

Ivan Iskrov: Financial progress and prospects

Speech by Mr Ivan Iskrov, Governor of the Bulgarian National Bank, at the Sixth Business Roundtable with the Government of Bulgaria, Sofia, 21 March 2006.

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Dear Minister Oresharski,

Ladies and gentlemen,

It is a pleasure for me to participate together with the Minister of Finance in this panel event dedicated to the financial development and prospects of this country's economy. Based on the statutory division of labour between the Central Bank Governor and the Finance Minister on the one hand, and between the Central Bank and the Government on the other, in my speech I will deal mainly with the issues relating to the country's external position, the development of bank lending and inflation, and the impact these variables have on the BNB's policy.

I would like to immediately underscore that these issues cannot be discussed, outside the context of economic growth prospects, the accession of our country to the EU, and the trends of development in world economy. For better understanding of Bulgarian economy in the recent years, several global trends influencing significantly the development of our economy should be highlighted.

Firstly, the dominance of the principle of free trade and the liberalization of capital movement, combined with the investors' increasing propensity to hold assets issued by third country residents, brought about the on-going growth of international trade and exchange of capital. In such an environment, where domestic demand is no longer restricted within the amount of the current national income, the current account deficits are not always an indicator of fundamental imbalances. As has been emphasized by an increasing number of scientists, central bankers, and finance ministers, the imbalanced external accounts of individual countries have become rather the rule than an exception (A. Greenspan, M. King). In addition, empirical research, as well as the European institutions (European Central Bank, European Commission) point out that the process of convergence is inevitably accompanied by current account deficits.

Secondly, the decrease in the long-term interest rates in the developed economies, and the accompanying reduction in the risk premiums in the developing economies, resulted in investors' pursuit of higher yield in the developing markets. There are multiple factors determining these developments, on which I would not focus today. What should be underscored is that these global trends channel significant in amount capital flows to the developing economies. Irrespective of the monetary policy regime (fixed or floating exchange rate), the absorption of larger capital inflows inevitably puts the monetary authorities to trial. To illustrate the large scale of this process, I will give Bulgaria as an example, where the capital inflow (in the form of direct investment and debt) was 1.5% of GDP in 1998, and in the recent two years it approximates 15% of GDP.

Thirdly, the significant and long-lasting growth since 2003 in the prices of oil and other energy resources considerably contributed to the international imbalances, and more particularly to Bulgaria's current account deficit. This process accounted for the considerable growth of the expenditures for imports of energy resources incurred by the importer countries, and for the enormous cash flows channeled to the exporting countries. For Bulgaria, these developments in energy resource prices resulted in an increase in the costs of import of such products from EUR 1.7 billion in 2002 (the year after which the process of sustainable oil price increase started) to almost EUR 3.0 billion in 2005. This trend was very strongly manifested in the past year, when the country's expenditures for energy resource imports grew by 52% against 2004.

These three global trends, in combination with the approaching full-fledged EU membership of our country, produce a unique environment that the Bulgarian economy has never before faced. This makes the analysis of the processes and economic policy decisionmaking very complex and difficult.

As I have already noted, in the recent several years, enormous volumes of capital were channeled into the country, the banking system acting as the natural intermediary for the effective distribution of these resources. This is not surprising at all, given the successfully implemented privatization of the banking sector in Bulgaria. At present, over 80% of the Bulgarian banking sector is owned by foreign investors, the majority of which are from euro area countries. As a consequence of strong competition and the

good investment prospects, the growth rate of lending to the private sector accelerated to levels of 48.6% at year end- 2004. The ratio of banking credit to GDP increased from 12.1% in 1999 to 45.0% at the end of 2005. Of course, this dynamics reflected to a great extent the process of convergence of the country's economy, and in particular the degree of financial intermediation, to the levels evidenced in EU Member States (112% of GDP). At the same time, the central bank cannot help asking the question to what extent the quick growth of bank credit may result in potential risks for the financial and macroeconomic stability in the country. The BNB was to determine the moment, after which the convergence grows into a self-propelled process of struggling for a market share. Such a transition entails considerable risks, as it does not lead to sustainable growth rates of both financial intermediation and economic activity and employment. Therefore, since the beginning of 2004, the BNB started a process of phasing in measures (primarily prudential and administrative) aimed at slowing down bank credit growth to a sustainable level, which would not put at risk the stability of the economy. Data indicate the central bank's policy resulted in a change in commercial banks' behaviour and reduced the growth of bank lending to 32.4% at the end of 2005. In the current year, while sustaining the effect of already implemented measures, we expect banking credit to grow with a rate below or near 20%.

As I mentioned earlier, the dynamics of banking intermediation in the country cannot be contemplated in isolation from the process of free movement of capital and the accompanying dynamics of the balance of payments current account. Intuitively, many economists tend to seek direct cause and effect relation between bank credit growth and the current account dynamics. They rely on the logic that the growth of banking intermediation increases the possibilities for consumption and investment, which combined with the existence of free trade and the slower response of domestic supply leads to the accumulation of external imbalances. Such reasoning is to a great extent rational, but it should not lead, as is clearly manifested in the BNB's policy, to defining the simple rule that the balance of payments dynamics can be directly controlled through controlling the banking credit rates of growth. This clarification allows me to turn to the next issue I would like to discuss, namely the dynamics of the country's external position.

The stable macroeconomic environment in Bulgaria, plus the sustainably high rates of economic growth and the prospects for its membership in the EU brought in an increasing amount of investments. Their share in the GDP in the first three quarters of 2005 increased to 26.6%, which marks the highest level reached since the beginning of economic reforms in the country. The growth of investments and the concomitant improvement of employment, increase both the current incomes of households, and their expected future incomes, which is associated with increased consumption and decrease in the savings in the economy. As a consequence of these processes, the gap of the balance of payments current account widened to levels over 5% of GDP in 2003 and 2004, and further expanded to 11.9% as of end-2005. From the perspective of current account immediate dynamics, each economy faces the question if the current level of deficit or surplus is determined by structural factors, i.e. it is close to a balanced level, which can be maintained within a medium-term, or it is the consequence of unsustainable trends and one-off factors. Both groups of factors played an important role in the development of the current account deficit in 2005. First of all, the above-mentioned growth of investments was accompanied by considerable imports of investment goods. In 2005, the imports of this group of goods grew by 31.2%, while their share in the total structure of imports reached up to 28%. This trend was associated with a slow-down in the growth of imports of non-energy raw materials and consumer goods. In the current year, we expect the rate of import of investment goods to remain high, given the rapid pace of technological innovation of the economy, which is mainly accounted for by the forthcoming EU membership of our country.

Multiple one-off factors had significant effect in the past year, which include the abrupt increase in the prices and volumes of oil imports, and the sweeping floods, which troubled our exports in the third quarter of the year. This year, the current account deficit is expected to drop below 11 % of GDP, mainly due to the slowed down growth of imports, and the recovery of exports growth, which has been evidenced since the last quarter of the previous year and the beginning of 2006. In January, the exports of goods increased by 27.5% on annual basis, and exports, excluding energy goods, increased by 17%. The continuing implementation of the reforms in the labour market and education, and the improvement of the business environment, including a significant improvement in the operation of the judiciary, are of key importance for maintaining competitive advantages and ensuring sustainability of the country's external position, as well as preserving the interrelation between salary growth and productivity of labour. As we are well aware, the revenues from tourist services influence considerably the country's balance of payments (15% of the country's exports of goods and services in

2005), which necessitates the very fast elimination of all existing obstacles to the development of this industry.

Before I conclude my presentation, I would like to focus on inflation dynamics. At first sight, this variable does not seem to be such a great challenge for us, compared to the issues discussed above. Looking at the prospects and having in mind the country's strategy for expeditious accession to the euro area, however, this is a macroeconomic variable which faces the country with the greatest challenges. The inflation criterion, as defined in the Maastricht Treaty (this is not the place to deal with the issue how good this definition is), is very strict and requires a purposeful policy going beyond the monetary and fiscal policies. In Bulgaria's case, under the currency regime of fixed exchange rate and extremely conservative fiscal policy, untapped prospects should be sought in encouraging competition and improving the business climate, thus ensuring to the economy the flexibility to respond to exogenous changes (including with regard to the prices of raw materials) and enabling supply to react more promptly to increases in demand (both domestic and external). In the past year, inflation reached 6.5 % under the strong proinflationary impact of the increase in the prices of energy resources (direct contribution of 1.0 % in the overall price increase). In addition, the largescale floods resulted in an unexpected increase in foodstuff prices (contribution of 2.6 % in the overall price increase). This year, inflation is expected to decline to 6.0%. The slow process of decreasing inflation is mainly determined by the harmonization of indirect taxes with the minimum levels in the EU, pursued early in the year. As the change in indirect taxes and administered prices has a direct effect on domestic inflation, their catching-up adjustment should be effected before the years during which they will be used as basis for evaluation of compliance with the Maastricht criteria – i.e. before 2008. From this perspective, earlier timing of harmonization of some excise taxes is a step to facilitate significantly the performance on the inflation criterion, as it would eliminate the proinflationary impact of an increase in these taxes in the years in which such evaluation will be made.

In conclusion, I would like to sum up that, in the light of the rapid change in the structure of our economy, the stable macroeconomic policy pursued by the Government and the BNB, and the prospects for EU membership, the concerns, expressed in the leaflet for this Conference, of possible overheating of the economy and the risks this entails for its stability, seem rather exaggerated. The country's external imbalance financed by capital inflows is more of a signal of stability, credibility and potential for development of our economy. Of course, the economic policy makers are not and may not be complaisant. The challenges Bulgarian economy is facing are well recognized, and there is the will to take all the necessary measures to preserve the stability and growth in the economy.

Ladies and gentlemen, thank you for your attention.