ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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EX ANTE CRISES' INDICATIONS

The condition of the Bulgarian economy by 2008 is analysed in terms of some evolving inner tensions and disbalances. The fastest growth in the sector of industry is due to construction whereas in the services sector – to financial mediation. Such a discordance could not continue in the future, so structural adjustments linked to the overall tuning of the economy, are both possible and probable. The second part of the article studies the changes in inflation rates, employment and income. A clear positive trend of inflationary pressures emerges, which is in line with the positive development of real income of households per capita. Material and financial resources are tied up in unproductive projects which pushes domestic demand further but the latter is not met structurally by a corresponding supply. The subject of the third part is financial mediation. The lending provided by the banking system is still being held at an unreasonably high level which does not correspond to the structural characteristics of demand. In the end some conclusions are drawn for the inner structural tensions building up in the economy, accompanied by intensifying disequilibrium. There has been made an attempt to formulate adequate macroeconomic management policies with a view to preventing serious economic and financial failures from happening as a result of the overheated to a certain extent Bulgarian economy.
JEL: E22, E27, E66, H30

The financial crisis loomed all over 2008 in Bulgaria – much more anticipated rather than a real one. The year abounded with some overwhelming contentions and analyses, all of them generally defined by: "*The world financial crisis won't possibly pass us by. Once it was felt in the developed countries, we cannot fail but to experience it*". What was avoided, however, was looking deeper into the sector developments and the engine features of the anticipated financial and economic difficulties.

Meanwhile the economy went on following its own positive development. The official information about the GDP's quarterly growth (on an annual basis) has been completely satisfactory – 7.0% growth for the first quarter, 7.1% for the second and 6.8% for the third one. The high rates of growth could be accounted for by the agricultural sector where the gross value added for the nine months of the year grew by nearly a quarter (starting from 2007 – an exceptionally unfavorable year for plant-growing). Some indirect indicators suggest that the GDP annual growth rate will settle at about 6.5%, which seems quite acceptable and satisfactory.

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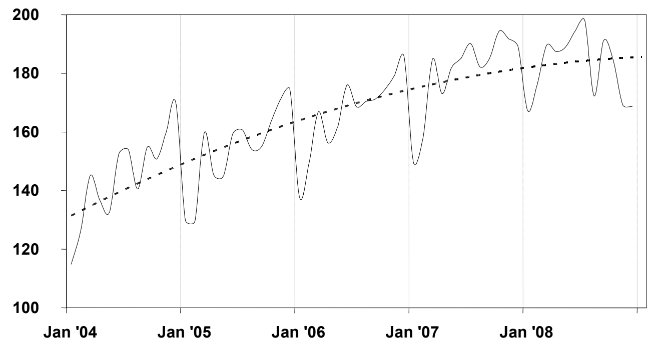
The monthly data about the industry sales can act as a barometer for the condition of the market and the market expectations. The sales index does not follow a smooth trend, but still it can be quite indicative (
Figure **1**). These sales possess a clearly outlined seasonal nature, typically with a significant drop in the beginning of the year. In 2008 as a whole, growth rates in industrial sales cooled down and the seasonal drop started a bit earlier. No doubt, this could be attributed to some purely psychological factors, linked with the overall ambiguity of the environment and the expectations for something more significant to take place. Anyway, what was witnessed was some postponed consumption of goods and services which were not of prime importance and whose consumption could be delayed.

Figure 1

Indexes of Industrial Sales (2000 = 100)



On Figure 2 one can trace the sector elements of developments in the industrial sales in 2008. The contracted demand can be seen in many sectors, but the most affected goods were those whose consumption could be deterred in time.

Industrial sales' indexes should not be overestimated. Their reliability is low and they are meant to give a preliminary (and simple) orientation about the nature of the processes taking place in industry. These indexes are based on the sample principle and therefore carry all the deficiencies of sample studies.[2] They are only valid in the short-term.

The combination of decreasing rates of growth in industrial sales and the relatively steady and not insignificant rates of growth in the newly added value (GDP), on the other hand, could be the result of structural adjustments being carried out in the industrial sector. Products of poor quality do not find market realization and higher quality presumes a longer life cycle.

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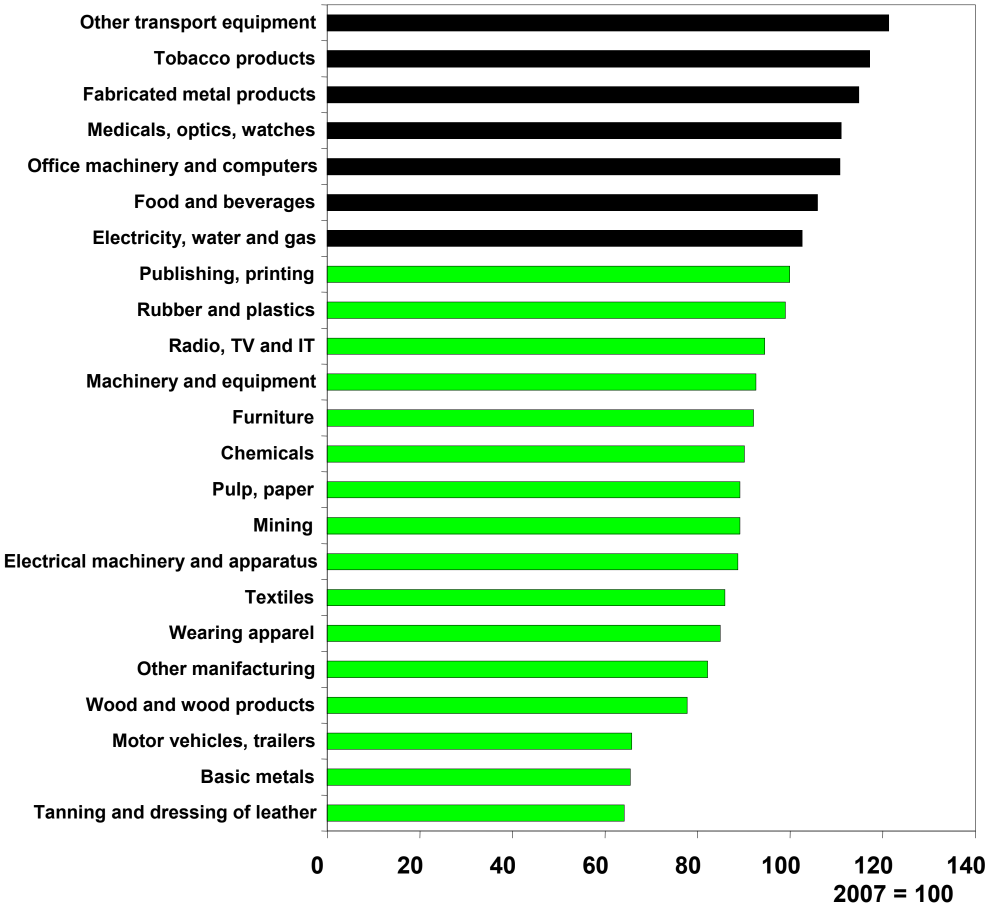
[2] Thus, in accordance with the methodology applied by the NSI (available on the Internet), the condition of the companies which did not respond to the survey is estimated by expert means, i.e. by using "*the method of replacing with the average sales for the sample valid for the respective sector group to which the company belongs*". However, the NSI does not publicize the number of non-responding companies, nor their sector group.

Figure 2

Indexes of Industrial Sales, 2008

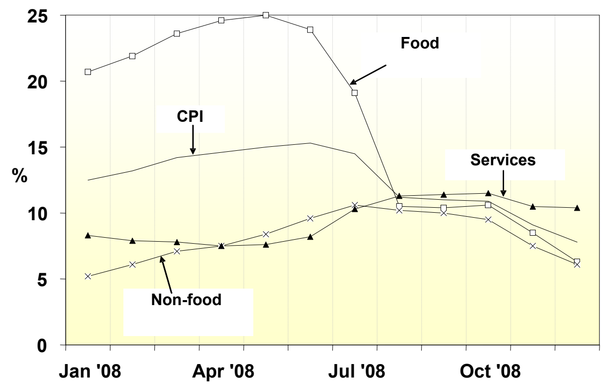


Developments in employment do not suggest any slump phenomena available. The registered unemployed in January 2008 were 273 000, dropped steadily to 215 000 in September and over the following three months leveled off at 232 000. The increase in registered unemployed at the end of the year could not be attributed to slump developments as far as it repeated the clearly outlined seasonal nature of employment in the last ten years. Such a downturn was witnessed in previous years as well.

The consumer price index (CPI – national methodology) remained constant at double digit levels on an annual basis but edged down from its peak of 15.3% in June and fell down gradually to 7.8% at the end of the year (Figure 3).The parabolic type of the annual inflation rate of 2008 was largely due to the sharp rise in prices during the second half of the previous year.

Figure 3

Bulgaria 2008: 12-month inflation



As for the structural characteristics of inflation it is logical for non-food price elements to take the upper hand. The primary impulse came from food prices (2007), and later on the other prices began catching up to make up for their delay. This was the situation after 1977 too, when the impetus gained by food prices consistently dragged upward the rest of the prices. Over the second half of last year the prices of services gradually prevailed and during the current year they will most likely be followed by the prices of non-food goods.

The average growth in consumer prices for 2008 settled at a double digit level – at 12.4%.

In the beginning the global financial crisis had a positive impact on the financial results in the industry. Over the first half of last year producer prices grew faster than consumer prices – for the first seven months of the year PPI was 10.1%, whereas CPI was 6.1%. The industry has managed to reduce the gap in price indexes through higher labor productivity, i.e. the price dynamics exerted a pressure on production structures. Over the five following months, however, PPI fell by a total of 10%, while CPI rose by 1.4%, which had a positive impact on producers' financial performance. PPI drop resulted from the international situation thus created and the fall in prices of input and raw materials on international markets (for example of liquid fuel).

An idea about how much more competition on international and domestic markets has intensified in the context of domestic production conditions can be gained by the change in the Real effective exchange rate (REER). For the first ten months of 2008 it grew by 4.1%, i.e. the local producers were facing worsening conditions for trade both on the domestic and foreign markets. REER rose independently of the appreciation of the USD over the second half of last year – in mid July the exchange rate was about 1,23 BGN/USD, whereas in November it went over 1,55 BGN/USD. The USD appreciation created favorable conditions for local exporters into the US dollar zone and reduced the competitiveness of the imports from this area. Still, however, the measure of the overall competitiveness REER has worsened. It is the consequence from the ever increasing link between Bulgarian economy and the euro area and the reorientation of foreign trade destinations, i.e. the gradual detachment of Bulgarian economy from the fluctuations in the USD and the increasingly narrower integration into the EU countries' economies.

On the other hand, the growth in the REER has raised the evaluation of local labor from international positions, i.e. the evaluation of local labor in terms of an internationally acknowledged currency (the euro) has risen and thus overtaking its domestic purchasing power. The imports of goods and services became more accessible to Bulgarian consumers which faced the domestic producer with higher requirements. The only possibility to deal with the changing conditions of competition was the increase in the production's efficiency – and the local economy has managed to do this. A telling example can be almost the same level of energy consumption in the country given a clearly positive trend of economic growth.

Notwithstanding the rising economic difficulties experienced by our major economic and trade partners local exporters continued their aggressive foreign trade policy, although with a visible trend of delay. The monthly rate of growth (on an annual basis) of the exports of goods (fob) as an element of the current account of the Balance of payments was 31.1% in February and went on steadily declining to 18.9% in October 2008. Almost in the same way (but with a certain delay) there decreased the analogical rates of imports of goods (fob) – from 27.8% in June to 22.7% in October. Such a closely linked change reveals the dependence of imports and exports and supports the expectations that the present global economic perturbations will bring about a reduction in the nominal deficit in the current account of the Balance of payments.

Significant changes have taken place in the financial and banking system. The influx of foreign currency into the country through the financial account of the Balance of payments was maintained at a relatively high level notwithstanding the rising deficit in the current account.

This resulted positively on the Gross International Reserves (GIR). For the first ten months of 2008 the net purchases of foreign currency of the Bulgarian National Bank (BNB) on the domestic foreign exchange market were record high – more than EUR 2 billion, with over 80% of these resulted from the foreign exchange trade of the BNB and the commercial banks. Investors viewed positively the local currency and given the perfect functioning of the CBA and the possibility to trade with a currency at a fixed exchange rate they showed a readiness to switch from foreign currency positions to leva positions. At the end of the period there was a certain change in the trend (the net purchases of foreign currency of the BNB for September and October amounted at EUR 365 million, (but the reduction in the purchase of currency at the end of the year is quite an usual and seasonal thing), which obviously resulted too from the apprehensions about the impact of the global financial crisis.

Some signs of tension became noticeable in the banking system too. The confidence between the commercial banks was shaken and as a result the price of the financial resource on the interbanking money market rose. The basic interest rate of the BNB, which followed the interest rates' dynamics on the interbank money market, started from a level of 4.68% in the early 2008 and gradually reached 5.77% at the end. The BNB reacted to the liquidity difficulties of the commercial banks and in the search to calm down the market loosened the monetary restrictions. In October 2008 the BNB restricted the deposit base of minimum reserve requirements, and later on (01.12.2008) reduced the minimum reserve requirements by two percentage points, in spite of the fact that the lending activities remained at a high level. The reserves of the commercial banks with the BNB were estimated at BGN 6,3 billion in September and fell to BGN 5 billion at the end of the year, i.e. the commercial banks had as a whole BGN 1,3 billion more at their disposal.

The experienced liquidity problems of the commercial banks can be clearly traced in their active search for financial resources, expressed in the increase in the interest on deposits (Figure 4). The commercial banks adopted the policy of offering all sorts of promotional deposit packages, quite often definitely beneficial to the depositors. Thus interest rates on deposits of an agreed maturity rose by more than two percentage points, whereas for 1998-2006 these had remained almost at a fixed level. Higher expenditure connected with the maintenance and attracting depositors, pushed up interests on credits too, in spite of the global trend for their reduction. The changes observed were connected too with the nature of the CBA and the impossibility for the BNB to pursue its own monetary and interest rate policy in particular, i.e. to exert an impact on the interest rates' levels in the country.

Figure 4
Bulgaria 2008: Interest Rates of New Business

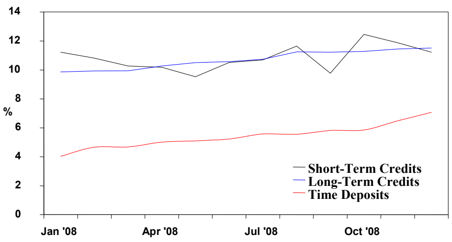
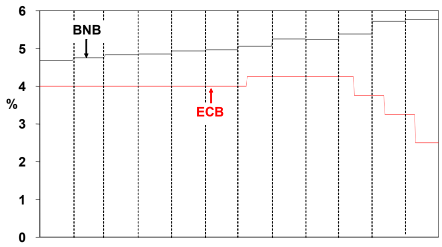


Figure 5
2008: ECB and BNB Interest Rates



It is worth noting that the ECB's interest rate (the minimum interest rate on demands for the basic refinancing operations), on the one hand, and the corresponding basic interest rate of the BNB, on the other hand (Figure 5) followed a completely opposite development. The comparison is quite conditional, however, as far as the economic functions of the ECB's interest rate and those of the BNB, on the other hand, are of a completely different quality. The ECB's interest rate is a major tool of the ECB in carrying out its discretionary monetary policy whereas the basic interest rate of the BNB has a passive nature and is made equal to the interest on one-day deposits on the interbank money market (index LEONIA). Despite that, however, the changes in the levels of both interest rates are indicative of the changes in the interest rates in the euro area and in Bulgaria.

After keeping for quite a long time its interest rate at 4% (13.06.2007 – 08.07.2008) the ECB raised it by 25 basic points fearing an acceleration of inflation. In the following three months however, the ECB found out that a greater threat to the European economy, under the current conditions, were the contraction in economic activities and the growth in both unemployment and the social tension, rather than inflation. As a result the ECB interest rate was decreased over the following three months by 175 basic percentage points down to 2.5%.

At the same time the basic interest rate of the BNB rose consistently, even accelerating over the last quarter of the year. The CBA restricts the BNB's authority to exercise control over the interest rates in the country and the only real tool for impact that remained (but still – indirect) is the percentage of the minimum reserve requirements. The restricted supply of fresh financial resources on the domestic market raised the overall interest rate in the country, which is at the same time an indicator for the relatively high and unceasing demand for lending by the real sector. Investors seemed to still assess positively the domestic situation and went on keeping their investment activities high. As a matter of fact this is also one of the reasons for the attractiveness of the country for foreign investors – formally it is advantageous and lucrative to keep both deposits of non-residents in resident commercial banks and to continue the credit expansion.

The official statistics has recorded a positive growth in real income of the people (in line with the representative studies of income per capita in households). For the first eleven months of the year the growth in real income per capita of households was estimated at about 3.4%, which can be defined as acceptable. It is a fact, however, that it is twice lower than the respective growth in GDP and in this respect the tradition of over the last few years of real income lagging behind was repeated again. The reason has to be looked for in the over inflated growth in accumulation, which is a form of deepening the unequal distribution of income. The redistribution processes in society favor but a small part of the social top crust, which (for one reason or another) would rather freeze their wealth in unproductive assets at the expense of the overall growth in welfare of the population, i.e. the low efficiency of the high relative accumulation preserves material resources and suppresses the growth in real income of the population.

If we go deeper in the economic structures, problems become better delineated. Investment activities are high, the rate of accumulation is kept at too high a level – for the nine months of 2008 it was over 38%! Moreover, the growth in stocks accounted for more than 15% of gross capital formation.

The exceptionally high level of investment recorded, under the comparatively modest rates of growth in GDP, suggests low marginal efficiency of capital investment. It is the outcome of investing in sectors that do not generate a new national income, i.e. investing in a kind of freezing of investment. This type of development is motivated by both the traditional circumstances and people's way of thinking and the poor quality of the institutional environment, which encourages it.

The particularity mentioned finds its expression in the Gross External Debt (GED) of the country. At the end of 2007 it was EUR 28,9 billion, and ten months later it became EUR 36,4 billion. The year will likely end up with a nominal growth in GED of about 50%! At the same time the growth in GDP, evaluated in nominal EUR too, was less than 20%. The overtaking development of GED is the reason its relative size (compared to GDP) to grow from 60.1% in 2003 to more than 106% at the end of 2008. The contribution of the accumulated GED to economic growth is shrinking more and more. The explanation lies again in the way of putting to use the GED issued, 95% of which now is a private foreign debt. The coming financial resources are being directed to sectors and activities that do not generate national income.

The active participation of the private sector in issuing GED releases the public sector from taking into consideration risky shock impact both of endogenous or indigenous nature. However, under some circumstances, the private debt accumulated might cause problems which in turn to become an obstacle to the normal functioning of the country's economy.

First of all, the inflow of foreign currency resources in the country increases the overall money in circulation and exerts a pressure on the trade balance. The BNB is unable to sterilize the incoming foreign currency resource, so it goes directly into the money market. The economy gets adapted to the respective model of currency turnover and becomes dependant on it. The possible change in the model of currency turnover will be felt painfully by the economy and lead to economic, aand most likely social shocks. The government should very carefully monitor currency movement inside the country and not allow a sudden shrinking of the foreign currency inflow. What is more, the government is supposed to foresee some adequate measures to counteract this.

Second, the prevailing part of the foreign currency resources entering the country are being invested in sectors that do not enjoy a foreign currency return. Such are for instance construction, trade, various services. They generate earnings in leva but not in foreign currency. Servicing debts is carried out in the respective original currency, which implies inclusion of the BNB and the GDR in providing the corresponding foreign exchange. In case of an unfavorable scenario, the GDR will get drained and the government will be faced with a dilemma: to start replenishing the GDR (through the issue of a new public debt) or switch to another foreign exchange regime.

As a total, for the nine months of 2008 investments grew by 35% (Table 1) under a GDP growth rate of 7%. The sectors "*Construction*" and "*Real estate, renting and business activities*" went on attracting investments with some exceptionally high rates of growth (75.2% and 97.4% respectively), in spite of the fact that these sectors were underlying the emerging financial crisis. This high dynamics is most likely due to a kind of inertia, but it also suggests that for the first nine months of last year lending to these sectors was not restricted or reduced. The Bulgarian investor and the Bulgarian economy go on reacting in a relatively inflexible and sluggish way, unable to manage to absorb the financial and economic signals in order to adapt quickly to the evolving conditions.

Table 1

Expenditure on acquisition of tangible fixed assets, BGN million

Sectors	9-months 2007	Composition (%)	9-months 2008	Composition (%)	Rate of Growth (%)
Agriculture, hunting and forestry	271	2.0	380	2.1	40.2
Fishing	2	0.0	2	0.0	-2.2
Mining and quarrying	316	2.4	241	1.3	-23.6
Manufacturing	2890	21.7	3203	17.8	10.9
Electricity, gas and water	1445	10.8	2140	11.9	48.1
Construction	1055	7.9	1848	10.3	75.2
Trade, car repair, personal belongings	2055	15.4	3325	18.5	61.8
Hotels and restaurants	830	6.2	564	3.1	-32.0
Transportation, storage and communications	1696	12.7	2067	11.5	21.8
Financial intermediation	450	3.4	509	2.8	13.1
Real estate, renting and business activities	1079	8.1	2130	11.8	97.4
Public administration, compulsory social security	806	6.0	1026	5.7	27.3
Education	63	0.5	106	0.6	69.0
Health and social work	95	0.7	147	0.8	55.3
Other community, social and personal service activities	270	2.0	302	1.7	11.7
Total	**13322**	**100.0**	**17991**	**100.0**	**35.0**

A significant part of investments were gobbled up by the service sector (the sectors "*Trade, car repair, personal belonging*" and "*Transportation, storage and communications*"). The abovementioned four industries make up 52.1% of investments for the nine months of 2008, on 44.2% in the previous year, i.e. the active financial saturation of these sectors was not discontinued. The latter will most likely provoke some economic and financial tension in the near future (by analogy with what took place in the developed economies).

Foreign investors have reacted much better to the current situation (Table 2). Some insignificant drop in FDI was recorded for the nine months in question but their structure has changed quite significantly. Contrary to the domestic trend, FDI in the sectors "*Real estate, renting and business activities*" and "*Construction*", as well as in "*Hotels and Restaurants*" shrank, but they rose significantly in "*Manufacturing*" and in infrastructure and service activities. Foreign investors have maintained their presence all throughout the year but have redirected their interests in accordance with the global situation.

Table 2

Foreign Direct Investment, EUR billion

Industries	9-months 2007	Composition (%)	9-months 2008	Composition (%)	Rate of Growth (%)
Mining and quarrying	13,4	0.3	17,0	0.4	26.7
Other community, social and personal activities	76,7	1.6	21,9	0.5	-71.5
Health and social work	0,1	0.0	1,2	0.0	1204.1
Education	0,6	0.0	0,2	0.0	-58.3
Real estate, renting and business activities	1785,9	37.9	1190,5	25.8	-33.3
Manufacturing	158,6	3.4	670,1	14.5	322.5
Electricity, gas and water	174,2	3.7	99,8	2.2	-42.7
Fishing	0,4	0.0	0,1	0.0	-73.0
Agriculture, hunting and forestry	34,1	0.7	47,3	1.0	38.7
Construction	562,7	11.9	405,2	8.8	-28.0
Transportation, storage and communications	74,7	1.6	178,5	3.9	138.9
Trade, car repair, personal belongings	453,5	9.6	712,8	15.4	57.2
Financial intermediation	1234,1	26.2	1131,9	24.5	-8.3
Hotels and restaurants	110,9	2.4	28,0	0.6	-74.8
Unclassified	35,2	0.7	117,9	2.6	235.2
Total	**4715,2**	**100.0**	**4622,4**	**100.0**	**-2.0**

Foreign investors' involvement with financial intermediation has remained high, logically connected with the high return recorded in the banking sector.

It is not a favorable circumstance that the overwhelming part of FDI goes to services, which do not generate foreign exchange earnings. All the five major service industries ("*Real estate, renting and business activities*", "*Construction*", "*Transportation, storage and communications*", "*Trade, repair and technical servicing of cars and motorbikes, personal belongings*", "*Financial intermediation*") involved almost three quarters of the FDI for the nine months of 2008. There is no doubt some vacuum in the economy in terms of the supply of such services, which the FDI is filling in on time, but there is also no doubt that these sectors offer a quick return and are of no long-term nature. Foreign investors' attention primarily to the service sector can be accounted for by the unsettled and unfavorable domestic institutional environment, which does not imply security and steadiness for any long-term investment. This trend should be changed in the future, most of all in the context of an appropriate configuration of the institutional environment.

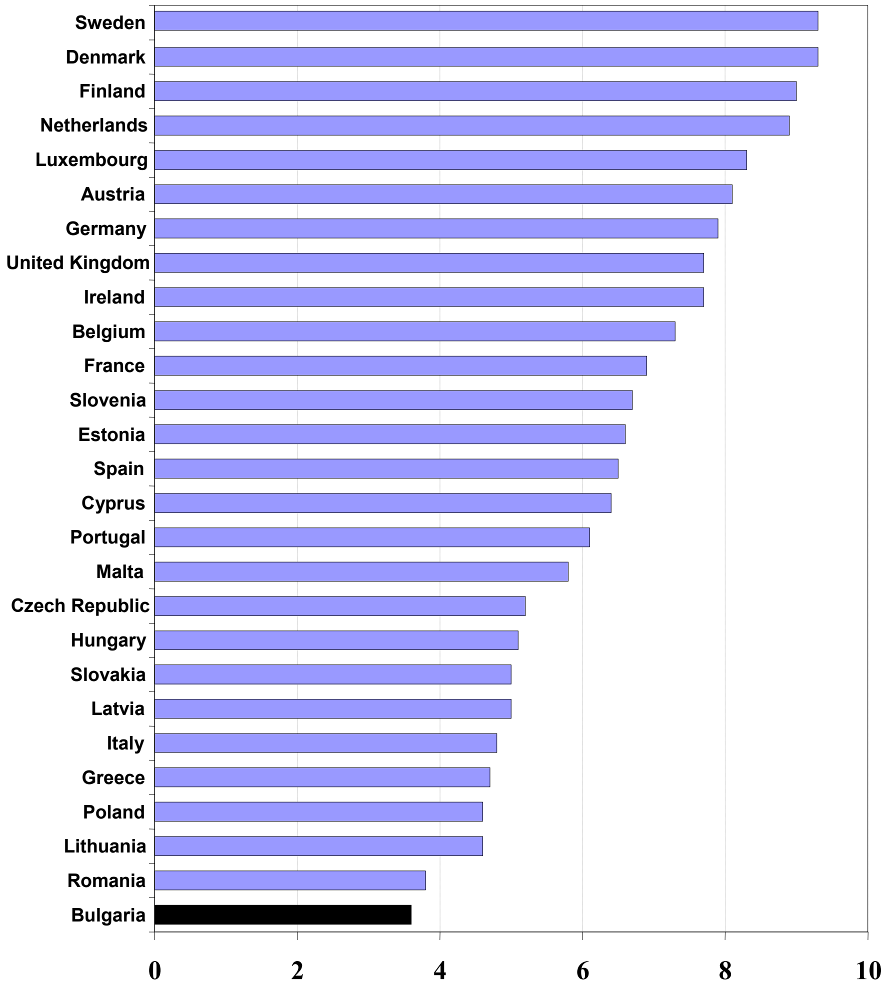
The adjustments in the structure of gross investments recorded do not reveal any tension available. What is more, the unfavorable inertia accumulated is still keeping its impetus. Obviously, it is a reflection of the traditional way of Bulgarian thinking which sees in real estate a supreme expression of wealth and prosperity. The local population's firmly established idea seems to be that real estate prices cannot fall significantly, let alone bring about a financial or economic crisis. Bulgarian economy continues to maintain inelastic structures of a great inertia and inability to adapt to the changing environment. The poor mobility of the Bulgarians, both in physical and mental terms, prevents them from putting the real estate already built in the center of the crisis. An appealing factor is the high profit, derived from such activities in the recent past, which go on feeding the individual greed, as well as the unbelief that the easy profit made can suddenly be drained. As a result the fictitious balloon is still being blown. Some analogy can be made in this respect with the existence and growth of the so called financial pyramids where the participants were actually aware of the possible crash of these pyramids, but hoped that the collapse would only take place after they had got their own (considerable) gain.

Macroeconomic management throughout the year has not been up to the modern requirements.

Corruption has remained out of control and growing, and the scandals erupted one after the other. The regular annual estimate of the international organization Transperancy International of the level of corruption in Bulgaria was 3,6 – the lowest ranking since 2000. This assessment claimed Bulgaria to be the most corrupt country of the EU (Figure 6). The consequences were clear. In fall, because of the absence of any results in the struggle against corruption and for misuse of funds the European Commission withheld its approval of two of the Bulgarian agencies, working with PHARE projects money to resume their activities and as a result these cannot sign any contracts now. It was confirmed too that financing infrastructure projects along ISPA was discontinued as well. Thus, the country has lost irretrievably EUR 220 million and another EUR 340 million have been blocked.

The problem with the so called European money is not only in the benefit from their arrival in the country as grants. The way it was with the IMF assistance, so it is now with the EU, the EU involvement with Bulgaria acts as a guarantee to foreign investors that the country is developing progressively. Not a single investor can have an overall view of the social and economic domestic processes and development. Such a responsible view, however, is held by the IMF and the EU. The inflow of European funds attracts other investors too, as well as vice versa – the discontinued financing from European funds stops other FDI. The ratio in this respect is for example 1 to 5 – each euro from the European funds is followed by at least another five in the way of foreign investment. Hence the much greater importance of keeping the flow of financial resources from the European funds compared to their direct contribution. The more so that it is a question of days of crisis.

Figure 6
EC: Corruption Perception Index 2008 (Transperancy International)



The global financial crisis has made politicians more sensitive and there has come an abundance of inadequate and not well-thought statements, only bringing about further confusion and chaos in the vague and difficult situation.

It has become a tradition in case of pitfalls in the economy in Bulgaria (and there is no shortage of them) to look quite as a must at the CBA and suggest almost invariably to unilaterally introduce the euro. In such cases people become all ears and carefully probe official statements. Isn't another grave failure coming like the one of ten years ago that seems to be still so fresh in mind?

Gloomy scenarios can come true in a Bulgarian version both with a CBA or without. The latter is not a heal-all for positive financial and economic development, nor could by itself lead to crises. What it takes is a series of connected unfavorable developments all over the front line of macroeconomic management in order to end up with some extremely negative effects. Let us recall that Argentine in 2002 could not hold the line when the US dollar had appreciated and because of domestic managerial failures too it had to give up the CBA and switch to a freely floating exchange rate when its currency was triply depreciated. Before that, however, (in 1997) when the financial crisis in South Asian countries was raging and the so called Asian tigers went through massive financial crashes, Hong Kong, due only to its CBA (introduced in 1983), managed to stand the trial despite the famous G.Soros's prophesy for their collapse.

What is good and bad about the CBA is the possibility open to change the exchange regime. It is bad because foreign exchange stability does not look irreversible, but it is good because a change in the foreign exchange regime provides a kind of economic incentive of last resort. Employers and industrialists, and especially the mega-minister P. Dimitrov, should have an answer to the question what they would do if the trade gap still remained quite large and the necessary foreign capital flows for its financing dried up drastically. The overall economic recession would become unavoidable in such a case, a number of bankruptcies would pile up and social unrest would intensify. Then, the devaluation of the local currency would appear as a kind of (for all that) and a bearable solution.

The example of the unilateral adoption of the euro by Montenegro is not determinative. Similar cases can be quoted elsewhere too (for example Ecuador's dollarization in 2001), but the opposite examples are plentiful as well. Our colleagues from the Baltic republics of a CBA have never thought about a unilateral euroization notwithstanding how dramatic their economic situation was. In addition, our EU membership imposes some implied constraints which we simply cannot ignore.

The unilateral adoption of the euro has its own specific negative material dimensions. In 2008 the money in circulation in Bulgaria was about BGN 8.2 billion. It was covered by EUR 4.1 billion of the country's GIR. Managing this money the BNB realizes an income of a minimum annual average of about 2.5%, i.e. it makes a nominal annual income of about EUR 100 million, which predominantly goes from the BNB straight into the government budget. Given a unilateral adoption of the euro this income will evaporate and be enjoyed by the ECB only. It is a completely different story provided Bulgaria were a member of the euro area – the seignorage from the euro issue is distributed among the member countries which are at the same time the ECB's shareholders. Giving up a substantial income in euro, without any compensation in these unsteady times, seems at least unreasonable.

The juxtaposition of various aspects of the economic 2008 leads to the natural question: How come poor macroeconomic management, inadequate and subjective reactions but good economic performance?

A lot of foreign capital has entered into the country over the last years. It tends to keep the economic tone relatively high. Bulgarian economy offers some attractive features which justify the foreign investors' interest.

To begin with, Bulgaria has become member of the EU since 2007 and this membership has made Bulgarian economy more attractive to the foreign investor. It is a guarantee that the overall improvement of the macroeconomic management is under way and that the supervisory functions of the EU, most of all in the institutional sector, won't allow the appearance of uncontrolled activities at a governmental level.

Second, Bulgarian economy offers a high return on investment. The net profit growth in the banking sector is the most telling example in this respect. This particular profit grew from BGN 267 million in 2002 to BGN 1,5 billion in 2008, i.e. the average annual growth rate for over six years in a row has been a third! Such a high return in a EU member-country cannot be easily neglected. At the same time labor costs are much lower than European standards whereas labor discipline and the quality of the labor force are within the European ideas. Last but not least one should take into account the favorable taxation which, although in the short-term, represents another stimulus.

Third, the Bulgarian economic prospects lie in its European integration and overcoming institutional and behavioral differences on a European scale. A good example is Greece, which from a country comparable to Bulgaria in terms of attitude of mind and economic potential, has managed for over two decades to work its way up and take a well-deserved place in the family of the European countries.

Bulgaria's membership in the EU creates many more beneficial opportunities for increased economic activities locally. Bringing the principles of macroeconomic management closer and closer to the European ones helps to increase responsibility of the subjective factor, enables the domination of economic and social freedom and the deployment of economic initiative.

The abovementioned features of the economy of Bulgaria at the end of the first decade of the 21st century result directly from Bulgaria's membership in the EU and are the positive effects from our inclusion into the European countries. Without the clear and implied presence of the spirit and institutional supervision of the EC Bulgarian economy would have looked much worse. It is almost impossible to work out directly the economic effects, but it is also impossible to think about a non-European present and still more – of a future of this country.

The specific features of Bulgaria and Bulgarian economy at the end of the first decade of the 21st century imply making a positive usage of the situation reated by the global financial crisis. The Bulgarian economy looks steady and its steadiness could be used to maintain and even further encourage economic growth.

One has to assess positively, too, the opportunities presented for the country from the return of our compatriots, who had left it in the search for a better economic present and future. These are economically active and enterprising (mainly young) people with their own visions and even material resources which will push forward the country's economic activities. A good example in this respect can be the experience in Israel, which has managed to give shelter to millions of its compatriots on a piece of land made but of sand and stone and still provide a prospering national economy..

A basic problem of the immediate economic prospects are the expressions of the global financial crisis, its possible manifestations and consequences, as well as the impact of the various elements of macroeconomic policies.

Construction will be affected. This might even turn out to be positive in view of the unreasonable and chaotic emergence of concrete jungles all over the country. The construction industry and the business connected with it account for one fifth to one fourth of the overall economic activities and the reduction in the sector will probably amount to a third. In accordance with official statistical data there are about 250 000 people employed in it but because of the significant part of unregulated employment there, some 35 000 – 40 000 will officially be made redundant.

The shrinkage in metallurgy will be linked to its overall modernization and will take time and material resources. Employment in metallurgy is not very high (about 100 000), so unemployment will hit about 10 000.

The pitfalls in the textile and tailoring industry will most likely have a temporary nature.

In the short term, a reduced demand for goods which are not staple commodities and whose consumption can be deterred for the future, is also likely to be experienced. Such is for example stationery and computer, furniture etc. The reduced demand for this kind of goods will to a great degree be the result of psychological factors, active media discussions on the problems of the crisis in particular, enhancing some vague anticipations and fears. This delay might be offset in the short-run.

Some other strains in other branches of the real sector get outlined too, but these have their own particularities and have little to do with the financial crisis.

Overall, the direct impact of the financial crisis will be in lower rates of GDP growth by 2-3 percentage points and higher unemployment of up to 50 000 people, i.e. of an annual average of 280 000 – 300 000 people, which is comparable to the situation in 2007.

There will be a definite (although indirect) strain in the banking system. The latter was actively lending money to construction and its shrinkage will lead to liquidity strains. There might appear some difficulties in servicing credits already granted, which for the moment are being somewhat covered by specific banking techniques (for example revolving credits). An indication is that the commercial banks need ever more fresher financial resources, which intensifies the fight for attracting new depositors.There is an analogical trend on the interbank money market.

There are no grounds to expect an attack on the CBA. The country's GIR are still kept at steadily high levels. These can cover the money in circulation about three times, which instills certainty.

The most serious risks are connected with shaking the foreign investors' confidence or its collapse.

Setbacks and problems in (un)assimilating the financial grants from the EU represent a very serious shock on the financial and economic stability of the country. The EU's presence and its involvement with Bulgaria, the way it was with that of the IMF before, go much further than the benefit of using their direct currency flows into the country. The EU is a kind of guarantor of the progressive economic development of Bulgaria.

The FDI flows, and more generally – of foreign currency resources – into the country is of a vital importance. The deficit in the current account of the Balance of payments remains worryingly high and its financing implies an obligatory inflow of fresh foreign financial resources. Otherwise, one would have to withdraw money from the GDR and as world experience has shown this situation invariably leads to a foreign exchange crisis.

Another hazard for the stability of the national economy is adopting the idea for the active state on a primitive level. The state involvement in the developed countries is resorted to in order to assist loss-making enterprises, financially and non-financially (on a credit basis), and not to appropriate investment projects. Here, in Bulgaria, state assistance is understood in the context of vulgar Keynesianism – large-scale involvement with investment projects and assuming direct economic liabilities. Under an environment of corruption out of control, consequences can only be deplorable. Here is the warning made by the ECB. It sounds especially up-to-date for a country like Bulgaria. Namely, "*At the current juncture, it is crucial that governments do not delay, but rather take decisive action to implement the necessary structural reforms in their countries and enhance the quality of public finances in line with the Lisbon Strategy. ... Experience has shown that policy activism has only led to the accumulation of fiscal imbalances and has not helped to solve the underlying economic and structural problems*".[3]

[3] Monthly bulletin, 12/2008. ECB (BNB, Internet), 76 p. Economists of markedly "*left*" beliefs in Bulgaria saw in the policies of the developed countries' governments in connection with the global financial crisis almost a direct return to the "*socialist practice*" of government planning and management. An outstanding representative of this circle of economists is I. Angelov. He is forced to use the usual market terms ("*regulated market economy*", "*increase in the regulatory and supervisory functions of the state*"), but in the open or not so much context of direct participation of the state in the economy. I. Angelov mentions among other things that in the USA "*the only pragmatic solutions*" involve "*nationalization of the financial institutions*", or that "*some big banks in the USA and other countries were nationalized"* but is taking pains to avoid commitment with specific examples of direct nationalization – there are no such examples. (Angelov, I. The global financial and economic crisis and Bulgaria. – Economic Thought, 2008, N 5, p. 47, 52, 57). The economic conception of the overall package for financial assistance to the failing financial and non-financial

The pending parliamentary elections in 2009, whose outcome seems so vague, are another special feature of the transition. There will be likely a new political configuration which might let a change in the macroeconomic policies. The signs for a growing social tension in the country might be accompanied, too, by the specific drawbacks due to the global financial crisis. Other socially irritating factors might evolve, such as for instance the crisis with the regular gas supplies from Russia in early 2009 and some other similar situations. The EU has unambiguously demonstrated its determination in imposing modern principles of parliamentary and macroeconomic management. All this will exert pressure on the behavior of the parliamentary and macroeconomic elite in Bulgaria, which is a prerequisite for increasing the country's attractiveness for the foreign and domestic investor.

The highest priority facing the new macroeconomic management will be to bring the relationships with the EU back to normal in order to make use of the financial support granted to the country in terms of the various programmers' financial grants. Success in this direction would mean improved quality of the overall functioning of the institutions, and the building of an organizational environment. Failure would be equal to social and economic disaster with destructive consequences. Such an outcome will most likely be avoided. If, however, processes take an undesirable turn, the economic prospects of Bulgaria will become substantially different.

A catastrophic downturn in macroeconomic development is unlikely. There are no grounds to expect major damage to the domestic economic structures, the more so that they have been built quite recently. These sectors, which are "*under fire*", do not have the capacity to drag behind them the predominant part of the economy. Over the last ten year Bulgarian economy has manifested steady economic growth rates (measured by the low variations in the GDP rates of growth), which is an indicator for the consistent progress on the economic front. This is a prerequisite, as well. for the forecasted low probability of a radical and dramatic downturn.

Such smooth adjustments are expected for the developed countries that were most affected, too. In 2008 these countries already experienced the initial shock from the global financial cataclysms. According to an IMF estimate of October 2008 the GDP rate of growth in the USA was 2.0% in 2007, anticipating it to drop to 1.6% in 2008 and slump to 0.1% in 2009. The same rates for the euro area are expected to be 2.6, 1.3 and 0.2%.

IMF's study presumes a fall in economic growth of the Central and East European countries growth rates but of a much lower degree. For South East European countries (Bulgaria, Rumania, Croatia) the GDP growth was for example 6.0% in 2007, expected to be 7.3% in 2008 and forecasted to plunge down to 4.5% in 2009. Bulgaria's GDP growth for 2009 is estimated at 4.2%.[4]

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companies complements the function of a creditor of last resort of the Central bank and is far away from real nationalization. Applying the specific measures can be disputed but this is not the objective of this study.

[4] World Economic Outlook. Financial Stress, Downturns, and Recoveries. IMF, Oct 2008, Table 2.1, Table 2.5.

The taxation policies' features are problematic. The government budget passed for 2009 stipulates the taxation policies and tax burden but still the prospects are not clear. The flat tax of 10% might be replaced by a progressive tax scale for the income of natural persons and by higher rates for corporate taxation. It is impossible to neglect the European practices in this respect. The consequences from alleviating the tax burden of the upper income groups are quite ambiguous. Investments rose but their structure is unacceptable for the public. Another problematic area is the ratio of direct and indirect taxes maintained. Exploiting direct taxes cozily from the bureaucratic point of view has its limits and as experience in Bulgaria has shown the heuristic optimum of direct taxation has been surpassed. What can very likely attract public opinion in the near future is VAT and the latter might be brought down closer to the European standards (downwards). This will have an impact on the item "*Correctives*" in the GDP statistics (as a difference between the gross value added by sectors in and the GDP) and change the structure of the gross value added.

Despite the frequently voiced public impatience there are no prospects for Bulgaria to join the Euro area over the next three years. The general price lag in Bulgaria on that of the Euro area is still quite significant (about 60%), so prices in the near future here will go on rising ahead of those in the Euro area. Both the ECB and the FED have reduced substantially their interest rates (down to record low levels) as an element of the policies to counteract the financial, respectively economic crisis, which will expand the money in circulation. A positive effect on investments can be expected in the short-term but in the longer run this will no doubt exert inflationary pressures. The more so on the general price level in Bulgaria.

As a matter of fact Bulgarian economy is preparing to join the Euro area through this overtaking inflation. Under the present gap between the levels of labor productivity, price convergence is a long and sustained process, but as international experience shows and common sense dictates, it is not normal for prices in Bulgaria to account for about 40% of those in the core of the EC countries. The comparative analysis demonstrates that an acceptable correlation between the price levels at the end of the first decade of the 21st century stands at 50% (maybe even close to 60% taking into account some purely heuristic criteria) and the problem lies in the way and speed of convergence. In any case no revolutionary changes are acceptable. Narrowing the price gap has to take place smoothly, so that the economy can painlessly adjust to the new environment.

If home macroeconomic policies do not fail dramatically, the coming three years will be spent under a substantial participation of foreign savings into the domestic investment process. The basic scenario envisages for the foreign financial flows to keep at sufficiently high levels so that the deficit in the current account of the Balance of payments could be financed without any difficulties. These flows will underlie the price hike, mainly through the expanding money in circulation. Provided the country retained its attractiveness for the foreign capital, the GDR will keep their positive trend, too, and the CBA will successfully pass the test of the current circumstances.

What is envisaged is that the gradual integration of the domestic economy into the European economic structures will suppress the deficit in the current account of the Balance of payments. The fiscal policies are supposed to encourage this process, most of all by cooling off the hot money supply. The BNB's capacity in this respect is highly restricted, so the fiscal policy should withdraw financial resources from the money in circulation and regulate the monetary restrictions.

As our own experience has revealed, this element (maintaining a budget surplus) lies in the focus of analysts' attention. Following automatically the Keynesian principles a great number of specialists recommend carrying out expansionary fiscal policies to counterbalance the danger of recession.[5] At that, some very important special features of Bulgarian economy are left over, which can change theoretical formulations.

The expansionist fiscal policies will increase the money in circulation and drive private investment away. The pressure on the home general price level will rise. Given a fixed exchange rate, the outcome will bring about a reduced competitiveness of domestic exports on international markets, on the one hand, and increased competitiveness of imports on the home market, on the other hand. Input expenditure into the production structures will outweigh (materials, raw materials, labor), i.e. the PPI will overtake the CPI. Imports will become more accessible for the home population which will naturally impair the trade balance, the current account in the Balance of payments respectively. Such policies will face both the foreign investors and foreign tourists with difficulties. The local population will find it much easier to go on foreign travel, i.e. the item "*Services*" ("*Invisible trade*") in the Balance of payments will get worse. This will have an impact on the stability of the national currency with all the ensuing negative consequences.

The USD will have a contradictory position on international markets. Global analysts have for years warned that the equilibrium exchange rate of the USD to the EUR, under the political and economic realities during the first decade of the 21st century in the world, stands at about 0,60-0,65 EUR/USD. After the terrorist attacks of 2001 the USA have maintained record high deficits on their current account and the Government budget. This condition does not correlate with a relatively strong USD. In spite of that, however, the USD holds in its way a worthy place on the international arena.

In the summer of 2008 the exchange rate settled at 1,23-1,25 BGN/USD, followed later by an appreciation of the US dollar by about a quarter. The reasons have to be sought for in public minds and the absence of reliable and generally accepted currency alternatives. Historically, people all over the world (with the exception of

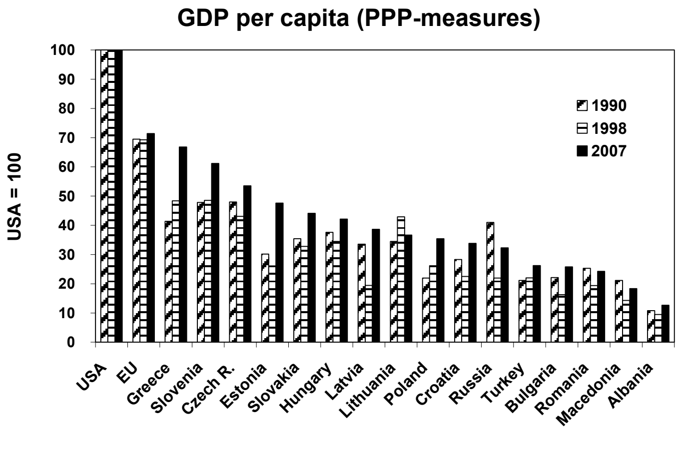
[5] Ivan Angelov, for example, admonishes that one should "... *remember the rule, proved by serious economic teaching a long time ago, that under a recession and depression aggressive stimulation is needed by using the tools of monetary and budget policies*", as well as that "*through additional direct and indirect budget expenditure domestic private and government consumption is encouraged, and so is investment consumption in order to offset losses from reduced exportsc*" (Angelov, I. The Global ..., ibid., p. 46-47).

Europe over the last years) and economic agents are used to look at the USD as a synonym of stability and the ultimate embodiment of wealth. All these people are not ready to admit that the USD might mislead them irrespective of current political and economic reality. The collapse in the financial markets worldwide has pointedly put the question of how to keep one's financial assets and then return to USD-positions without alternative. USD demand soared, and so did its price.

Over the next one-two years the USD is unlikely to be able to retain its too expensive exchange value. Putting up with a weak USD is not likely either. As experiences teaches maintaining a strong EUR will be followed by a new cycle of a mutual USD-EUR game, which was foreseen in the mid-term strategy in terms of a stronger USD in two years' time.

The CBA enables the quicker convergence of key macroeconomic indicators to the European ones. Under a fixed exchange rate overcoming the gap between the estimates of economic activities gets accelerated. The GDP per capita for instance (in USD-estimates, as far as the parity PPP-estimates make use of an analogical measurement) is expected to rise on an annual average more than 14% to reach at the end of the period nominally to USD10 000. The PPP values will be much higher. The World Facf book of the CIA[6] (Internet) assessed the parity value of GDP per capita in Bulgaria for 2007 at USD 11 800 (Figure 7) and it is supposed to go up to about USD 20 000 by 2011. This real level of consumption in Bulgaria will go over 50% from the average consumption per capita in the EU. Even these rates, however, are relatively low compared to what other countries in the region have achieved (our southern neighbor Turkey, for example, has managed to register better economic results, notwithstanding the fact that it is not a EU member).

Figure 7



[6] The estimates quoted from the yearbook The World Factbook are comparable to those of the World Bank (also available on the Internet). The difference lies in the macroeconomic indicator applied – in the first case this is GDP while in the second – the GNI.

One cannot remain unimpressed by the significant overtaking development of Bulgarian economy compared to that of the EU (assessed on a parity basis). The GDP per capita in terms of parity (PPP) estimates in 1998 was less than USD five thousand and over the following nine years it grew by 138% (by 10.1% an annual average, whereas for the same period the same indicator for the EU rose by 55% (by 5% on an annual average). The simple arithmetic says that provided the trend thus outlined were kept over the next two decades, Bulgaria could come as a whole very close to the EU economic levels. Such a convergence would only become possible given the favorable effect of our membership in the EU and abiding by the overall monetary and fiscal discipline imposed.[7]

[7] The results of the elementary arithmetic mentioned are in sharp contrast with the results from the same simple arithmetic used, but with incorrectly chosen indicators, made by I. Angelov (Angelov, I. The catching up economic growth and the competitiveness of Bulgarian economy. Macroeconomic survey. Internet, 2007, Table 1).