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Research Article

Specifics in Introduction and Functioning of the Currency Board in Bulgaria

Sergey Radukanov¹

Abstract

The article studies two main aspects of functioning of the currency board in Bulgaria: its characteristics and its specifics and peculiarities.

Concerning the characteristics of the currency board in Bulgaria, the attention is focused on several theoretical matters of the nature of the currency board: mechanism for introduction of the currency board; choosing the foreign currency, to which the local monetary unit is to be fixed; financing the initial currency reserve, in order for the currency board to start functioning; setting the fixed exchange rate to the reserve currency; establishing the amount of coverage of the quantity of cash in circulation by the currency reserves; administration of the currency board; implementation of the function “lender of last resort” in cases of liquidity crisis; supervision of the commercial banks’ operation.

Each country is characterized by its specifics in terms of management of public finances, condition of the real (non-financial) sector, service sector, monetary and banking system. These specifics are reflected in the monetary boards, introduced in the individual countries.

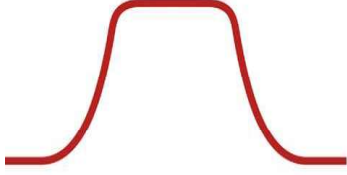
The article provides a detailed analysis of the specifics of the currency board in Bulgaria.

The options for an independent monetary policy of the central bank are heavily restricted, and on the other hand, the currency board attained the goal of its policy – ensuring of price stability. As of the present moment, Bulgaria joined the exchange rate mechanism (ERM II) in 2020 and makes every effort to cover the criteria for real convergence.

Keywords: Currency Board, Currency Reserves, Cash Basis, Bulgaria.

JEL Codes: E52, E58, E42

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Arastırma Makalesi

Bulgaristan'da Para Kurulunun Kurulması ve Çalışmasına İlişkin Özellikler

Sergey Radukanov¹

Öz

Makale, Bulgaristan'da para kurulunun işleyişinin iki ana yönünü inceliyor: Para kurulunun vasıfları, kendine özgülüğü ve özellikleri.

Bulgaristan'daki para kurulunun özellikleriyle ilgili olarak, para kurulunun doğasına ilişkin birkaç teorik konu üzerinde dikkatler toplanmıştır: Para kurulunun tanıtımı; yerel para biriminin sabitleneceği yabancı para biriminin seçilmesi; para kurulunun faaliyete geçmesi için başlangıçtaki döviz rezervinin finanse edilmesi; sabit döviz kurunun rezerv para birimine ayarlanması; dolaşımdaki nakit miktarının döviz rezervleri tarafından karşılanma miktarının belirlenmesi; para kurulunun yönetimi; likidite krizi durumlarında “son kredi mercii” fonksiyonunun uygulanması; ticari bankaların işleyişinin denetimi.

Her ülke, kamu maliyesi yönetimi, reel (finansal olmayan) sektörün durumu, hizmet sektörü, para ve bankacılık sistemi açısından kendine has özellikleri ile karakterize edilir. Bu özellikler her ülke için o ülkenin durumunu ortaya koyacak şekilde para kurullarına yansıtılır.

Makale, Bulgaristan'daki para kurulunun özelliklerinin ayrıntılı bir analizini sunmaktadır.

Merkez bankasının bağımsız bir para politikası için seçenekleri son derece kısıtlandı buna rağmen para kurulu, politika hedefine yani fiyat istikrarının sağlanması hedefine ulaşmıştır. Bulgaristan döviz kuru mekanizmasına (ERM II) 2020'de katıldı ve şu an itibarıyla gerçek yaklaşma kriterlerini karşılamak için her türlü çabayı gösteriyor.

Anahtar Kelimeler: Para Kurulu, Döviz Rezervleri, Peşin Para Esası, Bulgaristan.

JEL Kodlar: E52, E58, E42

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1. Introduction

An important prerequisite for the stability of the purchasing power of the money is the public trust in the monetary unit – only then that it can fulfil its monetary functions. This also provides the smooth and problem-free functioning of the economy.

Introduction of the currency board is a final resort, but considering the macro-economic situation, such decision for Bulgaria is inevitable. The reforms for re-structuring of the economy in our country are not implemented – a very small part of the enterprises put up for privatization are sold, and most of the state-owned enterprises are working at a loss. Investment decline as well as import and export decline are reported. Virtually, the real sector in Bulgaria is not operating at the required rate.

The situation in the financial sector is similar:

- New payment of the external debt of the country began in 1995.
- the central bank cannot counteract the high rates of inflation and thus, it fails to provide stable currency exchange rates and interest rates.
- the lost trust in the Bulgarian lev brings about an outflow of savings from the banking system;
- collaterals for the loans extended by the commercial banks are quite dubious.
- lack of adequate control upon the banks by the central bank.
- the non-performing loans' share grows significantly, and many banks go bankrupt.

The currency board is the monetary system, which provides the required stability of the national monetary unit. In this relation, analyzing the currency board Republic of Bulgaria is particularly interesting.¹ The present development has as its object the monetary council in Bulgaria, and as a subject – its characteristics. The goal is to explore the specifics of the currency board in Republic of Bulgaria, for the achieving of which, the following tasks must be fulfilled:

- presentation of the main discussion moments in theoretical aspect concerning the situation before the currency board introduction;
- exploring the specifics of the currency board introduced in Republic of Bulgaria.

2. Currency Board - Necessity and Conditions for Introduction

Adequate cash credit policy is the key factor for the economic development of a given country [Adamov et al., 2010; Al-Ghazali, 2021; Angelov et al., 2011; Angelov et al., 2012; Chaudhary, 2021; Hlibko, 2018; Hlibko et al., 2019; Marinov, 2009; Marinov, 2010; Milinov, Marinov & Radukanov, 2011; Petrova & Aleksandrov, 2018]. Unfortunately, central banks not always manage to introduce order in the cash credit processes and relations. This necessitates introduction of specific organization of the monetary system, also known as currency board.

Generally, the currency board is a negation of the central bank. Existence of the two institutions is inconsistent. Naturally, the question why emerges?

Main duty of the monetary council is to exchange the local currency freely and limitlessly into a reserve currency. It is this function that is the reason for the widely accepted

¹ Note: the notions „Currency board”, „Monetary council съвет” and „Currency council” used in reference books are synonymous.

definition of the **currency board – a monetary system, which resembles the gold device standard**. In practice, the role of the currency board is to regulate the currency in circulation, and the latter one depends on currency reserves (considering a stable and fixed exchange rate). The following variants of alternation of the quantity of money in circulation are possible:

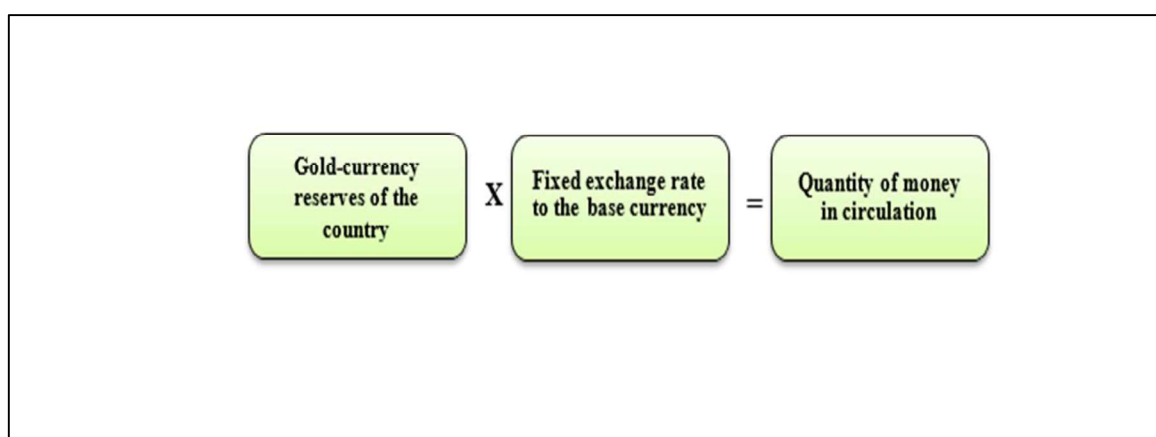
- foreign exchange reserves increase and therefore money in circulation increases;
- currency reserves decrease, and respectively the currency in circulation decrease;
- currency reserves are unchanged, hence the currency in circulation remain constant.

The mechanism of regulation of the quantity of currency in circulation is automatic. It does not depend on any subjective factors (such as political pressure, discretionary policy, as is the case with a central bank), but it's based on the objective circumstances – the quantity of the currency reserves.

This type of currency board is perceived as “classical”, and in the past, predominantly such types of currency councils would exist. Due to the fact, that the only duty is to observe the correspondence between the quantity of the currency in circulation and the currency reserves, no central bank is necessary (cash credit policy is not implemented). It is quite another issue that fact that at a later stage, currency councils would grow into central banks. In the present day, the currency councils are modified. They exist in a „soft” variant, where the central bank would usually administer the currency board. It has got the opportunity, although quite limited, to carry out cash credit policy.

In the past, monetary councils used to be introduced in the newly liberated colonies. Using low expenditures and small number of personnel an order was brought into the organization of monetary circulation. **The local monetary unit would be fixed to a stable foreign currency using the respective exchange rate**. Functioning of the currency board is subjected to one simple rule: **the quantity of currency in circulation must be equal to the currency reserves of the country using the fixed exchange rate** (fig. 1), i.e.[Radkov & Adamov, 1998]

Figure 1. Mechanism of Functioning of The Currency Board



Source: Bojinov, Radkov & Mihajlov, 2004

Each country is characterized by its specifics in terms of management of public finances, condition of the real (non-financial) sector, service sector, monetary and banking system. These

specifics are reflected in the currency councils, introduced in the individual countries. [Pukala, 2021; Marinov, 2011; Marinov, 2012; Milinov & Marinov, 2015; Vatev & Marinov, 2013; Sinkevičs & Petrova, 2019].

The currency board in Bulgaria *was introduced because the central bank failed to achieve the main goal of its policy – provision of price stability.*

When studying the theoretical nature of the essence of the currency board in Bulgaria one must focus on the following important moments:

- ***mechanism of introduction of currency board*** – it is arranged by means of certain legal regulation. On the one hand, strong political will is required to have such a regulation. This is a serious problem, and the unsuccessful policy of the central banks is a result of strong political pressure. On the other hand, international support is also required.

- ***selecting the foreign currency, which the local monetary unit is to be fixed to*** – the currency used should be recognised as an international payment instrument.

- financing of the initial currency reserve, so that the currency board will begin operating – the funding sources are mainly two – loans from international institutions (usually, the IMF) or sale and lease of state-owned property (enterprises, lands, etc.). In most cases it is recommended to use a „basket” of currencies for the reserves. It is also possible to use precious metals (gold, silver) or goods.

- determination of the fixed exchange rate to the reserve currency – the fixed exchange rate must be undervalued. It is assumed that the undervalued rate of exchange leads to growth of the export, i.e. favours the development of the real (non-financial) sector.

- Setting the amount of coverage of the quantity of currency in circulation by currency reserves – the currency in circulation must be at least 100% covered by the reserves. The asset of every currency board can be presented in a simplified manner as the sum of the two parts – the available currency and securities. Due to the effect of numerous factors, there is a possibility that the value of securities will diminish. For this reason, most specialists recommend higher cover funds (in the order of 105-110%);

- administration of the monetary council – when the monetary council is introduced in a country where a central bank is operating, it is best to use the specialists from the respective central bank. The main problem is that there is the possibility that they could be subjected to political pressure. In order to avoid this, some authors recommend the currency board to be constituted mainly of foreigners [Hanke & Schuler, 1996]. Concerning the personnel in comparison with the classical central bank, the currency board is characterized by two essential differences: 1) the number of personnel is too small; 2) training of specialists, who shall implement its management is quite easy.

- implementation of the function “lender of last resort” in cases of liquidity crisis –it is possible that another governmental institution will re-finance the commercial banks, although this option is not mandatory. Where „final“ creditor is missing, the banks will rely only on themselves. In that case, they will evaluate the credit worthiness of their customers more carefully, and thus, the credit discipline is much higher. It is believed that bankruptcy of one or several banks does not reduce the stability of the currency board. On the contrary – it makes the banking system better. This is also proved by the practice up to this moment;

- supervision of the commercial banks’ operation – in cases of a “hard” currency council the supervision upon the banks is limited. It is usually assigned to another institution.

3. Materials and Methods

This study is based on research of the scientific literature on the issues considered. The main specifics of introduction and functioning of the currency board are analysed.

All data and regulatory documents cited are originated from the official sources – Bulgarian National Bank's website.

4. Results and Discussion

4. 1. Macro-economic situation before introduction of currency board

The macro-economic picture before introduction of the currency board is quite unfavourable. The reforms for re-structuring of the economy are not implemented – a very small part of the enterprises put up for privatisation are sold, and most of the state-owned enterprises are working at a loss [Sotirova, 2008] Investment decline as well as import and export decline is reported. Virtually, the real sector in Bulgaria is not operating at the required rate. The situation in the financial sector is similar [Minasyan, Nenova & Yotsov, 1998]:

- new payment of the external debt of the country began in 1995;
- the central bank cannot counteract the high rates of inflation and thus, it fails to provide stable currency exchange rates and interest rates;
- the lost trust in the Bulgarian lev brings about an outflow of savings from the banking system;
- collaterals for the loans extended by the commercial banks are quite dubious;
- lack of adequate control upon the banks by the central bank;
- the non-performing loans' share grows significantly and many banks go bankrupt.

For the period referred to, the main generator of inflation is the policy of the central bank.² The method of refinancing of the commercial banks is also questioned. There are no clearly acknowledged rules and criteria to perform their crediting. At the same time, financing of the budget deficit becomes usual practice. Introduction of currency board targets termination of the option for uncontrolled „printing” of money, and therefrom – decreasing the inflation. It is erroneous to believe that the monetary council totally counteracts the inflation. It eliminates only that inflation, which is created as a result of abuse of the monetary mechanism through unjustified monetary emission.

In the background of the unfavourable macro-economic situation in our country before introduction of the currency board, we can add the political tension and the increasing mistrust of the economic agents to the governmental institutions. The only possible outcome for stabilization of the macro-environment concerning the monetary policy is establishing a specific monetary system – currency board.

²Note: A problem for all central banks is the political intervention to achieve short-term goals to the benefit of a local authority when implementing the monetary policy. It is no coincidence that a series of countries would protect in their legislations the independence of the central bank from similar influences. Incidentally, the problem of independence is also dealt with by several scientific publications.

4.2. Specifics of the currency board in Republic of Bulgaria

The currency board was introduced in Bulgaria on 01.07.1997 by virtue of coming into force of the new Bulgarian National Bank Act [Bulgarian National Bank Act]. The specifics of the monetary council are quite diverse.

From the point-of-view of the future joining of Bulgaria to the European Union, it was assumed that the German mark will implement the role of a reserve currency. This created a discussion, as the majority of the exchange of goods, payments of the external debt and currency reserves of the country were in US dollars. In practice, there were better economic grounds for the reserve currency to be the US dollar. The Bulgarian lev was fixed to the German mark under the exchange rate of 1000 BGL for 1 DM. Denomination of the BGL under a ratio of 1:1000 was done in July 1999, i.e. one new lev was exchanged for 1000 old levs (1BGN=1000BGL) [Bulgarian lev Denomination Act]. This means that 1 new lev is exchanged for 1 German mark (1BGN=1DM). The new European currency – the Euro was placed in circulation in the same year. The German mark would gradually be withdrawn from circulation and fixed to the Euro under a ratio of 1EUR=1.95583 DM. Therefrom 1EUR=1.95583 BGN.

Upon the Issue Department of the BNB was imposed the duty of performing the role of the currency board in a legislative way. Art. 20 of the BNB Act reads: „The main function of the Issue Department is to maintain complete currency coverage of the total sum of the monetary obligations of the Bulgarian National Bank and undertake the necessary action for efficient management of the gross international currency reserves of the bank.” The Issue Department was obligated to also draft the weekly balance of the currency board. Aiming at the policy of transparency of the condition of the board, the balance sheets (monthly and weekly) are published at the website of the BNB.

Currency reserves must provide coverage of the monetary basis, and in a broader sense it also includes the obligations to the government (i.e. the fiscal reserve) [Mladenov, 2009]. Since the latter ones are designed to service the external obligations, the respective coverage is necessary. Increasing of the coverage is a guarantee for stability and sustainability of the currency board. Fiscal reserve is reflected in the liabilities of the balance sheet of the Issue Department. Part of it can be invested (stored) in the commercial banks. In the last years this fact was an object of discussion. When storing the fiscal reserve in the BNB, the supply of money is not increased, and when it is in the commercial banks – the supply of money increases. [Minasyan, 2008]

Out of the „classical” instruments for carrying out of cash credit regulation of the economy, only the mandatory minimal reserves (MMR) are used. As of the present moment, they are 10% of the deposit basis. [Ordinance № 21] Open market operations and the interest policy are not applied. It is necessary to bring clarity concerning carrying out of the interest policy. Before introduction of monetary council in our country, the basic interest rate was determined at the discretion of the governor of the central bank. At the moment, it is set by a methodology, which is based on the level of the interest rate of the interbank money market. It expresses the demand and supply of money between the banks (obtained on a marketing principle).

BNB reserves its right, although under strict conditions, to credit the commercial banks. This is only possible upon the presence of liquidity risk for the banking system as a whole (systemic risk). The maximum period of the loan extended may not exceed three months, and the cover funds shall amount to 110% of the loan extended. Cover funds may only be: monetary gold; currency (Euro, US dollar and Swiss franc); state securities, emitted by the government of Republic of Bulgaria or guaranteed by it; first grade securities, emitted by foreign

governments and central banks or guaranteed by them [Ordinance №6] The amount of the loans extended may not exceed the deposit of the Banking Department in the Issue Department. Any exceedance expresses the presence of over-coverage of the obligations of the BNB with currency reserves. The credit-extending process is administered by the Banking Department, but the banks must always be inspected by the Banking supervision department.

Both before introduction of the currency board and under the present conditions, opening and closing of a given bank is implemented by the BNB. Of course, key role in these matters has the Banking supervision department.

4.3. Gold-Currency Reserves and Obligations

The assets from the balance sheet of Issue Department are the so-called gold-currency reserves of the board: (table 1)

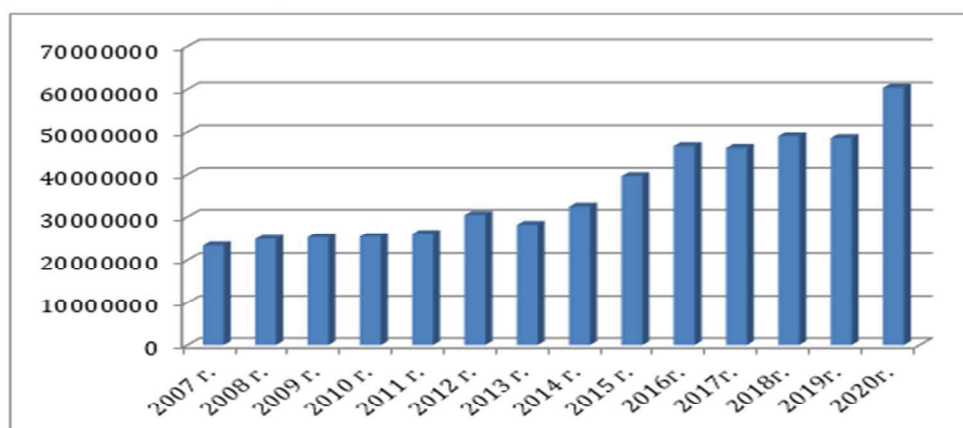
Table 1. Monthly balance sheet of Issue Department as of 29.10.2021

Assets	Thousands of BGN	Liabilities	Thousands of BGN
Cash and foreign currency denominated deposits	33856700	Banknotes and coins in circulation	23678911
Monetary gold and other monetary gold instruments	3913175	Obligations to banks	16367834
Investments in securities	22605838	Obligations to the government and budget organizations	10088629
		Obligations to other depositors	1571180
		Banking Department deposit	8669159
Total Assets:	60375713	Total Liabilities:	60375713

Note: Data source BNB statistics

The reserves are meant to provide the normal functioning of the board (fig.2.).

Figure. 2. Dynamics of gold-currency reserves for the period 2007-2020 (in thousands of BGN)



Source: Author's Calculations

Under „pressure” on the part of the economic agents there must be an adequate amount of foreign currency (Euro), which is to be exchanged against the local currency (levs) using the

fixed exchange rate. Reserves are not all stored as cash. Their maintenance in cash requires considerable transaction expenditures (expenditures for storage, security, etc.) and is deprived of any economic logic. It has been assumed that part of the reserve will be invested, such is the practice in our country and in the other countries, where monetary councils have been introduced. Of course, this does not diminish the stability of the board. Management of the assets is implemented on the following principles: security, liquidity, profitability. [Manchev, 2008] This means that the invested assets can quickly be brought into cash.

In this relation, the assets can be provisionally considered into two groups: marketable and investment. What's characteristic is that every following position has diminishing liquidity. It is considered that the two balance sheet items (monetary funds and deposits in foreign currency and monetary gold) provide the liquidity of the board. Nevertheless, they also provide profitability, although insignificant. Deposits in foreign currency are made in foreign banks and are accumulated at certain interest rate. Small part of the monetary gold is stored in the form of ingots in a standardized stock exchange form, while another part is also stored in foreign banks accumulating minimum interest. From psychological point-of-view holding gold by the central banks renders its positive effect upon the economic agents. It is not by chance that at times of crisis, the demand of gold intensifies, as an alternative and secure investment.

Investments in securities have the largest share among the assets. Their management has been regulated by standards. State securities of only first-grade issuers are prevailing. BNB Act provides the general instructions. According to art. 28, par. 3, item 4, issuers of debt securities must be „evaluated with one of the two highest scores of two internationally recognised credit rating agencies”. BNB prepares a list of countries, which meet these conditions.

Liabilities represent the obligations of the BNB. In particular, they include: [Minasyan, 2008]

- banknotes and coins in circulation – all cash in the population, at the cashier's offices of the companies and the commercial banks;
- obligations to banks – money in the accounts of the commercial banks at the central bank (the so-called reserves of the commercial banks);
- obligations to the government and budget organizations –so-called fiscal reserve;
- obligations to other depositors – i.e. the Deposit Guarantee Fund;
- Banking Department deposit – this position expresses the exceedance of the reserves above the obligations (over-coverage).

5. Conclusion

The currency board in Bulgaria accomplished its main purpose – providing of price stability. At the same time, reliability of the banking system is also determined by the stability of the currency board. It is a specific monetary system, which successfully performs its role under the conditions of a global economic and political insecurity. Liquidity of the board grows, which is a positive indication against any potential future macro-economic instability. Eventually, the quality and dynamics of the reserves are guarantee and decisive factor for the normal functioning and development of the national economy.

All of this provides us with grounds to believe that the monetary council in Bulgaria creates favourable situation for faster joining of Bulgaria to the Eurozone.

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