CENTRAL BANKING PUBLICATIONS LTD

Quarterly Journal

CENTRAL BANKING

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Central Banking Publications

A reprint from

Central Banking Journal

Volume 18 Number 1

August 2007

Central Banking Publications Ltd
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Scorecard for Bulgaria's currency board

After ten years of running under a new law, Bulgaria's central bank can be proud of its record writes Steve Hanke.

During 1990, I spent a good deal of time in Belgrade, where I served as the personal economic advisor to the deputy prime minister of Yugoslavia and where inflation was a major problem. Indeed, from 1971 to 1991, Yugoslavia's annualised inflation rate was 76%. Only Zaire and Brazil topped that dreadful performance. To solve the inflation problem, I recommended an orthodox currency board.[1]

From my vantage point in Belgrade, I was well positioned to observe the events unfolding in Bulgaria. The real economy was collapsing, inflation was surging toward triple digits, foreign debt was crushingly high and the Bulgarian lev was inconvertible. This state of affairs was similar to that faced by Bulgaria after a succession of wars that began in 1912 and ended in 1918. To save the day, the League of Nations sent a three-man mission to Bulgaria in 1928. The most notable member was Jacques Rueff, a French economist. He proposed that Bulgaria adopt a full gold-exchange standard. This proposal took effect in December 1928 and the lev became convertible into gold at a fixed rate for the first time since before the first world war.

Lessons of 1928

I thought the lessons of 1928 were relevant for post-Communist Bulgaria. As a consequence, I wrote a monograph with Kurt Schuler.[2] Our monograph proposed an orthodox currency board and included a draft law for such a system.

During 1991, I began visiting Sofia to introduce the currency board idea to government officials and the public. In particular, I can recall my meetings over the years with Todor Vulchev, who served as governor of the Bulgarian National Bank from January 1991 to January 1996. He had studied my proposal carefully and understood it. Indeed, during our meetings, he required no staff prompting. From our first meeting until the last, his position remained the same: we at the Bulgarian National Bank are in full control and can't envision a scenario in which that wouldn't be the case. In consequence, we have no need for currency board rules.

These conclusions were echoed in official circles until late 1996. Faced with a hyperinflation that virtually wiped out Bulgaria's banking system and sent the real economy into a free fall, the official resistance to the idea

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of a currency board began to crumble. What forced it to completely collapse was a turn in public opinion as well as a revolt carried out in the streets of Sofia.

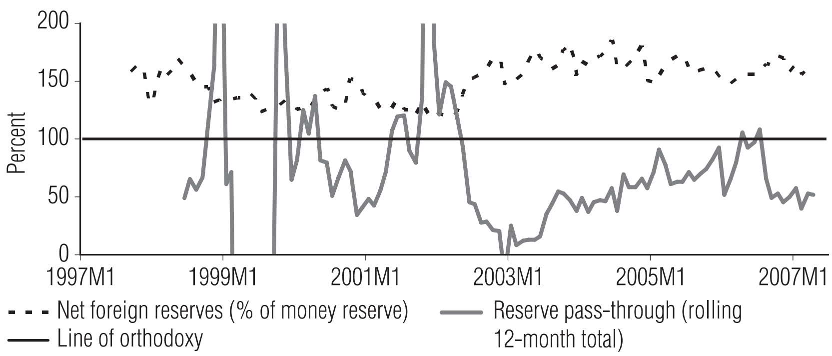
The public had lost all confidence in the government and the BNB. Instead, it embraced the currency board idea. As an indicator of the public's support for the currency board idea, consider that one of my books, *Currency Boards for Developing Countries*[3], had been translated into Bulgarian and reached the top of Sofia's bestseller list in early 1997.

In March 1997, President Petar Stoyanov appointed me as his economic advisor. My immediate task was to draft a currency board law and assist in implementing it. My draft a law for an orthodox currency board contained no central-banking features. Importantly, my 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. This would have ensured a tight link between changes in international reserves and changes in monetary liabilities as well as the automatic adjustment of the system.

On July 1 1997, Bulgaria introduced a currency board law to govern the Bulgarian National Bank.

Slight deviations That said, the Bulgarian currency-board law deviated from the strict orthodoxy I had proposed. In particular, it specified a floor of 100% on the level of international reserves covering lev reserve money, but no ceiling on these international reserves. As a result, the proportion of international reserves allowed to pass through to lev reserve money can deviate substantially from 100%, breaking the link between changes in international reserves and reserve money. Another major problem created by Bulgaria's "currency board" law is the fiscal reserve account which I have analysed in some detail in an earlier issue of *Central Banking*.[4]

Figure 1: Net reserves and reserve pass through (currency board orthodoxy=100)



The only other feature of the current set-up that I have criticised repeatedly is its staff size which in August of 2006 was 932.[5] If the central bank were operating as an orthodox currency board, it could operate with a staff of 100 or less.[6]

Figure 1 tells the story of Bulgaria's deviation from currency board orthodoxy. The Bulgarian National Bank has not allowed the monetary base to expand and contract exactly as an orthodox currency board would have. However, it has preserved the exchange rate of the lev against the German mark and later the euro by allowing full convertibility and holding a high level of reserves, much as an orthodox currency board would have and unlike its own behaviour before 1997. And Figure 2 shows how dramatically Bulgaria's economic indicators have improved since the introduction of its quasi-currency board in 1997.

In terms of currency board orthodoxy, the Bulgarian system merits a grade B. In terms of overall economic performance "before" versus "after" the currency board, Bulgaria receives an A. □

Figure 2: Before and after – Bulgarian economic indicators

	Real GDP growth (%)[a]	CPI inflation (%)[b]	Lending rate (%)[c]	Fiscal balance (% GDP)	Foreign reserves ($m)[d]
1990	-9.10	23.90	na	na	na
1991	-10.80	333.50	69.60	na	615.60
1992	-8.40	82.00	49.70	na	1,207.19
1993	-11.60	72.80	66.40	na	960.16
1994	-3.70	96.00	101.20	na	1,311.17
1995	-1.60	62.10	39.80	na	1,545.82
1996	-8.00	123.00	435.00	-12.70	792.94
1997	-5.60	1061.20	7.00	-2.50	2,474.09
1998	4.00	18.80	5.20	0.90	3,056.38
1999	2.30	2.60	4.60	-0.90	3,221.77
2000	5.40	8.20	4.70	-1.00	3,460.26
2001	4.10	7.50	11.11	-0.90	3,580.33
2002	4.90	5.80	9.21	-0.80	4,747.04
2003	4.50	2.30	8.54	-0.40	6,704.77
2004	5.70	6.10	8.87	1.80	9,222.15
2005	5.50	5.00	8.66	2.30	8,694.76
2006	6.20	7.30	8.89	3.20	11,756.13

Source: International Monetary Fund, World Economic Outlook Database, April 2007. a. Annual percentages of constant price GDP are year-on-year changes; the base year is country-specific. b. Data for inflation are averages for the year, not end-of-period data. c. Weighted average rate charged by credit institutions on new loans (including overdrafts) in leva to the non-financial corporations and the household sectors with terms up to one year. d. = (total reserves minus gold) + (gold): gold (national valuation) is the dollar value of official holdings of gold which, beginning in February 2005, are valued at market prices. For the period July 1997 to January 2005, gold was valued at either 500 Bulgarian leva per fine troy ounce or at the end-of-period London gold market price, whichever is lower. Prior to July 1997, gold was valued at $300 per fine troy ounce.

Notes

1. See Hanke, Steve H. and Schuler, Kurt, *Monetary Reform and the Development of a Yugoslav Market Economy*. London: Center for Research into Communist Economics, 1991.
2. Hanke, Steve H. and Schuler, Kurt, *Teeth for the Bulgarian Lev: A Currency Board Solution*. Washington, DC: International Freedom Foundation, 1991.
3. See Hanke, Steve H. and Schuler, Kurt, *Currency Boards for Developing Countries: A Handbook*. San Francisco: Institute for Contemporary Studies Press, 1994.
4. Hanke, Steve H. and Sekerke, Matt, "How Bulgaria is destroying its 'currency board'", *Central Banking*, volume XIV, no. 1, August 2003.
5. Pringle, Robert (ed.), *The Morgan Stanley Central Bank Directory 2007*. London: Central Banking Publications Ltd, 2007, p. 38.
6. Hanke, Steve H. "Reflections on the BNB," *Trud*, March 3, 2006 (Bulgarian).