

Currency Board Brings Bulgaria Stability, Says Raiffeisen Report

31 January 2008, Thursday

Introduction

Since 1997 Bulgaria has been operating under a currency board arrangement that was implemented by the Bulgarian National Bank (BNB). The exchange rate of the Bulgarian lev was fixed by law to the deutschmark and later to the euro at the level of 1.95583. Legally, the currency board is institutionalized through the Issue Department of the BNB, whose primary function is defined as maintaining full foreign exchange cover for the total amount of the BNB's monetary liabilities. The currency board arrangement is expected to be maintained until the country joins the Eurozone in 2011-2012 (projected).

Factors that underpin the currency board

Full coverage of monetary base with FX reserves

The conventional type of currency board requires 100% coverage of the monetary base (money in circulation plus commercial bank deposits at the central bank) with foreign currency reserves. A certain cushion of at least 10-20% above the monetary base is usually recommendable.

Yet the Bulgarian currency board was designed in a way that foreign currency reserves equal much more than 100% of the monetary base, as they also cover the government's deposit with the central bank and the deposit of the central bank's Banking Department (the latter being set aside as a safeguard against systematic liquidity problems). According to the latest data as of the end of 2007, foreign exchange (FX) reserves grew 33.7% yoy to EUR 11.94 bn. The monetary base thus accounted for 60.8% of the official foreign reserve. This ratio was traditionally even lower until September 2007, when the central bank increased the minimum reserve ratio by 4 percentage points to 12% effective 1 September. Thus, the share of the monetary base that represents banks' reserves with the central bank increased substantially after the hike.

In fact, even if one considers the entire BGN-denominated portion of the broader money supply aggregate - M2 - the foreign currency reserve still covers 90.6% of it (end of Dec-07, 99.3% end of Nov-07). **This means that hypothetically, if the money in circulation, the bank deposits with the central bank and all of the BGN-denominated deposits were to be converted into EUR (in case of panic) the official reserve would still suffice to meet this demand.** Hence, the stock of foreign currency reserves is more than adequate not only compared to the level of reserve money, but also to the broader money supply aggregate (M2).

Sustainable fiscal policy

The last few years have all ended with fiscal surpluses and 2007 should not be an exception. In November, the government's year-to-date surplus reached 7.1% of the projected GDP due to the over-collection of tax revenues, which far exceeded original projections. Despite some extra spending of 2.5% of GDP in December, the full-year surplus is likely to exceed the government's latest target of 3%. For 2008, the cabinet is again targeting a 3% surplus and, considering the government's traditionally conservative planning of revenues, the 3% goal may be overshoot again this year.

Stabilising/'sterilising' role of fiscal reserve

Thanks to restrictive fiscal policy and the pursuit of budget surpluses, the government's fiscal reserve has grown substantially over the last couple of years. The fiscal reserve plays an important role in controlling the money supply and keeping inflation in check. On the one hand, its growth reduces total absorption by capping government spending, thus easing inflationary pressure from the demand side. On the other hand, Bulgaria's currency board has not been designed according to the conventional currency board rule. Foreign reserves cover not only the monetary base, as is usually the case, but also the government's deposit with the central bank's Issue Department and the Banking Department's deposit with the Issue Department.

As a result, the government has the power to 'sterilise' the considerable inflow of foreign capital using its deposit with the central bank, so that fiscal reserve growth does not directly translate into monetary base growth (which would have been the case if a classical currency board had been in place).

The latest statistics show a substantial increase of the fiscal reserve in the course of 2007 due to the better-than-projected collection of budget revenues. The fiscal reserve consists of the government's deposit with the BNB (the larger part) and foreign currency reserve assets. At the end of November, the central government's fiscal reserve reached BGN 9,445.9 mn after growing by 41% yoy. BGN 7,976.8 mn of the total reserve represented the central government's deposit with the BNB at the end of November, up considerably by 45% yoy. Thus, while official foreign reserves had grown 34% yoy as of the end of November, money in circulation had increased at a much slower pace of just 17% yoy as of the end of November. The overall monetary base rose by 26% yoy over the same period, but this faster growth rate was a result of the increase of the minimum required reserves from 8% to 12% from the beginning of September.

To sum up, as long as the government sterilises the inflow of foreign capital using its fiscal reserve, money supply growth will stay under control and not act as a pro-inflationary factor. As mentioned above, the approved state budget for 2008 targets a 3% surplus, which may end up being even higher at the end of the year, considering the government's traditionally conservative planning of revenues. This suggests that the course of fiscal reserve accumulation is likely to continue in 2008, and the inflow of foreign capital is not expected to excessively fuel the money supply and inflation.

External public debt

The stock of public external debt is minimal and hence does not require a serious outflow of foreign currency to service it. According to the latest data (as of the end of 2007), the stock of external public debt was EUR 4.074 bn or just 14.2% of our GDP projection for 2007. Public debt (both external and internal) is not likely to grow tangibly in the medium term, as the government is pursuing a policy of fiscal surpluses and budget deficit financing is not an issue.

Financing of the current account deficit

In the last two years, the current account deficit has been offset entirely by counter-inflows of capital and the overall balance of payments (i.e. C/A+KA) has been positive, resulting in a rapid accumulation of foreign reserves. Moreover, the financing of the current account deficit has been carried out in the soundest way possible - i.e. via net FDI inflows.

FDI does not create debt that will have to be repaid later and that will worsen the current account balance further in the future as interest service is accounted for there. It also does not represent hot money (in contrast to most portfolio investment) that may be withdrawn abruptly in the event of a turnaround in investment sentiment. FDI coverage of the current account gap amounted to exactly 100% in 2006 and 92.3% in Jan-Nov of 2007. The market consensus is that FDI inflows will remain high and will cover at least the bulk of the current account gap in the medium term.

Banking sector stability

Theoretically, under a currency board arrangement, domestic central banks no longer play the role of the lender of last resort for local commercial banks. Thus, in case of liquidity problems, banks cannot rely on the central bank to bail them out. Under Bulgaria's currency board arrangement, however, the central bank's lender of last resort function is quite limited but still exists. The central bank can extend short-term loans to local banks in case of systematic liquidity risks to the entire banking system. These short-term loans must be entirely collateralized with gold, foreign currency or other liquid assets. For this purpose, the central bank's Banking Department maintains a deposit with the Issue Department (the latter acting as the currency board) that may be used for short-term emergency lending to banks.

Even if the law provides the possibility of such a bail-out, the domestic banking system has remained stable and sound since the introduction of the currency board arrangement and no bank has resorted to central bank loans. Despite rapid credit growth in the last few years, the banking sector remains well capitalized, while the share of non performing loans is still quite low. According to the latest data, capital adequacy for the banking system is

13.9% (as of the end of September 2007), while regularly serviced loans account for 97.5% of all loans (as of the end of November 2007). Moreover, over 85% of the local banks are majority-owned by well-established foreign banks, which would ensure adequate funding by parent banks in the hypothetical case of liquidity problems.

Political stability

The last two cabinets since the introduction of the currency board arrangement in mid-1997 have completed their four-year mandates without any serious political problems. The current coalition cabinet that took office in mid-2005 is also widely expected to fulfil its four-year mandate. Hence, the currency board has not been subject to any serious political risks since its inception and is not likely to face any in the near future. Moreover, there is wide consensus among all of the bigger domestic parties that the currency board will be kept in place and the Bulgarian lev - pegged to the euro at the current exchange rate (1 euro = 1.95583 lev) until Bulgaria's accession to the Eurozone. Hence, it is very unlikely that the Bulgarian National Bank act (which represents the legal foundation of the currency board arrangement) will be changed in parliament considering the current political atmosphere.

ERM II and the Eurozone

Recently there have been rumours in the market that the country will enter ERM II very soon (first it was November 2007, then the end of 2007, then January 2008, etc.) but none of these dates have been realised so far. Considering last year's substantial inflation (12.5% at year-end, 8.4% average) and the upward revision of inflation expectations for 2008, the probability that Bulgaria will enter ERM II soon has decreased considerably. Although inflation is not a formal criterion for ERM II entry, European Commission and European Central Bank officials are widely speculated to informally consider it. According to speculation, neither EC and ECB parties are unwilling to let Bulgaria enter ERM II before the country has clear prospects of reducing inflation to a level closer to the Maastricht criterion. Thus, while a 2008-2009 target for ERM II entry and a 2011-2012 target for euro adoption seemed too pessimistic a year ago, they appear somewhat optimistic at present.

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