The Bulletin

OMFIF

Summer 2020
Vol.11 Ed.3

Uncharted waters

Navigating the post-Covid recovery

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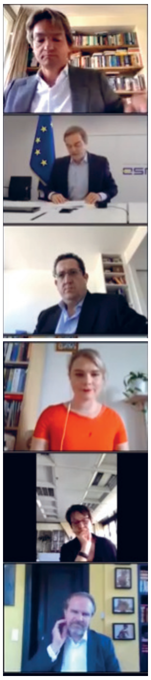

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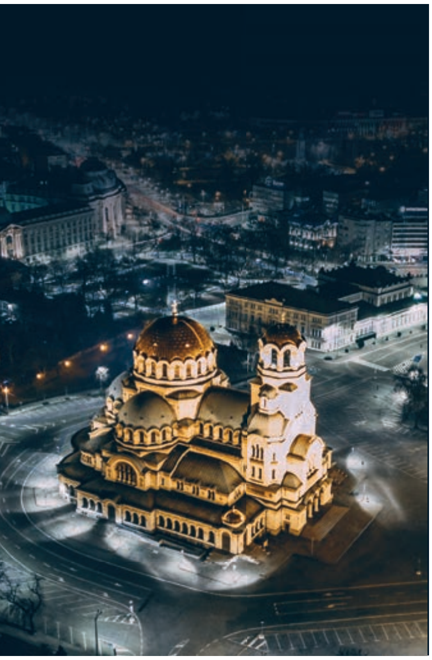
In love with the lev

Bulgarians are wary of abandoning a currency that has done so much for them

Steve Hanke
Johns Hopkins University

Earlier this year, we witnessed a dramatic dialing back of Bulgaria's headlong rush to abandon its lev and adopt the euro. Prime Minister Boyko Borisov felt that the Bulgarian public was in no mood to be dragged into the European Exchange Rate Mechanism.

1997 was both one of the worst and best years for Bulgaria. It started badly. In February, Bulgaria's hyperinflation peaked at the astronomical rate of 242% per month. Then, things got better. On 1 July, a currency board law was adopted, and the Bulgarian National Bank, specifically its issue department, began to operate under currency board rules. These required the lev to be fully backed by Deutsche Mark reserves, now euro reserves, and to trade at a fixed exchange rate with the German currency. With that, the lev became a clone of the Deutsche Mark, and good news followed.



The currency board results were immediate and dramatic. The annual inflation rate collapsed to 13% by mid-1998. Interest rates slumped, too, with the BNB basic rate falling to 5.3% in October 1998 from more than 200% in early 1997. That was not all. The demand for the currency board's remodeled lev soared. Foreign reserves at the BNB were boosted as well. After all, the only way lev could be obtained was by exchanging Deutsche Marks for lev at the fixed rate of exchange. The BNB's foreign reserves rocketed to \$2.5bn by the close of 1997 from \$864m at the end of 1996.

In addition to these immediate, positive results, the currency board allowed Bulgaria to weather all post-1997 external financial crises – including the collapse of the Russian ruble in 1998 and the 2008 financial crisis.

Discipline and resilience

The currency board also allowed Bulgaria to weather the 2014 collapse of the Corporate Commercial Bank (KTB). The KTB catastrophe was not caused by the currency board system, but by the failure of the banking and supervision departments of the BNB to properly regulate and monitor the KTB. Unlike most cases in which banking and currency crisis are joined at the hip, the KTB crisis did not disturb Bulgaria's currency. Thanks to the currency board system, the country did not witness a typical banking-currency crisis. The crisis was restricted to the banking sector. So, Bulgaria's currency board mitigated the damage that accompanied the collapse of the KTB.

Importantly, the currency board has imposed fiscal discipline on Bulgaria's politicians and fiscal authorities. The government cannot borrow from the currency board. In consequence, since the installation of the currency board in 1997, fiscal deficits have been tightly controlled, and the level of Bulgaria's debt relative to its GDP has plunged. It was 96.2% in 1997 and has fallen to 18.6% in the most recent accounts. Bulgaria's fiscal discipline and debt reduction have made it a star fiscal performer in the European Union.

The geopolitical aspects of Bulgaria's currency board should not be allowed to pass without mention. Former President Petar Stoyanov confided to me, while I was his chief economic adviser, that Bulgaria would have had much more difficulty entering the North Atlantic Treaty Organisation in 2004 and the EU in 2007 if it were not for the confidence and stability created by Bulgaria's currency board.

Perhaps that is why more than 50% of Bulgarians support the currency board and the lev, while only around 25% favour the adoption of the euro.

The Bulgarian public is smart enough to know that you never should try to 'fix' things that are not broken. But, with the onset of the coronavirus pandemic and while the Bulgarian public was looking the other way, Prime Minister Borisov changed course. He falsely argued that Bulgaria was missing out on EU funding because Sofia was not a member of the euro area. Then, in a desperate attempt to recapitalise the First Investment Bank, which is a precondition for Bulgaria's possible entry into the ERM II, the Bulgarian Development Bank, a state-owned bank, purchased rights to FIB shares at double their market price.

Only time will tell how the European Commission's directorate-general for competition will view this questionable manoeuvre and whether Bulgaria's government will move a step closer to what most Bulgarians fear: the loss of their beloved lev. ●

Steve Hanke is Professor of Applied Economics at the Johns Hopkins University and a Member of the OMFIF Advisory Board.

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