resolve to follow an anti-inflationary path of development.

The strength of the country's financial stability depends not only on the BNB monetary policy but on its integration in a comprehensive program for radical structural reforms in the real sector and the banking system. Only the initiation of profound structural changes in privatization and strict financial discipline of all economic and financial agents may lay the ground for a sustainable reduction in inflation, by pursuing modestly restrictive monetary and fiscal policies.