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How Bulgaria is destroying its "currency board"

A transfer of government funds threatens Bulgaria's monetary framework argue Steve Hanke and Matt Sekerke.

Since June 11 2003, the Bulgarian National Bank (BNB) has been without a governor as Bulgaria's parliament wrangles over a replacement appointment. (Never mind that this replacement date has been in the government's diary for six years.) At issue is not just the choice between the favourite of prime minister's party (NMS), Ivan Iskrov, or the incumbent Svetoslav Gavriiski, but the government's access to the so-called fiscal reserve. In particular, the socialist opposition (BSP) in parliament has indicated that the question of using the fiscal reserve must be answered before the dispute over a new governor can be resolved.

Early in 1991, one of us coauthored a draft currency board law for Bulgaria[1]. It contained no central banking features. The draft law specified a floor of 100% and a ceiling of 110% on the level of international reserve assets covering the board's monetary liabilities to ensure a tight link between changes in international reserves and monetary liabilities, and the automatic adjustment of the system.

Off to a bad start

In 1997, prior to the introduction of Bulgaria's currency board-like system, the original draft law was amended over the objections of Hanke, who was President Petar Stoyanov's advisor at the time. In consequence, the final law became a pale imitation of a pure currency board law. Importantly, it specified no ceiling on reserve cover. Accordingly, the BNB can engage in discretionary monetary policy via neutralisation (also called sterilisation), and it has done so. Indeed, of all the modern currency-board-like systems,

1 Steve H. Hanke and Kurt Schuler *Teeth for the Bulgarian Lev: A Currency Board Solution*. Washington, DC: International Freedom Foundation.

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Bulgaria has had the most active monetary policy[2]. Another problematic issue created by Bulgaria's quasi-currency board law is the fiscal reserve.

The government's cash

The fiscal reserve is a number of government deposits distributed between the BNB and commercial banks in Bulgaria. The deposits that are kept at the BNB are considered part of the monetary base, which the issue department is required to back 100% with international reserves. The government is proposing now to transfer the fiscal reserve deposits (or some of them) at the BNB to commercial banks. The details for doing so are not clear, but the government's objective is: the government wants to loosen monetary policy. Allowing the fiscal reserve to be moved around at the government's discretion removes the fiscal reserve from the monetary base and makes it an instrument of domestic credit policy. When transferred to the commercial banks, the government deposits will encourage an expansion in bank lending. An operation along these lines is characteristic of central banking, not currency boards.

What will be the results of the government's programme, if it is carried out? We have illustrated the effects in Figure 1 below. In the initial phase (denoted A), the BNB holds foreign reserves to back its monetary liabilities, as defined in the law on the Bulgarian National Bank. Monetary liabilities include base money as it is commonly understood (currency and bank reserves) plus government deposits – the fiscal reserve. Commercial banks lend to Bulgarian firms and households (generically called "domestic assets" in the figure) against deposits received. These two T-accounts are consolidated in a third T-account. The liabilities in this third T-account represent broad money. All quantities are, of course, stylised, but they are in proportion to the current position of the BNB and the commercial banks in Bulgaria.

In phase B, the government transfers all of its deposits to the commercial banks. The BNB retires the government's claim on its assets by paying out foreign reserves, and the government establishes its claim on the commercial banks by re-depositing the foreign reserves with them. At this point, neither base money nor Bulgaria's net international reserves, measured on a consolidated basis, have changed.

A short-lived expansion

But this is not an equilibrium position for the banking sector. Banks can earn greater returns by transforming foreign assets into domestic assets. In other words, foreign and domestic assets are imperfect substitutes and banks accordingly reallocate their portfolios from foreign reserves, which earn a relatively low return, to domestic assets, which earn a relatively high return. Therefore, in phase C, domestic assets expand from 75 to 100 and foreign reserves fall from 50 to 25. The supply of broad money is still unchanged, but its composition is altered, with the foreign component contracting and the domestic component expanding. It follows that the expansion in domestic credit (domestic assets) desired by the government results in a reserve outflow from the consolidated financial system. This translates into a deterioration in the balance of payments.

2 Steve H. Hanke "On Dollarization and Currency Boards: Error and Deception." *Journal of Policy Reform*, v. 5 (4) 2002.

So far we have assumed that the demand for broad money (lev currency and deposits, in our simplified model) will remain constant. But what if the government's action causes Bulgarians to lose confidence in the lev? If they convert their lev currency and deposits into euros (the BNB's reserve currency), foreign reserve drains will continue, putting speculative pressure on the lev. Accordingly, monetary conditions will tighten up and interest rates will increase as foreign reserve levels and base money decline. Under this scenario, what began as an attempt to loosen monetary conditions will backfire, as monetary conditions become tighter, not looser.

Credibility damaging

If the BNB attempted to offset the foreign reserve outflows – which it can do (and has done) under the current law – it would send unnecessary shocks through the Bulgarian financial system and defeat the credibility and (mostly) automatic adjustment of Bulgaria's currency-board-like system. It would damage its hard-won investment-grade credit rating and open the door to additional interference in what is at best a fledgling market economy. A successful attack on the lev would also derail Bulgaria's entry into the European monetary union.

A way out

Unfortunately, the fiscal reserve issue will probably persist so long as the fiscal reserve exists at the BNB. The fiscal reserve must be disposed of somehow. A simple plan for doing so consists of the following measures:

Firstly, retire the government's deposits at the BNB and place the counterpart foreign assets on account with a commercial bank not headquartered in Bulgaria. The deposits should be used to buy back Bulgaria's foreign debt. Secondly, amend the Bulgarian National Bank law to redefine the monetary base as lev notes, coins, and foreign exchange-collateralised bank reserve deposits only. And thirdly, institute a ceiling on the international reserve backing of the monetary base of 110% to make the currency board mechanism fully automatic.

To achieve a more permanent independence from government intervention, the BNB should also liquidate its banking department and separate the banking supervision department from the issue department completely. The reserve requirements for banks should also be eliminated. If these measures are implemented, Bulgaria will at last have a currency board. There will be no more opportunities for government interference and Bulgaria will remain on track for accession to the European monetary union. The latter benefit should appeal to Bulgaria's politicians. It is more than can be said for the Eastern European countries that have those coveted central banks. □

Figure 1: How reallocating the fiscal reserve leads to an expansion in domestic credit

Balance sheets of the Bulgarian National Bank (issue department), commercial banks, and a combined balance sheet

A. Before

Bulgarian National Bank		Commercial banks		BNB + Commercial banks	
50 FX reserves	**50 Mon. liabilities**	75 Domestic assets	75 Deposits	**50 FX reserves**	25 Base money
	25 base money			**75 Domestic assets**	100 deposits
	25 Govt. deposits				

B. After

Bulgarian National Bank		Commercial banks		BNB + Commercial banks	
25 FX reserves	**25 Mon. liabilities**	75 Domestic assets	75 Deposits	**50 FX reserves**	25 Base money
	25 Base money	**25 FX reserves**	**25 Govt. deposits**	**75 Domestic assets**	100 Deposits

C. Later

Bulgarian National Bank		Commercial banks		BNB + Commercial banks	
25 FX reserves	25 Mon. liabilities	**100 Domestic assets**	75 Deposits	**25 FX reserves**	25 Base money
	25 Base money		25 Govt. deposits	**100 Domestic assets**	100 Deposits