

**Movement of Capital and Payments. Monetary and
Financial Policies and Convertibility of the Bulgarian Lev,**

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1. The European Union - on the Horizon

1.1 What is the Final Goal?

1.1.1 Definition

Monetary union is the final stage in economic and financial integration among countries, in the specific case analyzed in the present paper among the countries participating in the Treaty of Maastricht providing for the implementation of such a union as the ultimate objective of the convergence toward a unified Europe. Membership in such a union would require the adoption of a common currency and its circulation as a single legal tender (or the final and irrevocable pegging of exchange rates among the currencies of the participating countries), as well as the conduct of common monetary (including foreign-exchange) policy.

The Treaty of Maastricht specifies a time-frame for achieving the final goal in three stages of economic and monetary convergence:

- 1) The first stage includes both integration processes having evolved to a large extent even before the Maastricht Treaty and processes whose concluding phases coincide with the end of the first stage of convergence two years after the signing of that treaty in early 1992. These processes could be summarized as a gradual liberalization of the movement of goods, labour and capital within the territory of the European Union (EU);
- 2) The second stage started on 1 January 1994. In the area of monetary and foreign-exchange policies it is characterized by the creation of a new institution to replace the European Monetary Cooperation Fund (EMCF), established in 1973, which had performed functions related to the short-term financing of intervention operations in the early phases of monetary integration. The new institution was named European Monetary Institute (EMI) and is managed by a Council consisting of the Governors of the central banks of the member countries. The EMI is entrusted with the task to promote cooperation in the area of monetary policy and to execute the technical preparation of the transition to the third stage of the European Economic and Monetary Union (EMU);
- 3) The third stage (known also as a "full EMU") is to commence with the final and irrevocable pegging of the currencies of the member countries to a (common) European currency unit (ECU) and their subsequent withdrawal from circulation, as these currencies are replaced by the fully-fledged supranational currency of the EU which from just a unit of account at present is to become the single legal tender within the territory of the EMU. Originally (in accordance with the Treaty of Maastricht), this final stage was envisaged to begin on 1 January 1997 or - in case this proves to be impossible - not later than 1 January 1999, even if the participant countries which fulfil the four membership criteria specified further down in this paper do not represent absolute majority. Nowadays it is quite certain that the earliest possible date for replacing national currencies with the (common) European currency unit is 1 January 1999. A new institutional framework is relevant to the third stage of the EMU. The EMI is to grow into a European Central Bank (ECB) and a European System of Central Banks (ESCB).

Irreversibility of commitments under the Treaty on EMU is explicitly stated in a Protocol to the Treaty of Maastricht which has later been ratified by all signatories.

1.1.2 Macroeconomic Criteria for Participation in the EMU

The Maastricht Treaty sets out four criteria as preconditions to be satisfied by each country wishing to join the monetary union. One of them (the third criterion) concerns directly the stability of currencies, but all four criteria, in essence, have bearing, although indirectly, to monetary policy. These criteria are the following:

- 1) a high degree of price stability, apparent from a rate of inflation that does not exceed by more than 1.5 percentage points that of, at most, the three best performing member states in terms of price stability;
- 2) sound public finance, expressed in achievement or, at least, close approximation of two target ratios:
 - government budget deficit not exceeding 3% of gross domestic product (GDP);
 - stock of government debt, as at the moment of joining the EMU, not exceeding 60% of GDP;
- 3) nominal exchange-rate stability, apparent from the observance of the normal fluctuation margins ("bands") provided for by the Exchange-Rate Mechanism (ERM) of the European Monetary System (EMS) for at least two years, without devaluing against any other member state's currency;
- 4) durability of economic and monetary convergence being reflected in the convergence of long-term interest rates, their level not exceeding by more than 2 percentage points that of, at most, the three best performing member states in terms of price stability.

The problem, however, is that, having been formulated in such a rather conservative variant consistent with price stability as the primary and ultimate objective of the ESCB, the criteria enumerated may prove to be difficult for achievement even for the most "sound", in an economic sense, western economies. Therefore a relative "relaxation" of these membership preconditions in the future, which some of the provisions of the treaty allow for due to possible different interpretation of their wording, does not appear impossible. For the time being, however, such a scenario is not envisaged, at least officially.

Despite that some uncertainty remains with regard to the question how strictly the Maastricht criteria will eventually be applied by the incumbent EU member states, these criteria should serve as a long-run strategic goal for macroeconomic policy in Bulgaria. The principal argument in support of such a conclusion is of domestic character: prudent macroeconomic policy is imperative for sustainable growth. Within the context of integration processes, any refusal to follow such a *direction* of development could be interpreted as non-compliance with the commitments undertaken by Bulgaria through the ratification of its European Agreement. The possible steps and performance of the east European most "diligent" reformers could be a minimum standard in this respect. Bulgaria has already missed one opportunity to be treated in the same group with the Visegrad four. The statute of a country

lagging behind, always in the shadow of the front-runners, cannot and should not be satisfying.

1.2 Where are the Countries of Western Europe?

1.2.1 Historical Overview

Monetary integration among west European countries has evolved only at a later stage of their economic integration. The foundations of the EMS were laid down in March 1979, more than two decades after the signing of the Treaty of Rome. Attempts for coopeartion in the monetary area, however, have started as early as in the beginning of the 1970s, following the demise of the Bretton-Woods international monetary system.

In 1979 the European Currency Unit (ECU) was introduced, as a weighted currency basket including the national currencies of the European countries participating in the system. The "grid", formed by the "central" rates of all EMS currencies *vis-a-vis* the ECU, as well as the "narrow" (plus-minus 2.25%) and "broad" (plus-minus 6%) fluctuation bands, also came into being. Thus the ERM, although the currencies participating in the EMS and its currency basket (the ECU) were not obliged to join it, turned out to be, in fact, at the heart of the newly-established system.

Growing convergence of exchange rates, inflation rates and interest rate levels, as well as of many of the remaining major macroeconomic indicators, witnessed over the 1980s led to a new impulse in the evolution of the ideas for monetary integration. In the Treaty of Maastricht, signed on 7 February 1992, the EMU attained concrete dimensions and assigned to participating countries irrevocable obligations.

1.2.2 Current Situation and Prospects

There is a substantial degree of differentiation among the present EU member states. The 15 countries currently forming the union are at various phases of the programme for their common convergence into a future EMU. In the area of monetary policy, their differences can be reduced mainly to:

- the stability of national currencies and their participation in the ERM;
- the level of the long-term nominal interest rates and of the rates of inflation;
- the fiscal and other macroeconomic and structural characteristics of their economies.

Comparing the actual values of the relevant variables registered during the recent years with those prescribed by the Maastricht criteria may serve as a good illustration of still differing macroeconomic indicators of the EU countries. In 1992, for instance - the year of signature of the Treaty on EMU - divergence of inflation rates and long-term interest rates was considerably larger than that provided for in the Maastricht Treaty. ERM problems in the late summer and early autumn of 1992, when the British pound and the Italian lira left the mechanism, as well as the adoption in August 1993 of extremely broad, from the viewpoint of historical experience within the EMS, fluctuation margins for the ERM currencies (plus-minus 15%) may be regarded as a certain step back, and away from convergence commitments to an EMU. According to the data for last year, only three countries - Germany, Luxembourg and Ireland - comply with all criteria. Most countries experience problems with the government debt target ratio, although the criterion for a government budget deficit below

3% of GDP seems more difficult to meet. Greece, Spain and Italy face the most serious hardships in satisfying the criteria. This differentiation engenders inside tensions about the possible unfavourable effects for both groups of countries: the one that will prove successful in achieving the Maastricht requirements by the end of 1999, and the other in which countries will initially have to retain their national currencies. These and some other unresolved problems will be discussed by the end of 1995; until then the finance ministers of the EU member countries have to coordinate a plan for transition to a single European currency. Such a plan is to be deliberated at the forthcoming biennial summit to be convened in Madrid.

From the perspective of east European countries in general, and Bulgaria in particular, processes in countries such as Greece and Portugal, and Spain as well, which have structural characteristics of their economies and incomes closer to the Bulgarian ones, deserve special attention. These three countries, and most of all Greece, are still far away from the Maastricht EMU membership criteria. Countries such as the Czech Republic and the Baltic states, for example, have even performed better than Greece according to some indicators (exchange-rate stability, government budget deficit, government debt).

With view to existing differentiation, a variant of the EMU, which has to be based on the right to membership without participation in the ERM provided for in the Treaty of Maastricht and to permit two or more fluctuation zones around each of the four membership criteria, seems quite possible. According to such a scenario for the development of integration processes, the future EMU could consist of at least two groups of countries: countries that have met the Maastricht criteria themselves (such as Germany, the Netherlands, Denmark, France, Luxembourg), and countries that have satisfied possible broader requirements than those of the Maastricht criteria (the vanguard of reforming east European economies might be also among this latter group). In this line of thoughts, two possible approaches to the establishment of an EMU have gained popularity during the recent one or two years: the so-called "big bang" approach according to which all member states will adopt simultaneously the common legal tender and reject their national currencies, and the so-called "critical mass" approach according to which a step-by-step process of an EMU creation through an initial participation in the union of a "core" group of countries having fulfilled the Maastricht criteria, to be gradually joined later by other countries, will be followed. Despite continued discussions and debates on the pros and cons of each one of the two alternative approaches to "start" the EMU, the opinion in favour of the "critical mass" approach has recently been gaining stronger hold. This means that the so-called "core Europe", within which the European currency unit is to be gradually introduced on 1 January 1999, has already been taking shape. Given such a scenario, financial institutions in the countries of "core Europe" are expected to maintain dual book-keeping, in their national currencies and in the single European unit, over a two-year transition period. Such a phased approach, however, has its own problems too. Changes in the government debt criterion will apparently be required, if political aspirations of France and Germany to attract into "core Europe" at least Belgium, or, as a better alternative, Benelux as a whole, are sustained.

No matter the number and complexity of the problems, waiting for their solutions, among the incumbent EU member states, re-formulation or relaxation of the criteria provided for in the Treaty of Maastricht to a degree facilitating the incorporation of new countries appears unrealistic. Even for a member state such as Greece, for example, it is now accepted that its

incorporation is not likely to occur together with the second group of countries that will join the EMU.

1.3 Where are the Countries of Eastern Europe?

1.3.1 Historical Overview

In the recent past the currencies of the former socialist countries were inconvertible. Due to the state monopoly on foreign trade and foreign-exchange transactions, state-owned foreign trade companies (also sometimes called foreign trade "organizations") in these countries were the only economic agents granted the right to effect foreign trade transactions and operate, in connection with their activity, with foreign exchange and foreign-exchange accounts. Exchange of currencies took place according to announced official and commercial exchange rates and in compliance with existing legal restrictions.

1.3.2 Current Situation and Prospects

Following liberalization of prices, foreign trade and the exchange-rate regime at the beginning of the ongoing process of transition to a market economy, different forms of *partial* (mainly internal) currency convertibility were introduced in the countries of central and eastern Europe. In the majority of them current account convertibility has - more or less - been achieved. In many of these countries (including Bulgaria) *de facto* capital account convertibility (to a higher or lower degree) has also resulted from insufficient effectiveness of exchange controls.

In principle, east European countries have to pass through processes analogous to those which the countries of western Europe that aspire to become future participants in the EMU themselves have to advance through. But these are only few of the numerous accompanying problems resulting from the uniqueness of the transition from a planned to a market economy to which the countries of central and eastern Europe will continually have to search for solutions in their economic and monetary convergence to the European west. Along the road to an EMU, eastern Europe must first arrive there, where western Europe, or the larger part of it, stands at present, and only after getting there it can progress further on, in the pursuit of the final goal. This implies that east European countries have to walk down the road marked, in the case of western Europe, by the Treaty of Rome and the Single European Act. Within the context of payments regulations, this would mean that the countries of the European east should first achieve full convertibility of their national currencies through liberalization of their regimes regarding current and capital account transactions. If the process of accession into the EMU is not to be indefinitely protracted over time, these countries must, in parallel with the liberalization of their current and capital account regulations, accomplish the transition from the present state of their economic and monetary systems to the state typical nowadays for the western countries.

2. Bulgaria and the European Union - Main Issues from the Perspective of the Payments Regime

The long and difficult road which lies in front of the countries of central and eastern Europe before they join the EMU is well illustrated by their macroeconomic performance in the recent years. The overwhelming majority of the countries in this group nowadays remain still

at a rather big distance from meeting, or at least approximating, the Maastricht membership criteria. In terms of inflation (which varied between 20 and 120% on a consumer price index (CPI) annual basis in 1994 in the nine countries with European agreements) and, as a consequence, in terms of the level of long-term interest rates, none of the east European states is, and could not claim over the following two or three years to be, ready for EMU membership. In terms of the two remaining criteria, namely exchange-rate stability and "safe" government indebtedness - only the Czech Republic, to some extent the Baltic countries, and to a lesser degree Slovenia approximate and could, in a foreseeable future, conform with the membership requirements of the Maastricht Treaty.

Bulgaria with inflation rate of 121.9% (cumulative), nominal lending-rate levels and nominal depreciation of the Bulgarian lev of more than 100%, budget deficit of 6.3% of GDP and a high, even problematic for servicing, government debt was in 1994 in the rear compared to its east European partners of the former Council for Mutual Economic Assistance (CMEA) along the road to the monetary integration of Europe. At the same time, its macroeconomic performance in the first half of 1995 and anticipated outcomes for the entire year appear to be more optimistic. Cumulative inflation for the first six months of 1995 was a little above 15%, nominal interest-rate levels dropped almost by a half, the exchange rate remained stable, and government (both domestic and foreign) debt service did not create serious problems. The tendencies observed suggest that the hope for Bulgaria to participate in the process of economic and monetary convergence of Europe on an equal footing with the remaining central and east European states has not been completely lost yet. Such a membership in the would-be union, on equal terms, however can be achieved only if consistent stabilization fiscal and monetary policies, supported much more definitely than in the recent five years by structural and institutional reforms, are conducted.

Three relatively self-contained sets of problems, which need their solutions if Bulgaria wishes to retain some realistic chances for a full membership in a future EMU, are now confronting its economic policy in the areas related to the foreign-exchange regime, convertibility of the lev and monetary policy:

- *achieving current account convertibility of the lev;*
- *liberalizing the regime of capital account transactions; and*
- *pegging the exchange rate of the lev to the European currency unit,* with the ensuing effects on the formulation and implementation of monetary policy in particular, and macroeconomic policy in general.

The above-mentioned three sets of issues are further down successively considered. We refer to these as "sets of issues", and not "stages" or "phases", since work on them can and must advance in parallel, if Bulgaria wishes to join the EMU within a foreseeable time-frame. They can, on the other hand, be logically distinguished from one another quite easily and unambiguously. Parallel progress in the three mentioned areas is not only imperatively predetermined by the strategic goal chosen, but is also feasible, as we shall attempt to prove in the next sections of the paper.

3. Currency Convertibility - Some General Issues

3.1 Definition

By tradition, i.e. by the first 2-3 decades of this century, the notion of "convertibility" has been used to designate the unlimited right of a holder of a currency to exchange it into gold at a predetermined fixed rate. At present, gold does not play a substantial role in international payments and, therefore, convertibility of currencies into gold is not an up-to-date concept. The term "convertibility" in its modern context relates to *the right of a holder of a national currency to freely exchange it into each and every other national currency at the prevailing exchange rate*. The "prevailing" exchange rate may be either pegged, or floating.

3.1.1 Internal and External Convertibility

From the perspective of the holders of money balances, difference is made between *external* and *internal* convertibility.

External convertibility denotes the right of non-resident domestic currency holders to convert it into foreign currencies. Such restricted convertibility in the form of external convertibility is usually applied by countries striving to stimulate the inflow of foreign capital. Within a more general context, external convertibility provides incentives for non-residents to engage in transactions in countries having introduced external convertibility of their currencies. External convertibility of a currency is directly related to private foreign investment, especially when complemented by the right to repatriation of profits and of receipts from liquidation of non-residents' assets in a country.

Internal convertibility, on the other hand, relates to the right of residents to convert their money balances into foreign currencies. Although this form of restricted convertibility also has some implications for the inflow of foreign investment, it is of greater significance as a disciplining factor for national macroeconomic policy.

By the right which internal convertibility grants to residents to arbitrate between the local and foreign currencies, it exposes domestic macroeconomic policy to foreign competition. This creates risks for governments, but, at the same time, forces them to pursue internationally coordinated and competitive policy. In cases of a fragile equilibrium coordination between government financial policy and central-bank monetary policy attains greater importance. The sharp turn in the financial policy of the government headed by Prof. Berov in 1994 compared to 1993 is the most recent illustration of the above-mentioned general conclusion. This turn was imposed by a "flight from the lev" rather than by any direct pressure of international financial institutions. It is a different matter that the discontinuation of official foreign financing in 1993 accelerated the depletion of foreign-exchange reserves and thus catalyzed the process of "taking confidence away" from the lev, as a reaction of economic agents to the bleak macroeconomic policy conducted.

3.1.2 Current and Capital Account Convertibility

With view to the *objectives* which convertibility is wished and designed for, a criterion determining the nature of the transactions requiring convertible currency is applied. The traditional differentiation is between convertibility on current account transactions (current account convertibility) and convertibility on capital account transactions (capital account convertibility).

Current account convertibility is defined as the right to convert the local currency into foreign currencies for the purpose of effecting payments related to imports of goods and

services. The dividing line between current (particularly the so-called "invisible") and capital transactions is quite blurred. For all practical purposes, including, and most of all for, international negotiations, whether a country has or has not achieved current account convertibility is judged *unambiguously* by the fact whether the respective country has accepted or not Art. VIII status according to the Articles of Agreement of the International Monetary Fund (IMF). In particular, Art. XXX (d) of the IMF Articles of Agreement determines the following scope of the transactions and payments considered to be current:

"Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation:

- (1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
- (2) payments due as interest on loans and as net income from other investments;
- (3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and
- (4) moderate remittances for family living expenses; (Art. XXX, (d))".

Some of these payments transactions, from a purely economic point of view, bear the nature of capital transactions. Their inclusion in this category is predetermined by the necessity to stimulate and facilitate current transactions which, as a rule, require repayment of short-term bank loans and transfers for depreciation of direct investments.

Capital account convertibility relates to the right to convert the local currency into foreign currencies for the purposes of capital transactions and transfers. In reality, it is less frequent than current account convertibility. As a consequence of the tendencies of capital markets liberalization and financial sector deregulation on a global scale dominant since the beginning of the 1980s, capital account convertibility, *de jure* or *de facto*, has been encompassing an increasingly larger number of countries. All EMS member states have abandoned controls on capital transactions, thus ensuring capital account convertibility for their currencies.

The primary concern for current account (like internal) convertibility is the competitiveness of the economy and economic policy, while for capital account (like internal) convertibility it is the economy's capability to attract foreign investment that really matters.

3.2 Currency Convertibility: Preconditions and Implications

3.2.1 Implications of Introducing Current Account Convertibility

Introducing current account convertibility, when complemented by foreign trade liberalization, has the following more important economic implications:

- Extends the world structure of prices to the reforming country. In a market economy, world prices ensure the most clear and precise signals for production and investment decisions and decentralization of this type of decisions.
- Impacts competition in local markets. What made western countries rich was not just the market economy itself, but competitive markets. No one likes competition, since it is a

constraint, yet only the actions of the others can make each and every producer to perpetually improve production in order to survive. The external source of such competition is particularly important for the economies in transition, whose productive sector was monopolized to a substantial degree in the pursuit of scale economies.

- Current account convertibility of the local currency unit provides access to international markets of goods and services, thus contributing to the improvement of consumption standards.
- Through the opening of local markets to foreign competition and the equalization of domestic with international prices, current account convertibility leads to a more efficient allocation of resources in those industries in which the country has a comparative advantage and to a higher productivity, thus stimulating investment, employment and growth.

The favourable medium- and long-term economic effects of current account convertibility may be derived only if a certain minimum of preconditions are met, so that convertibility can be "sustained", and not abandoned after a short period of time. Ensuring these preconditions, however, has its own short-term costs.

3.2.2 Preconditions for Introducing Current Account Convertibility

There are four most frequently commented preconditions for introducing and maintaining current account convertibility:

- Prevalence of an appropriate exchange rate;
- Availability of sufficient foreign-exchange reserves;
- Macroeconomic policy which is consistent with a stable functioning of the economy;
- Price system which reflects relative efficiency and utility of products being the principal incentive mechanism.

There is no universal recipe how to determine the level of the exchange rate which is "appropriate" and of foreign-exchange reserves which is "sufficient". It can be stated, as a general rule, that the "appropriate" exchange rate is that one which equilibrates the demand for and supply of foreign currency in the absence of exchange restrictions and within the context of a specific macroeconomic policy. Under a regime of a floating exchange rate it is usually easier to combine current account convertibility with external balance. If, however, fiscal and monetary policies remain overexpansionary, inflationary pressure would escalate, causing a prolonged depreciation of the national currency. Such a situation of instability will harm investment and growth.

"Sufficient" foreign-exchange reserves are needed to allow the country to (a) absorb domestic or external shocks without resorting to exchange restrictions until macroeconomic policy and/or the exchange rate respond to these shocks and (b) finance temporary or seasonal fluctuations in net foreign-exchange receipts without experiencing large temporary fluctuations in the exchange rate. The greater the significance awarded to exchange-rate stability, the higher the level of foreign-exchange reserves. No strictly defined method of "calculating" the sufficiency of foreign-exchange reserves exists. Practice has, however, shown that, at least in the past, maintenance of foreign-exchange reserves equivalent to at least three months of imports has proved to be sufficient for sustaining convertibility under a regime of a "pegged" /fixed/ exchange rate. The Republic of Korea adopted Art. VIII status (in the IMF) in 1988 with reserves equivalent to its imports over a three-month period; the Kingdom of Thailand accepted Art. VIII status in 1990 with reserves equal to five months of

imports; Poland virtually liberalized all current account transactions (without accepting the obligations under Art. VIII) with foreign-exchange reserves and external credit lines equivalent to imports of four months and a half. In 1991 Bulgaria did the same with practically no reserves.

In an ideal case, the attainment of macroeconomic stabilization is a prerequisite for the introduction of current account convertibility. In a more realistic scenario, however, what is important is that the macroeconomic policy conducted right after the introduction of current account convertibility should be consistent with internal equilibrium, i.e. it should equilibrate aggregate demand with the available resources and the growth of aggregate demand with the potential growth of GDP. Otherwise, inflationary pressure would erode the economy's competitiveness, leading to current account deficits at a given exchange rate. Alternatively, macroeconomic instability may give birth to the depreciation-inflation-depreciation spiral.

Fiscal policy, and in particular the tax system, is of key importance for current account convertibility. Without a reliable tax base there is an inevitable recourse to the financing of government expenditures in an inflationary way, which undermines confidence that convertibility will eventually be sustained. From the perspective of monetary policy, money supply growth should certainly be contained under strict control. The lesser the budgetary demands for credit, the easier to control the supply of money; but such a monetary policy also requires the relevant institutional development of the financial system and of the central-bank policy instruments.

Well-functioning price system and system of incentives are an essential precondition, if the impact of convertibility contributing to a more efficient allocation of resources is to reach the real economy. In order to extract all positive effects of convertibility on efficiency, employment and growth, abolition of foreign trade controls, tariff barriers, domestic trade and price controls, restrictions on labour market functioning and of other administrative obstacles is also necessary.

3.2.3 Implications of Introducing Capital Account Convertibility

The attitude that the distinction between current account convertibility and capital account convertibility is already outdated and does not correspond to present-day realities has widely been asserted in the literature of the recent decade. Turbulent processes of deregulation of financial markets in the industrial countries and their close interdependence have been pointed out in favour of this argument. The opinion that capital account convertibility is as much significant now for the smooth functioning of the world economy as current account convertibility was after World War II (and still remains) for free international trade has been gaining increasing support.

Among the favourable implications which deregulation of capital flows would have on the economy of a country, those most frequently spelled out are:

- the rise in social welfare, possible due to the access to foreign savings which expand the local resource base. This is an additional opportunity to increase investment and accelerate growth;
- the drop in national spending originating from occasional temporal (seasonal) disparities between periods of overconsumption or overproduction;
- easier access of countries to international financial markets, reducing, in effect, the price of

the funds borrowed from abroad;

- more opportunities for risk diversification in the trade with financial assets, which otherwise would have been absent;
- greater competition in the financial sector, easier specialization in the supply of financial services, and more incentives for financial innovation.

Although these potential favourable implications are not being disputed at present, the number of the countries (particularly less developed ones) which have introduced capital account convertibility is, in practice, much lower than that of the countries having introduced current account convertibility. The reasons for such an outcome are two: a) the conditions needed to maintain capital account convertibility are much more rigid than those needed to maintain current account convertibility; and b) the opinion that retention of controls on capital transactions has its logical and practical motivation is still widely spread.

The arguments in favour of maintaining restrictions on capital transactions are normally associated with their role:

- to facilitate the management of balance-of-payments crises and exchange-rate instability, which could have otherwise been exacerbated by fluctuations in short-term capital flows;
- to direct domestic saving to financing investments within the country instead to acquiring foreign assets, and to restrict foreign ownership on local factors of production;
- to extend the opportunities for the state to tax financial transactions, income and property;
- to prevent capital flows from offsetting efforts for stabilization and implementation of structural reform programmes.

These arguments do have some pragmatic sense, although being difficult to defend from theoretical grounds.

Balance-of-payments crises or instability of the exchange rate, however, could have hardly been put under control through restrictions on capital transactions only. External balance problems have their roots and fundamental causes outside capital flows, and therefore imposition of restrictions on the latter cannot replace the actions needed to eradicate the true causes of the mentioned crises. Capital restrictions are, at best, just palliating, and may be put into action only until any suitable policy measures have manifested their effect.

It is also unlikely that restrictions on capital flows may be successful in retaining domestic saving within the country in the absence of sufficient incentives for such a behaviour. It should be once more underlined in this case that outflows of capital are usually caused by other factors and policy actions should be directed at such factors themselves.

It is unlikely as well that taxation of capital transactions may be assisted by restrictions on capital flows. Naturally, when local tax rates on capital transactions exceed considerably foreign ones, imposition of capital controls may be useful for keeping the tax base safe from erosion. Yet it must be also admitted that the efficiency of such restrictions over longer spans of time cannot be guaranteed if incentives for circumventing these restrictions are still available.

As for the usefulness of controls on capital transactions in assisting the efforts for stabilization and reform, such an argument sounds realistically only for relatively short periods of time. In assessing the relevance of this type of restrictions to objectives such as

successful stabilization and reform it should be taken into account that the existence of restrictions itself may impair credibility of reforms undertaken, even if only due to the fact that it allows the reforms to be protracted.

All arguments in support of the maintenance of restrictions on capital transactions are implicitly based on the proposition that these restrictions are efficient. Analysis of this question has indicated that restrictions on capital transactions are most efficient when combined with foreign-exchange and trade restrictions to preclude both current and capital account convertibility. In developed as well as in less developed countries, introducing current account convertibility creates numerous channels for hidden capital flows as well. When incentives for their use (such as, for instance, anticipated significant changes in the exchange rate) are at hand, substantial flows may pass through these channels.

3.2.4 Preconditions for Introducing Capital Account Convertibility

In the recent 15-20 years the United Kingdom, New Zealand, and Mexico managed to successfully introduce capital account convertibility, while Chile, Argentina, and Uruguay did not and had to return to the regime of restrictions. Lessons from these episodes suggest that if a country is to successfully and irreversibly introduce capital account convertibility and reduce related financial risks, it should have conducted in advance certain policy creating the preconditions for opening the capital account. If such a policy and the necessary preconditions have not been established, substantial speculative flows might emerge, making it difficult to sustain convertibility prematurely introduced. In decreasing order of importance, these preconditions include:

Accomplished fiscal reform. As a consequence of the fiscal reform, the government budget deficit should have considerably been reduced, and that part of it which still remains should be financed in a non-inflationary way. A substantial government budget deficit financed through the printing of money would stimulate residents to export their savings abroad in order to circumvent the inflation tax. For the purpose of sending a signal to the public that the opening of the capital account has been irreversible, even a much more significant decrease in the government budget deficit might be needed compared to that which is consistent with price stability and stable growth. Completion of the tax reform and availability of a broad and stable tax base are thus imperative for a lasting reduction of the government budget deficit.

Conduct of financial policy that minimizes divergence between external and domestic conditions prevailing in financial markets. This means that domestic interest rates of "traded" financial instruments must be comparable (with an adjustment for anticipated changes in the exchange rate) with those prevailing in international financial markets. Furthermore, the domestic financial system must be strengthened so that it could successfully compete with foreign financial institutions and survive periods of large fluctuations in asset prices. As a minimum, this would require restructuring of those financial institutions which have a large share of uncollectible loans in their assets and consolidation of the capital base of the entire financial system.

Strengthening and "rendering safe" the domestic financial system. Elimination of restrictions on capital transactions would lead to the introduction of new financial techniques and instruments, new sources of funds and new participants in local financial markets. These changes would increase competitive pressure which might eventually lead to a higher efficiency of financial markets, introducing at the same time substantially complicated

elements of risk. This might result in a sharp discontinuation of payments and credit flows when risks that have not been foreseen suddenly materialize. That is why improving the local system for supervision of financial institutions before opening the capital account is of essential importance.

Elimination of restrictions on flexibility of wages and prices. Since the 1980s, periods of substantial volatility of asset prices have been recurring, so countries, and in particular those having introduced capital account convertibility, have to adapt their economies and, especially, their financial structures in order to survive the mentioned volatility of asset prices. The volatility being discussed here may have highly unfavourable consequences on employment, production, and wealth in economies which have been administratively restricting flexibility of wages, prices and interest rates. Elimination of this type of restrictions before introducing capital account convertibility is an important precondition if the economy is to react more flexibly to real and financial shocks.

Tax evasion stimulating capital flight. The experience of developed countries has shown that harmonization of local taxes on financial transactions with those prevailing in the other countries is necessary. Such harmonization must be achieved before the final abolition of controls on capital transactions in order to avoid possible large tax-motivated capital flows.

4. Current Account Convertibility of the Lev and International Payments

4.1 Historical Overview

In the beginning of February 1991 Bulgaria virtually introduced, by Decree No. 15 of the Council of Ministers, current account convertibility of the lev, as part of the radical economic reform launched. The most important restrictions which remained in force after this decree became effective were the (then) unresolved problem of the debt of the Bulgarian Foreign Trade Bank (BFTB), about a dozen inherited bilateral payments agreements with countries such as Afghanistan, Brazil, etc., and the limits on the amount of foreign currency purchased by Bulgarian residents for tourism abroad. This restricted internal convertibility of the lev introduced at the start of the reform has been surviving for five years now the political and macroeconomic turbulence of the Bulgarian transition, as restrictions have gradually been abolished or relaxed. Thus, the assumption of the BFTB debt by the state and the deal concluded with the London Club commercial creditors eliminated perhaps the most significant restriction on external payments and on the current account convertibility of the lev. And the "tourist" limit, officially increased from the foreign currency equivalent of BGL 10,000 to USD 2,000, is very easily circumvented in practice. Liberalization in Bulgaria was much more decisive right from the start of the reform compared to that in such "diligent front-runners" of transition as the Czech Republic and Hungary. In the Czech Republic, for example, legislation is now being prepared to permit residents to open accounts in foreign currencies in local banks, as a step toward the adoption of IMF Art. VIII status. This paper is not the right place for a detailed analysis of this matter, yet we are of the opinion that Bulgaria has already paid the price for introducing current account convertibility of the lev without taking full advantage of its fruits.

4.2 International Obligations

Bulgaria has assumed direct international responsibilities with regard to the current account convertibility of the lev by its membership in the IMF and by its European Agreement.

4.2.1 Art. VIII of IMF Articles of Agreement

Bulgaria's IMF status is in compliance with Art. XIV of the Articles of Agreement of this international institution. In essence, such a status permits to a country to maintain and adapt exchange restrictions which it has applied as of the date of its admission as a member of the IMF. Art. XIV status is considered as temporary. Any member country is expected to accept obligations under Art. VIII. Although this should be a voluntary act of the respective country, Art. XIV provides for a mechanism of supervision and initiative on behalf of the Fund for the acceptance of Art. VIII and for possible sanctions (discontinuation of the purchases of IMF credit).

A country with Art. VIII status assumes obligations under items 2, 3 and 4 of the mentioned article not to introduce restrictions on payments and transfers related to international transactions, not to apply discriminatory exchange practices and multiple exchange rates (coefficients), and to repurchase its currency from other member countries (external convertibility).

A country which accepts the obligations under Art. VIII practically declares that its foreign-exchange regime is free of the restrictions mentioned in Art. VIII. Formally, this is implemented through a letter to the Managing Director of the Fund. Before that an IMF team reviews in detail the foreign-exchange regime and practices of the respective country.

By adoption of Art. VIII status a country signals to its foreign partners that it will conduct prudent macroeconomic policy and, thus, will not be forced to resort to exchange restrictions with regard to current account payments and transfers.

As of 31 July 1995, 104 countries from a total of 178 IMF members have accepted Art. VIII status. Among these, 7 are economies in transition - Lithuania, Latvia, Estonia, the Kyrgyz Republic, Croatia, Moldova and Poland. Slovenia has announced its intention to accept the obligations under Art. VIII from 1 September 1995, and the Czech Republic and Hungary are in a preparatory process to do the same from 1 January 1996. By the end of 1995 Bulgaria will lose its image of a country applying a more liberal foreign-exchange regime than that of a number of other transition economies, an image that it has not even been insistent to avail in order to demonstrate determination to reform.

4.2.2 Europe Agreement

Articles 60-62 of Bulgaria's Europe Agreement refer to the payments regime. Although these texts are formally defined as mutual obligations, they represent, in practice, unilateral obligations of Bulgaria, insofar the currencies of all members of the European Community (EC) are fully convertible.

Analysis of the articles mentioned allows to draw at least two conclusions:

1) Art. 60 provides for an obligation of Bulgaria to maintain current account convertibility on the transactions that "concern movement of goods, services, or persons [between the Parties] which have been liberalized pursuant to this Agreement". With some approximation it could

be stated that this would mean that Bulgaria has agreed to assume obligations analogous to those under IMF Art. VIII with respect to the EC.

2) Articles 61 and 62 approach in detail the convertibility of the lev on some capital transactions, mainly those related to direct investments. These texts suggest that, even as early as at the stage of association, Bulgaria's European partners cannot be contented with only current account convertibility of the lev. They have reached an agreement for an immediate obligation for convertibility with respect to the repatriation of profits and the depreciation of direct investments. This, by the way, is in compliance with the Bulgarian Law on Foreign Investment of 1992. In addition, Bulgaria has assumed a commitment to introduce capital account convertibility of the lev through a phased approach. In particular, Art. 62 stipulates that this country shall take measures "permitting the creation of the necessary conditions for the further gradual application of Community rules on the free movement of capital", following an initial five-year period.

4.3 Rights of Bulgaria Pursuant to International Contracts and Defence of Bulgarian Interests

With regard to the payments regime and convertibility, it is good for the Bulgarian party to clearly formulate, first and foremost for itself, what are its rights and interests in. Are they in the avoidance or delay, for as long as possible, of the transformation of the lev into a convertible currency? We do not find arguments in favour of such a thesis. International rules are clear, and established long before Bulgaria's opening to the world. Convertible currency, together with all the preconditions needed for its introduction and sustainability, is an essential element of the linkage of the Bulgarian economy with the world economy, and an essential component of the reform. From this viewpoint Bulgaria's rights, as provided for in international contracts, pertain to ensuring transitional periods during which the necessary preconditions for transition to convertibility of the lev should be achieved.

What contradicts, and what could harm, Bulgaria's interests is giving up the transitional periods, not doing the preparatory work needed.

4.4 Proposals and Time-Frame

In essence, Bulgaria is ready to introduce immediately full current account convertibility of the lev by accepting IMF Art. VIII status. In the recent four years Bulgaria has been exercising *de facto* current account convertibility. The regime of a floating exchange rate currently applied in this country, the prospective sharp fall in inflation and the reduction of the government budget deficit as a percentage of GDP, being imposed also due to some other reasons, over the next few years, as well as the level of foreign-exchange reserves and the prospective balance-of-payments situation in 1995 do support such a conclusion.

There are just two formal obstacles remaining which still prevent the adoption of Art. VIII status:

- the limit on the purchase of foreign currency by residents for touristic purposes of up to USD 2,000 per annum, which in practice is inactive; and
- the formal existence of 10-12 bilateral payments agreements, most of them also inactive.

These agreements are viewed as an instrument for applying multiple exchange rates and discriminatory foreign-exchange policy.

A possible sequencing of the necessary steps for the acceptance of Art. VIII status is the following:

1. The Ministry of Trade and Foreign Economic Cooperation (MTFEC) reviews and analyzes the bilateral payments agreements. All of these are operated by the Bulbank (the former BFTB). Analysis must indicate which of them are active and which are not. Depending on the specific results, a time-frame should be adopted for a gradual elimination of this type of agreements following their expiry and non-renewal, while in cases where possible elimination should be immediate.
2. The Governor of the Bulgarian National Bank (BNB), in his capacity of Governor of the IMF for Bulgaria, invites an IMF mission to review Bulgaria's exchange-rate regime and practices in connection with its intention to accept Art. VIII status. The mission is then being informed about the government's intentions and time-frame for the elimination of the bilateral payments agreements, or about the fact that those of them which need to remain in force, this being duly substantiated, do not violate the obligations under Art. VIII.
3. The Council of Ministers adopts an amendment to its Decree No. 15 and abolishes the limit for resident individuals to purchase foreign currency.

With the acceptance of Art. VIII of the IMF Articles of Agreement, Bulgaria automatically fulfils the obligations under Art. 60 of its European Agreement.

Limits on the purchase and exportation of currency for touristic purposes have usually been motivated by the need for efficiency of capital controls. Elimination of the limit on the purchase of foreign currency for touristic purposes may be replaced by modifications in the administrative procedures regarding the issuance of foreign currency permits for "invisible operations". It is possible, for instance, to retain the licensing regime for free transfers abroad, the permits up to a certain amount (let's say USD 5 or 10 thousand per annum) being automatic, while above this amount the control should be strengthened and requirements for documentary evidence for the issuance of a permit increased. By the way, prevailing practices in Bulgaria at present are much more restrictive with regard to "invisible" operations, in particular transfers for medical treatment, financial support to students, etc., than with regard to the "touristic" limit. Taking its decisions on the basis of an outdated and contradictory legal and regulatory framework, the administration is in a position to issue such permits in a quite arbitrary fashion. It is even more important, however, that the administration deals with trivial matters related to modest sums of several hundreds of USD, while at the same time capital outflows in huge amounts are not a problem at all.

4. In our opinion, assuming international obligations with regard to the current account convertibility of the lev makes it imperative to stabilize the legal and regulatory framework of the related subject matter through the adoption by the National Assembly (NA) of a *Law on the Foreign-Exchange Regime and Exchange Controls*. A draft for such a law may be worked out within a term of one year. (There is, actually, one draft, from 1992, for a *Law on Transactions in Foreign Currency Assets and Exchange Controls*.) In elaborating the draft, the contradictions among currently effective laws and regulations on this subject matter,

having been adopted and amended in different years, need to be made consistent or removed. The most important among the latter are:

- Law on Transactions in Foreign Currency Assets and Exchange Controls (1966)
- Law on the Economic Activity of Foreign Persons and for Protection of Foreign Investment (1992)
- Law on Banks and Credit Activity (1992)
- Law on the Bulgarian National Bank (1991)
- Decree of the Council of Ministers No. 56 (1989)
- Decree of the Council of Ministers No. 15 Amending the Foreign-Exchange Regime (1991)
- Ordinance for the Import and Export of Foreign Currency Assets (1994)
- Rules for the Implementation of Decree No. 56 of the Council of Ministers
- Ordinance on Payments (1992)
- Ordinance on the Extraction and Processing of Gold, Silver, Platinum and Transactions Therewith... (1966)

5. Capital Account Convertibility of the Lev and International Payments

As clear from item 3.2.4, Bulgaria is not ready to announce capital account convertibility of the lev right now, without becoming prone to substantial economic and financial risks. That is why we propose here a phased and gradual approach.

5.1 Current State

Although the lev is officially inconvertible for the purposes of capital account transactions, the administrative capacity to enforce existing restrictions is remarkably weak. Anecdotally, the conviction has been spreading out that it was short-term capital flows, from nearby countries with more unstable macroeconomic conditions in particular, that have played a substantial role for the several significant depreciations of the lev, mostly in November 1993 through March 1994. It will not be surprising if it eventually turns out that the stability of the lev in early 1995 is due to a much larger extent to an inflow of capital rather than to an improved trade balance. Unfortunately, a quantified account for these processes is rather difficult to present. This is due, in particular, to the poor quality of balance- of-payments statistics.

5.2 International Obligations

If Bulgaria wishes to join the EU in the future, it should accept its rules on capital transactions without any restrictions. In particular, this country has future commitments in this respect under its European Agreement. Art. 61, item 2 envisages that after the elapse of the fifth year since the entry into force of the agreement, Bulgaria shall not introduce "any new foreign-exchange restrictions on the movement of capital and current payments connected therewith between residents of the Community and Bulgaria and shall not make the existing arrangements more restrictive". Furthermore, Art. 62 defines a time-frame (within the two stages of the Agreement) for the methods and measures Bulgaria should adopt for "enabling Community rules on the movement of capital to be applied in full".

5.3 Rights of Bulgaria Pursuant to International Contracts and Defence of Bulgarian Interests

Ensuring transitional periods for the introduction of capital account convertibility of the lev may, in fact, be considered as defending Bulgarian interests. If these transitional periods, however, are not used to prepare the conditions necessary for such a purpose, the country risks to suffer either the economic and financial hazards of a transition to full convertibility without the availability of the minimum necessary conditions, or the foreign political hazard of demanding a prolongation of the transitional period.

5.4 Proposals

Cognizant of Bulgaria's unreadiness for introducing full convertibility of the lev, we would propose a *gradual approach*. The process should be guided by two principles: priority of *external* to internal capital account convertibility and of *long-term* to short-term transactions. In more detail, the sequencing might be the following:

1. External convertibility of direct investments;
2. Convertibility of trade credits;
3. Convertibility of long-term portfolio investments;
4. Convertibility of short-term portfolio investments.

In order to achieve a gradual implementation of the opening of the capital account, in the *Law on the Foreign-Exchange Regime and Exchange Controls* proposed in item 4.4 future actions to liberalize capital transactions must remain within the competence of the government. The aim of such a Law is to bind future governments not to restrict current account convertibility.

External convertibility of the lev with regard to direct investments, because of its currently existing domestic legal and regulatory framework - the Foreign Investment Law, can be guaranteed immediately by the law mentioned in the preceding paragraph.

The necessary minimum of preparatory measures, directly relevant to the issue discussed, we would recommend includes the following:

1. The BNB should be required to comply with its legally entrusted obligation to compile Bulgaria's balance of payments and to specify its information sources, improve the compilation methodology and discuss and coordinate it with other interested institutions, such as the National Statistical Institute (NSI) and the MTFEC, in order to minimize the inconsistencies between customs and banking statistics. To this end, the BNB should strengthen the staffing of its respective organizational unit. Highly-qualified experts are presently employed in it, but only three in number. Having coped with this personnel problem, the BNB could then apply for technical assistance by the IMF on matters related to the balance of payments.

We would remind in relation to the above-said that in 1992 the World Bank extended a technical assistance loan (TAL) in the amount of USD 17 million earmarked for the establishment of an information group on Bulgaria's foreign debt. USD 3 million of this loan

were disbursed. The Foreign Debt Group was constituted within the BFTB and carried out an immense technical work on the reconciliation of the BFTB (in fact, Bulgarian sovereign) debt to external creditors. Following the completion of this process the Group, insofar its staff was retained, was transformed into an organizational unit within the BFTB. In the meantime, official liabilities to the IMF, the World Bank, the EU, Japan and other individual G-24 countries have been accumulating, while the information regarding the structure, maturities, interest-rate conditions, etc., on these new official credits remained dispersed in the Ministry of Finance (MoF) and the BNB and is being maintained (at least at the BNB) on an almost voluntary basis.

Without a reliable information basis for the processes in the external sector of the Bulgarian economy any decision regarding the convertibility of the lev could not avoid elements of gambling. The NA Economic and Budgetary Committees could invite a hearing of the Minister of Finance and the Governor of the BNB on the issue of the information basis of the foreign debt service.

2. The administration which deals with the implementation of the regime regarding the permitted capital operations should be strengthened. The "division of labour" between the MoF and the BNB in this respect should be clarified.
3. The necessary measures (organizational as well, if needed) to enhance banking supervision, and to monitor external foreign currency open positions of banks in particular, should be undertaken.
4. A joint task force comprising representatives of the MoF and the BNB should be appointed to involve in the following activities:
 - to examine in detail the literature on the experience of both developed and less developed countries which - successfully or not - have achieved full convertibility of their currencies in the recent 15 years or so;
 - to make forecasts for the macroeconomic parameters needed to minimize the financial risks originating from the transition to full convertibility of the lev;
 - to assess the order of the likely risks;
 - to propose to the government measures and a time-frame for the liberalization of the regime of capital transactions as a preparation for the examining of "ways for enabling Community rules on the movement of capital to be applied in full" envisaged by Art. 62, item 2 of Bulgaria's European Agreement.

6. Incorporation of Bulgaria into the EMU

6.1 *What are the Gains?*

The most essential likely positive effects for Bulgaria from its inclusion into the EMU are associated with:

- 1) "import" of stability of the national currency; During the years of transition following the liberalization of the domestic foreign exchange market the lev has enjoyed relatively long periods of stability, but has also suffered several shorter periods of disturbances and jump-like crises. Its replacement by the ECU - in compliance with the expectations for a high

degree of stability of the European currency unit - would have rendered stable the relatively variable value of the legal tender within the territory of Bulgaria.

2) "import" of price stability; Insofar macroeconomic theory and practice point to the instability of the national currency as a major source of price and economic instability - for small and very open economies in a regime of a floating exchange rate such as Bulgaria, in particular - the change-over from the lev to the ECU would also stabilize the domestic price level.

3) "import" of central-bank reputation; The reputation of a central bank is being established decades after decades by the pursuit of prudent, independent, long-run, non-inflationary monetary policy. As performing the functions of a central bank from quite recently and under the circumstances of an unprecedented in economic history, and, therefore, bearing a high degree of uncertainty, transition from a command administration of the national economy to markets, the BNB - although hard-working - has not managed yet (due to objective reasons, but not only) to establish for itself a reputation comparable to that of the future ECB - independent and modelled according to the Deutsche Bundesbank. Subordination of the BNB to the ECB within the ESCB would raise the confidence of economic agents in the central-bank institution and in the policies it is conducting.

4) lower uncertainty and greater predictability of macroeconomic environment and macroeconomic policy; In combination, the first three effects lead to the fourth one.

5) lower inflation expectations; In combination, the first four effects lead to the fifth, which is very important for the macrodynamics of prices and output and establishes a favourable environment for a non-inflationary growth and higher employment.

6) elimination of the foreign-exchange risk within the EU (at the same time the foreign-exchange risk with respect to the transactions with countries outside the EMU remains), and hence growing incentives for trade in goods, services and financial instruments within the territory of the Union, which, in turn - through scale economies and comparative advantage - will contribute to a more rational use of scarce resources, increased efficiency and productivity, and higher growth.

7) participation in an "optimal currency area " (according to its standard definition by Mundell as an area of free movement of factors of production), and hence - by analogy with the arguments in support of the effect outlined in the preceding paragraph - growing incentives for long-run economic growth and a gradual approximation of living standards in Bulgaria to those in west European countries.

6.2 What are the Losses?

The most essential likely negative effects for Bulgaria from its inclusion into the EMU are associated with:

1) loss of the relative autonomy of monetary (including exchange-rate) policy (i.e. the monetary instrument of macroeconomic regulation is handed over to the future ECB, while the fiscal one, as a consequence, undergoes a substantial modification); this loss is, in fact, the principal one - it can be decomposed into elements in accordance with the possible alternative variants of the targets, mechanisms and instruments of monetary policy (and their

interdependence with those of fiscal policy) over different time periods and reduced to a set of specific modifications of theirs. Within a more general economic and political context this principal loss could lead to the following (derivative to the sacrificed independence of monetary policy) major unfavorable consequences:

2) loss of the ability to adjust (level out) the balance of payments and stimulate GDP through changes in the exchange rate (in particular, through a depreciation (devaluation) stimulating net exports directly and, eventually, aggregate demand and production);

3) relative loss of national sovereignty (the central bank could not finance - through the government budget - expenditures which can be substantiated from a national viewpoint, such as for "cushioning" economic shocks or for defence);

4) danger for materialization of the anticipated by many experts long-term pro-deflationary bias of the future ECB (influenced by the price stability priority provided for in the Treaty of Maastricht and by its structuring according to the Deutsche Bundesbank model), which may constantly radiate recessionary impulses for the economies - especially harmful under conditions when there is no synchrony in the economic cycles of the participant countries (a situation typical for western Europe during the recent recession, despite aspirations and efforts for convergence);

5) another aspect of the lost, to a large extent, sovereignty of national economic policy is related to the inability to conduct active industrial policy in support of desired structural changes, including such for infant industries; we deem, however, that such a "loss" is illusory: possible earlier accession to the EU will rather be a means for restructuring the nation's productive and export potential according to comparative advantage and through competition in international markets. That is why a quicker incorporation into the EMU is recommendable. The sooner the institutionalization of the market in Bulgaria, the more prepared for accession the country.

6.3 Legal and Regulatory Implications

The monetary aspects of the legal and regulatory implications of Bulgaria's incorporation into a future EMU relate to the need to harmonize Bulgarian laws and regulations (some of which are quite outdated) regulating the areas of:

- monetary policy;
- foreign-exchange policy;
- fiscal policy;
- economic policy, as a whole.

Substantial changes will be necessary in the laws on the central bank and the government budget.

As regards international laws, Bulgaria will have to join, at a certain stage, the EMU, signing and ratifying the following international treaties:

- the Treaty of Rome establishing the European Community;
- the Single European Act;

- the Basle Act on participation in the European Monetary System;
- the Treaty of Maastricht on Economic and Monetary Union.

Moreover, it will be necessary to constitute and institutionalize the structural units and mechanisms of the common European monetary integration in legal forms, both domestic and international, by achieving harmonization of Bulgarian law with international law, as well as of national with the common European policy and the instruments of its implementation, in connection with:

- the establishment and functioning of the EMI (the ECB);
- the establishment and functioning of the ESCB;
- the need to modify the objectives, structure and functions of the BNB in conformity with its future role of one of the "national central banks" within the ESCB.

In compliance with the proposals further on (item 6.5) related to the establishment and functioning of certain institutions and mechanisms facilitating Bulgaria's accession to the EMU, legislative constitution and definition of the activity of some of the following possible structures (alternatively) will be needed:

- national stabilization fund;
- regional (east European) stabilization fund;
- agreement within the ESCB for coordinated multilateral stabilizing interventions;
- currency board;
- national fund for mitigating the effects of economic shocks (shock-absorber fund).

Explanation concerning the role of such structures is given in item 6.5 of the present paper.

6.4 Implications for Macroeconomic Policy

According to the provisions of the Treaty of Maastricht, the incorporation of a country into the EMU would cause serious changes in the targets, mechanisms and instruments of macroeconomic policy on a national level. In brief, the implications of the Maastricht principles for national macroeconomic policy could be presented as a division of the centres for administration and regulation of its two major components: common (supranational) monetary (including foreign-exchange) policy is being formulated and implemented in a centralized manner by the ECB, independent and legally devoted to price stability, while - despite some common guiding rules which considerably modify it - fiscal policy remains to a large extent decentralized on a national and regional level through the autonomy of local government budgets. Apart from the two principal components (monetary and fiscal) of macroeconomic policy, integration processes - even in this case much earlier before entering the stage of the EMU - influence, and in western Europe in practice have already influenced, its remaining components (trade, incomes and structural policies). The result is: loss of trade policy as an instrument of macroeconomic regulation on a national level (due to its transfer to a supranational level of regulation within the EMU); modified (unified at a supranational level) incomes policy; modified (coordinated at a national and supranational level) structural (supply-side) policy.

Due to the high degree of mutual interdependence of the components of macroeconomic policy and their joint impact on the economic environment, changes in all of them - directly or indirectly - have serious implications for monetary policy as well. The strongest, however,

is the interrelationship between monetary and fiscal policy, that is why the emphasis of the analysis further down is placed on the link between them itself.

The loss of monetary (and foreign-exchange) policy as an instrument of macroeconomic regulation on a national level (resulting from its transfer to a supranational level of regulation within the EMU) has two direct consequences for the revenue side of the government budget:

- loss of the inflation tax as a source of revenue for the government budget;
- loss of seigniorage as a source of revenue for the government budget.

At the same time, participation in the EMU would mean access to substantial items in the expenditure side of the EU budget and would provide opportunities for:

- subsidies for national agriculture in line with the Common Agricultural Policy (CAP) of the EU;
- subsidies for the structural development of backward regions in line with the Structural Funds (SF) of the EU.

In such a way the national budget could be relieved from the need to make certain expenses, and this would partly compensate the losses of the above-mentioned revenue sources and contribute to some extent to its balancing.

Besides the direct impact on monetary policy, an incorporation of Bulgaria into the EMU could have indirect implications too; the latter result from the modified fiscal policy discussed and are related to:

- the requirement for balancing (with permissible small deviations and exceptions) the national budget;
- the imposition of a limit on government indebtedness;
- the inability for direct financing of the government budget deficit by the central bank by virtue of a legislative act of the national parliament;
- the prohibition for financing through an overdraft of the central and local government budgets.

Another macroeconomic problem arising from the accession in the EMU is associated with offsetting aggregate demand and supply /price/ shocks. Standard prescriptions of modern macroeconomic theory for adjustment to an external price shock or for countercyclical stabilization policy assign an essential role to monetary policy. Through changes in the money supply the central bank can "cushion" the effect from a price shock and to "smooth" fluctuations and the cyclical pattern of economic activity (at the expense of certain increase in the price level over a medium term - mostly in the former case). As a consequence of the centralization of manipulation with the monetary instrument on a supranational level, accommodative monetary and countercyclical stabilization policies could be conducted only within the entire EMU, i.e. when the shock has common European, and not national, dimensions. In such a sense, non-accommodated economic shocks with a regional or national significance could cause changes in production and employment. To offset them to a certain degree, the states within the EMU could use national fiscal instruments, such as shock-absorber funds operating as automatic stabilizers of the local economy.

6.5 Stages, Institutions, Mechanisms

Differing opinions and forecasts about the future course of economic convergence in Europe are quite natural, given its high degree of uncertainty today. Views on its chronological, organizational and institutional implementation are, therefore, still varied and widely discussed. However, from the perspective of the transition to a monetary union, a process of accession of Bulgaria into the EMU is further down outlined; it could possibly evolve over the following several stages (certain institutions and mechanisms relevant to each one of the stages are also suggested):

1) Stage I - a regime of a managed float of the lev implying a gradual narrowing of the fluctuations of its exchange rate *vis-a-vis* the European currency unit (ECU) until finally pegging to it (within broader or narrower fluctuation margins); possible duration: 3-5 years; such an exchange-rate regime could be substantiated from an economic point of view within the context of:

- deepening integration processes, which imply a gradual equalization of price levels resulting from the mobility of the factors of production;
- the conduct of prudent macroeconomic and monetary policies, consistent with the approximation of the Maastricht EMU membership criteria;
- receding inflationary processes due to the progress to later stages in the transition (i.e. due to the movement away from the initial price jump typical for the first, and strongest, wave of post-socialist price liberalization and the several weaker ones that followed, and together with the gradual marketization of the economy through the processes of privatization, imposition of hard budget constraints for all economic agents, and development of institutional structures to regulate the economy within a market environment).

The biggest difficulties for the gradual long-term stabilization of the lev before its final pegging to the ECU will arise in connection with the need to maintain a positive, or at least leveled-out, (overall) balance of payments with view to the commitments of this country to the repayment of its foreign debt. However, opportunities for a reasonable corrective policy still remain (before, rather than after, the inclusion of Bulgaria into the EMU), since the current and capital accounts react in the opposite way to an appreciation/depreciation of the national currency unit (or a rise or fall of local interest rates). The inflow of lasting receipts from exports (before the liberalization of capital flows) and/or of direct foreign investment (after it) into the country could have a stabilizing impact on the exchange rate in the setting of a non-debt-accumulating and non-inflationary growth.

2) Stage II - pegging the lev within admissible fluctuation margins, implying that the latter could be gradually narrowed or defined in a straight-forward, one-time fashion right within the "normal" ERM fluctuation margin. If the approach of a gradual pegging in several steps is preferred (which does not exclude the variant of a crawling peg), the second stage discussed here might be, in fact, a first stage, as an alternative to the period of the managed float outlined in the above paragraph. The possible phases for the narrowing of the fluctuation margin could be at least three: within plus-minus 15% (the present-day ERM "band"), plus-minus 6% (the recent ERM "broad band") and plus-minus 2.25% (the recent ERM "narrow band") of the fixed rate of the lev *vis-a-vis* the ECU (this second stage also leaves room for an alternative - a managed float (implicit or explicit) within the same fluctuation margins); probable duration: at least 2 years, so that the requirements for participation in the third stage of the EMU are met; in case the pegging of the exchange rate does not evolve over several

phases but is instead directly introduced within the "normal" fluctuation margin, the period of managed float would have preceded it (and would perhaps have continued within a longer time horizon than in the case of being followed by a phased pegging).

During the stages enumerated above, the following institutions could be established and functioning in Bulgaria:

- stabilization currency fund - national or regional (i.e. east European) according to its objectives and territorial scope, or - as a better alternative:
- an agreement within the ESCB for coordinated stabilizing interventions, in which the BNB should be a party.

In the first case the central bank could have at its disposal a fund in a liquid form and in a sufficient (from the viewpoint of the turnover of the local foreign exchange market) volume representing a basket of currencies (including currencies of non-EMU countries) which could be used for interventions stabilizing the national currency (if the national variety of the stabilization fund is opted for) and/or the currencies of the countries of central and eastern Europe (if the regional variety is chosen).

In the second case stabilizing interventions could be coordinated and jointly conducted by all ESCB banks at a much larger scale, thus achieving a much stronger effect. Both variants have had their material or ideal historical precedents.

The first variant - in its national variety - was applied by Poland, pursuant to an agreement with the IMF right after the pegging of the Polish zloty. The regional variety, on the other hand, has been discussed since the early 1990s by the Association for Monetary Union of Europe within the context of a future incorporation of the countries of central and eastern Europe into the exchange-rate mechanism of the EU. As regards its implementation, the establishment of an ECU-Zone Surveillance Board has been proposed to manage the reserves of the fund and its short-term financing mechanisms, to monitor macroeconomic policies of the participant countries and, if necessary, to enforce adjustment of their economies. This Board was supposed to include representatives of the east European countries, the EMI (and the ECB at a later stage), the IMF, as well as of the European Bank for Reconstruction and Development (EBRD) and the Bank for International Settlements (BIS) in Basle.

The second variant of cooperation is provided for by the Treaty of Maastricht, insofar close consultation and coordination of actions in the area of monetary and foreign-exchange policy within the EMI and the ESCB (under the second and third stage, respectively) is envisaged.

The benefit from such mechanisms for the stabilization of east European currencies through the provision of additional resources for foreign-exchange interventions is apparent. Their major possible negative effect is, however, also clear: insofar these mechanisms would be established on a multilateral basis, the loss of a certain economic and political independence is unavoidable.

3) Stage III - final and irrevocable pegging of the lev to the ECU (without allowing any deviations from the peg) and/or replacement of the lev by the ECU.

In the final stage of a possible monetary integration of Bulgaria into the EMU and before the lev is finally replaced by the ECU as a legal tender, an institution similar to the currency

boards operating in some post-socialist economies could be established. Within this context, analysis of the experience of countries such as Estonia and Latvia could be quite useful.

Another institution which could be created and functioning during the last stage is related to the lack of national immunity against the impact of economic shocks. Insofar monetary policy is transferred to a supranational level, and fiscal policy is, as a result, modified, accommodative and/or countercyclical stabilization policies remain possible only at a common European level. To mitigate the effects of such shocks special shock-absorber funds, similar to the reserve funds of banks, which should operate on the principle of the automatic stabilizers of the economy (transfers and taxes) could be applied. These funds may be characterized as a fiscal instrument which replenishes (self-finances it) in times of economic boom or favourable aggregate demand and supply /price/ shocks through automatic (calculated through formulas and obligatory) or voluntary installments from the increased profits and/or incomes in order to be used for equilibrating aggregate demand and supply or for stabilizing the overall price level in times of recession or unfavourable shocks.

Conclusion

Insofar the transition of the incumbent EU members themselves to a single currency unit and a common monetary policy within the overall convergence of their macroeconomic parameters by the year 2000 - despite their commitments undertaken in the Treaty of Maastricht - is to a high degree still subject of an uncertainty with serious economic and political implications, the convergence process of the east European countries with association agreements toward the Maastricht EMU criteria appears to be quite indistinct and problematic. That is why flexibility of legislation and policies will be needed in the pursuit of this ambitious, supranational, common European goal to guarantee timely reaction on the part of Bulgaria to deviations and possible changes along the road to or within the EMU itself. Within this context, the opinions and thoughts exposed above regarding the benefits, the costs and the probable stages, institutions, and mechanisms of a possible accession of Bulgaria into the EMU correspond to the current state of this problem and are not insured against potential corrections or variants in the path of the European integration and convergence, and, therefore, should not be considered as firmly accepted or universal.

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