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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ

Година XVIII

ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ

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Written revised versions of the presentations from two bilateral meetings, held in 2007 in Budapest and in 2008 in Sofia, and organized by the Institute of Economics at the Bulgarian Academy of Sciences (BAS) and the Institute for World Economics at the Hungarian Academy of Sciences (HAS).

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Miklós Somai[1]

WEALTH TAX: PROS AND CONS

In Hungary the eighteen years period passed since the change of political regime has seen the formation of a socio-economic pattern in which there are practically no middle class in that sense of Western European society. People are better off than in the past across a range of measures but the benefits are not spread equally: there are winners or losers of the transition but nobody between. Strong and increasing polarization of the society has now become an obstacle to economic and social progress.

The paper analyses the possibility to increase the efficacy of the national economy in a totally new way as it admits the very important – even if indirect – role of the social cohesion and solidarity. If one cannot require effective work, responsible and rational decisions from tired, frustrated and more and more indifferent people all those factors which are capable to stop and reverse this process have a strong indirect effect on the economic performance of the country. The reorganisation of the taxation system towards wealth tax and the decentralisation of decision making on public spending could boost Hungary's integration into Europe and its social and economic development.

JEL: H24, H26, E24, E26

> *"A too great disproportion among the citizens weakens any state. Every person, if possible, ought to enjoy the fruits of his labour, in a full possession of all the necessaries, and many of the conveniences of life. No one can doubt, but such an equality is most suitable to human nature, and diminishes much less from the happiness of the rich than it adds to that of the poor."*
>
> *David Hume: of Commerce, 1752*

With this study my aim was to analyse the possibility to increase the efficacy of the national economy in a totally new way as it admits the very important – even if indirect - role of the social cohesion, solidarity and common feeling in the matter. If one cannot require effective work, responsible and rational decisions from tired, sick, moody and more and more indifferent people – so most of the Hungarian society – all those factors which are capable to stop and reverse this process have a strong indirect effect on the economic performance of the country. Based on the examples of modern and successful countries, the reorganisation of the taxation system and the decentralisation of the decisions could boost both the integration of Hungary into Europe and its social and economic development.

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During the research project, first I collected foreign countries experiences from France, the United Kingdom, Finland, Sweden, Denmark, Germany, Spain and of some other countries (Luxembourg, Switzerland). Afterwards, I concentrated to working out recommendations concerning the details of the tax reform and decentralisation in Hungary.

In Hungary the eighteen years period passed since the change of political regime has seen the formation of a socio-economic pattern in which there are practically no middle class and middle sized enterprises both a mainstay for Western countries society. In the Hungarian society there are the wealthy and the poor as well as in the economy there are co-existing big corporations almost entirely controlled by foreign capital and a too large number of micro enterprises comparing to population.

While political stability could be guaranteed by a strong middle class, economic prosperity could be maintained by major contribution of middle size enterprises. The lack of the "centre" creates a political switch repeating each four years and recurrent economic instability necessitating an economic policy with social restrictions. Restrictions increase even more the difference between the wealthy and the poor as well as between economic performances and possibilities of the big and the small enterprises. Nowadays this process has become self-generating and Hungary which was two decades ago quite homogenous a country, is on the way towards Brazilian socio-economic pattern. This goes quite obviously in the contrary direction of that expected when joining the European Union and also conflicts with interest of old member countries.

I am convinced that this trend is not inevitable and that Hungary must not necessarily follow it. There is an alternative. In order to find it out we must clearly analyse factors reinforcing the above pattern and changes to be accomplished for putting the country on a new path.

More than twenty years of research activity and experiences of everyday life make me arrive at the following conclusions:

- Strong and increasing polarization of the society has become an obstacle to economic and social progress. Official macro-economic statistics – at least until recently – seem to contradict this, but they appear to contain serious methodological errors. Recent scientific findings proved that GDP growth as the most important indicator of economic progress is now extremely misleading and outdated. In my quality of researcher in economy I consider as my principal task to work out recommendations with the aim of increasing prosperity of the majority of people. Prosperity for the majority of people does not mean soundly progressing macro-economic data. Prosperity means rather the following things: having a job, finding satisfaction in it, having decent income and home, having time to relax and spend it in an intelligent way and so on. To achieve the above listed objectives it is especially necessary – besides a private economic sector of a sound constitution – that the public services in a large sense of the word (public health, education, public security, public transport, environmental policies, institutional system, etc.) could work at an appropriate level. Nevertheless, in the past eighteen years we have seen but the decline of the public sector.

- The current state of the public sector can be explained by two main causes: lack of financial resources and lack of ideas. While the last thing concerns the responsibility of the government in power, the lack of resources is to be explained more in details. Generations who had grown up and lived in the previous, more homogenous, egalitarian society were rapidly and seriously demoralised by the aggressive expansion of the new regime. Many of them felt that those becoming wealthy were not the talented and hard-working people, and efforts of several decades became valueless. Tax avoidance and corruption concern wide social layers, and its negative influence on public sector resources is at a far more extent due to wealthier people than to poorer.

- Tax avoidance is possible chiefly by reason of that the bulk of income tax is collected on the basis of officially proved and registered personal incomes. It is to be remarked that in Hungary only the public employees pay a tax proportional to their very incomes. In the private sector – dominated by small and mostly by micro-enterprises – the undertakers and the employees are registered almost exclusively at minimal wages. These individuals whilst not registering the bulk of their personal incomes make constant efforts to make their business incomes exempted by producing double bills and by putting down private expenditure as business costs.

- Corruption is in close relation with excessive material polarization of the society. For enterprises it is crucial to win public contracts. In a country plagued by public budget imbalances and, generally speaking, by a financially failing public sector, the salaries of public employees are at such a low level that it incites both parties to corruption: the one who gives and the one who accepts bribes. In Hungary even the foreign enterprises learnt the ropes quickly. The example of corrupted high level directors is followed, of course, at lower levels, too, although stakes are smaller and business relations are intermingled with family links instead of those purely financial operations.

On the basis of the above mentioned facts, I formulated the following hypotheses:

As the general sharing of taxation based on the registered income, on the one hand, is inequitable – for it charges very unequally certain social layers – and, on the other hand, is inefficient for unequal sharing of tax burden raises far less public money than the equal sharing, it is recommendable to put the emphasis of taxation on the wealth which better reflects social richness and is better demonstrable. In this way it could not happen that a poor family pays more taxes than a richer one. As in Hungary the wealth tax is for the time being practically an unknown, non-existing instrument but it is applied in a number of developed countries, in the course of the research I extracted and to analysed existing systems.

At the end of the 1990s, in OECD countries with wealth tax in effect, from the combined wealth tax and legacy duties an amount equal to 3-4 percent of GDP flowed into the public treasury each year. In Hungary legacy duties generate budget revenue of only less than HUF 1-2 billions. If we want revenue equal to 3-4 per cent of the GDP to flow into the Hungarian budget from the wealth tax to be introduced, this would mean an amount of HUF 900-1.200 billions a year. Budget deficit could practically disappear, so one of the conditions of the introduction of the euro could be realized with much smaller than expected socio-economic damages.

With the introduction of the wealth tax, resources for the public services could increase. But increased resources should not be spent in the existing structure. Now the matter is that the decision about the distribution and the spending of the public revenues is taken in 90 per cent by the central government. This mechanism generates a corruption of a very large scale at the highest levels. Giant projects – e.g. the construction of new metro-line in Budapest, or that of several hundred kilometres of new motorways for HUF hundred billions – are easy ground for diverting public money either in private pockets or in political parties' budget. People have a feeling that they are totally outsiders concerning decision making. For an efficient spending of public resources which serves better the needs of the population decisions concerning localities must be taken nearer to the people, at the lower level of the public administration. To be sure, the possibility of local corruption increases, but at lower levels it is more difficult to obscure the bad handling of the public money, or to force the approval of spectacular but useless investment projects. It is very probable that after the satisfaction of basic needs of local administration, there will be left no more money for other purposes.

Decentralisation could bring about a further decrease in the budget deficit, especially if there remained only two administrative levels as in Denmark where the 2007 Local Government Reform practically abolished the middle level. The 271 municipalities merged into 98 small regions, and the counties were replaced by 5 regions, the latter having only one important responsibility: hospitals.[2]

Novelty

When recommending a shift in public burden sharing towards wealth tax, I consider the potential for an increase of the economic effectiveness from a totally new aspect: actually I recognise the very significant although indirect role of social cohesion and solidarity. As one cannot expect tired, sick and more and more indifferent people to do effective work or make rational decisions, all factors able to stop and reverse this tendency may improve, even if indirectly, a nation's competitiveness.

Cons

The wealth tax, as a mean of taxation, came to the limelight at the end of the 1970s. By that time wealth tax had already been established mostly in Germanic and Scandinavian countries, and in that period of new enthusiasm it was extended to some Latin countries as Spain and France, an Anglo-American one (Ireland) and even Japan. The timing proved to be unhappy in that growing mobility of both

[2] See Larsen 2006

capital and persons, a side-effect of globalisation, underperformed governments' expectations about tax revenue.

Since then, many countries (Austria in 1994, Denmark in 1996, Germany in 1997 and Sweden in 2007) decided to abolish their wealth tax or changed it for a similar regime. Italy converted it into a local property tax and the Netherlands turned it into a tax based on net value of the capital assets. The main points of criticism about wealth tax are as follows:

- it may contribute to capital outflow, i.e. it can cause productive capital to leave and discourage foreign investors from entering a country – at least this was the factor for which Ireland and the Netherlands did away with wealth tax;

- it is not neutral enough, i.e. the different elements of the tax base on which the tax is raised are very unevenly affected, a reason for which the Constitutional Court in Karlsruhe stated against the wealth tax: while real estates were considerably undervalued, listed securities and financial assets could not be undervalued;

- it entails high management cost compared with relatively low returns, e.g. in the Netherlands the aggregated cost amounted to more than one fourth of the tax yield;

- it may distort resource allocation when it is levied both on corporate and individual wealth – as was the case in Germany or Austria;

- it is not as equitable as it appears to be, as during the last two decades, in each developed country with a wealth tax, the gap between rich and poor has increased at a speed never seen before.[3]

- it may not be in harmony with tax payers' solvability. It is especially true for real estates located in big cities or other fashionable places where prices are likely to go up very fast.

Pros

Before enumerating the arguments in favour of wealth tax I have to confess that during my investigation in the different tax regimes I was most of all impressed by the French "solidarity tax on wealth" (ISF). This tax is levied on the net worth (assets minus liabilities) above € 790,000 held by natural and in some cases of legal persons on 1st January. Tax rate varies from 0.55% for the lowest band to 1.80% above € 16,48 Mn.[4]

Taxable values are:

[3] See Heckly 2004
[4] See Barème de l'ISF

- properties (30% exemption for main residence);
- cash (and alike savings);
- means of production (e.g. company's drink stock);
- usufructuary right;
- furniture (5% flat rate or detailed account);
- financial placements;
- all sort of vehicles (cars, planes, boats, etc.);
- racehorses;
- jewels (gold, precious metals).

Exempted are:

- professional goods (of the main activity);
- business properties and shares (of the main activity);
- agricultural goods (partially);
- antiquities (>100 years) and veteran cars;
- intellectual property rights;
- capital value of annuity;
- employees' shares

French residents must include all worldwide assets, while non-residents are only liable for wealth tax on assets physically situated in France. However, in order to attract high-earning professionals there is a partial exemption for five years from ISF for most people moving to France after 6th August.[5]

Even if ISF has continually been criticised in recent years, there are arguments for its maintaining:

- it stimulates economic use of the wealth rather than treasure-accumulation;

[5] See Cabinet Gregory 2009

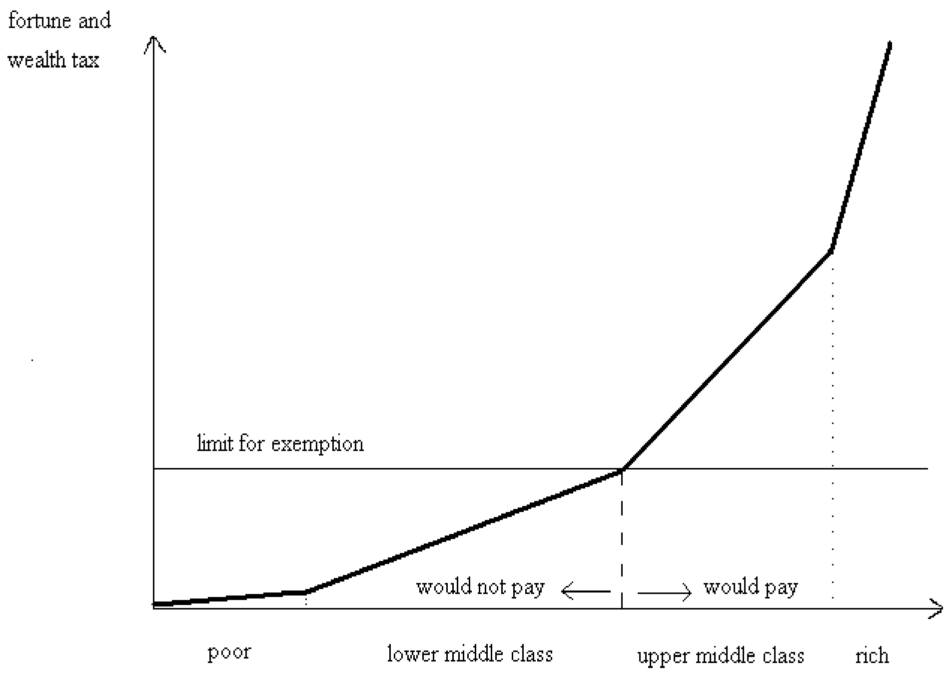
- it dissuades from living from rent – according to 1789s principles;
- it helps to reduce the national budget imbalance.

How to introduce wealth tax in Hungary?

Before introducing a new tax, it is good to clear first on whom to levy it and how much revenue to generate from it. At this point I have to refer to a study from a Hungarian sociologist, Zsuzsa Ferge[6], who ranked our society into four groups: poor (15% of the population), lower middle class (40%), upper middle class (35%) and rich (10%). When advocating the introduction of a wealth tax, I think it would be wise to levy it on the upper classes only, i.e. on the winners of the economic transformation process (see Figure 1).

Figure 1

Wealth tax in Hungary: a possible solution

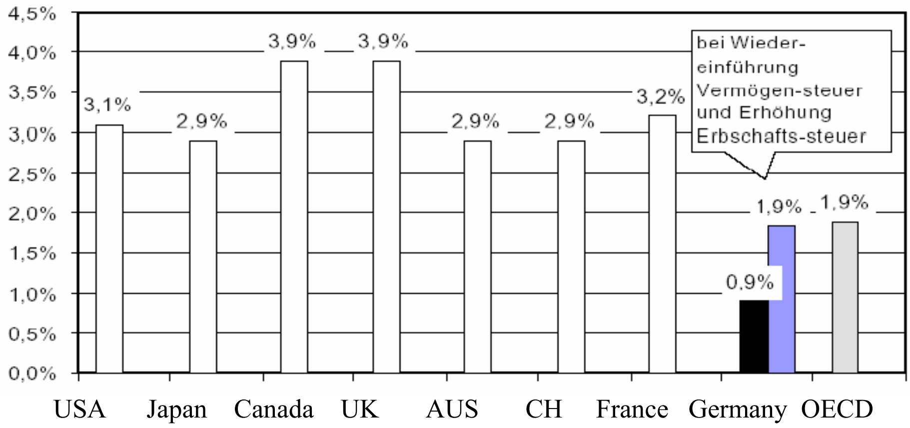


As for the revenue to be raised with it, a minimum of 3-4% of Hungarian GDP (i.e. € 3-4 bn) has to be aimed at, a level similar to that observed in countries where, in 1999, both wealth tax and inheritance tax were in vigour (see Figure 2).

[6] See Ferge 2006

Figure 2

Wealth and inheritance tax as a % of GDP



Source: Vermögen- und Erbschaftsteuer Ergebnisse der Untersuchung des *Deutschen Instituts für Wirtschaftsforschung* Wirtschaftspolitische Informationen ver.di Bundesvorstand Berlin - Bereich Wirtschaftspolitik – Oktober 2002 http://www.verdi.de/hintergrund/wirtschaftspolitik

A further question is what assets to be involved? The French ISF represents a good example: properties, vehicles, cash and alike savings etc. are covered by the tax. One thing is sure: the wealth tax should be levied on registered and controllable assets.

Nevertheless, under the circumstances of current life in Hungary, also the following are to be taken into account:

- as a significant part of personal fortune has been brought into companies, the wealth tax should be conceived in such a way that this fortune cannot escape from it;

- in order to avoid that fortunes be divided up among relatives – as it happened with the luxury tax levied on properties of a value of over HUF 100 mn (~€ 400,000) – on families living at the same postal address the wealth tax should be levied;

- it is important that the time factor be taken into account. By multiplying the sum of the tax to be paid by a simple regressive coefficient like 1/x, where x represents the number of years having passed since the acquisition of the asset, the process of getting rich and the obligation of paying the tax remain relatively close to each other in time, so there is a good chance the tax is actually paid;

- and finally, the tax burden should be alleviated for those whose fortunes are not due to unrepeated events of the transition (like privatisation), or loopholes in law, or simple tax avoidance but originate from taxed revenues. E.g. by offering the possibility of lowering the wealth tax by average personal income tax paid in the last 5-10 years.

Considering the above we can conclude that wealth tax in Hungary would have further "pros":

- an economically more homogenous society has more chance to be competitive world-wide;
- winners of the transition would be made entered the burdensharing of public finances;
- with more tax money collected the public services could be modernised.

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
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Miklós Szanyi[1]

CLUSTERS IN HUNGARY AND IN CENTRAL EUROPE

Regional clusters evolved spontaneously at various places in the world following different development patterns. Their success in enhancing competitiveness moved governments and entrepreneurs to copy the patterns. Later on cluster development became part of the European Union's long-term Lisbon competitiveness program in the form of innovative clusters. This article introduces the basic characteristics and features of regional clusters. Then, it argues that without paying due attention to the proper establishment of the basic features fulfillment of other policy goals, like curbing innovation process, cannot be expected.
JEL: F23, L52, O32

Introduction

Agglomeration of economic activity is a phenomenon which has occurred as long as human history. In ancient times certain business activities (e.g. trading) concentrated in specific locations, mainly in large settlements of population. Centers of active and vibrant economic development and welfare continued to attract various businesses later on. With the advance of capitalist economic and social development some of these centers begun to specialize in certain industrial activities. Technological development remained an important driver of specialization also later on. Improved production technologies increased batch sizes suitable to deliver ever increasing numbers of customers and promoted economies of scale and scope. For example, 100 years ago the Pittsburgh area of the United States accounted for 80 % of world steel production. Hence, regional concentration is not a new phenomenon. What is then new in clusters? What are their beneficial features? If yes, how should be clusters promoted?

This document explores possible answers to these and related questions. Its main concern is the proper distinction of clusters from other types of economic activity concentrations, both theoretically and empirically. The paper is structured therefore as follows: the first part deals with some conceptual questions. How and why are

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economists concerned with the phenomenon, what are the most important theoretical underpinnings of the cluster concept? We briefly introduce here the ideas of Michael Porter who has provided some of the most influential contributions in the field recently. In the second section we discuss the most important features of modern working clusters, and also highlight some special circumstances that may influence cluster development: cluster size and specificities of transition economies. In the third part cluster mapping survey results are introduced. Cluster mapping may identify those geographic locations and economic activities where a critical mass of firms and related institutions, as well as economic potential is concentrated that may create a sound basis for institutionalized forms of clustering.

1. The concept: agglomerations, traditional and dynamic clusters

As early as the work of Marshall (1890), there has been an awareness of the importance of geographical proximity in determining the location of industrial activity. Marshall argued that clusters develop as a consequence of three factors (a) the presence of a skilled local labor market, (b) key inputs from suppliers and (c) rapid know-how transfer between firms leading to technological spillover. Similar arguments have been put forward in Krugman (1991, 1995) and Krugman and Venables (1995). Econometric evidence from Audretsch and Feldman (1996) also suggests that innovative activity – at the core of cluster development – tends to cluster due to technological and knowledge-based spillovers.

Much of the literature has sought to interpret the reasons of three simultaneous observations. The first was that a large portion of total world output was being produced in a limited number of highly concentrated industrial core regions. The second observation was that firms in related industries tended to co-locate and thus form spatial clusters. The third observation was that both these phenomena tended to be persistent over time as these agglomerations became institutionalized. Once in place the agglomerative process tended to be cumulative and therefore path dependent. In more recent scholarly work further empirical observation has come to the forefront: certain agglomerations tend to produce superior innovative outputs.

One of the central outcomes of this literature is that in imperfectly competitive markets economic activity is likely to be spatially distributed in an uneven fashion. Industries will tend to cluster in response to agglomeration economies – where cost savings and efficiencies from production emerge as a consequence of proximity. Examples of agglomeration economies include access to a local skilled labor force, existing physical and technological infrastructure, links between universities and industrial activities. Agglomeration economies are especially important in industries where innovation is a central factor in the success of industrial activity. Firms in related industries will be attracted by the innovative activities of other firms through learning spillovers between them. Networks of communication and interaction between the firms in the cluster play a large role in the sustainability of the cluster.

A distinction can be made among different types of agglomeration economies (i.e. various kinds of rationale of agglomeration process). One type relates to general economies of regional and urban concentration that apply to all firms and industries in a single location (urbanization economies), representing those external economies enjoyed by firms as a result of saving from the large-scale operations of the agglomeration as a whole. These are the forces leading to the emergence of industrial core regions and metropolitan regions. A second type is the more specific economies that relate to firms engaged in similar or inter-linked activities that lead to the emergence of industrial districts (localization economies). Such districts provide the base for flexible production systems that can serve volatile markets. In both cases agglomeration economies are rooted in functioning processes where linkages among firms, institutions and infrastructure of a given location give rise to economies of scale and scope. Examples are the development of general labor markets and pools of specialized skills, dense interactions between local suppliers and customers, shared infrastructure and other localized externalities. Agglomeration economies arise when such links lower the costs and increase the returns of the firms taking part in the local exchange. Presence in agglomerations improves performance by reducing the costs of transactions for both tangibles and intangibles.

Clustering is generally defined after Porter's first description (Porter, 1990) as a process of firms and other actors co-locating within concentrated geographical area, cooperating around a certain functional niche (competing elsewhere), and establishing close linkages and working alliances to improve their collective competitiveness. This concept is related to but goes beyond that of agglomeration of related activities. Whereas simple co-location may be associated with favorable external effects that are not intended but rather incidental, joint strategies and actions motivated by the anticipation of mutual benefits are fundamental to clustering.

The industrial clustering work of Porter (1990, 1998 and 2003) is regarded as seminal. Conversely to the prevailing in the US local development approach focusing on diversified economies, he advocated specialization according to historical strength by emphasizing the power of industrial clusters. Porter emphasized that firms' competitiveness was determined by multiple factors only partly endogenous to them. In his "diamond model" four sets of interrelated forces were brought forward to explain industrial dynamics and competitiveness. These were associated with factor input conditions, sophisticated local demand conditions, related and supported industries and firm structure, strategy and rivalry. A core notion arose around his model stressing that collaborative, mutually supportive group of actors could enhance regional competitiveness in global markets and thus creates growth and other benefits. Also, the significance of face-to-face contacts and personal demonstration, exchange of experience, the role of geographical proximity for knowledge transfers and innovation has been explored and emphasized.

Another string of related economic thought elaborated on knowledge creation and innovation as a social process engaging individuals that exchange tacit and explicit knowledge. Trust-based relationships and social capital may thus be important for enabling horizontal cooperation between individuals within and across firms and institutions. Further support for Porter's findings comes from research on the importance of social networking as central to cluster development (Pouder and St.

John 1996, Saxenian 1994). With reference to CEE, the work on developing country clusters is also important. Of note – the research of Nadvi (1997) and Nadvi and Schmitz (1999) who provide excellent case analyses of labor-intensive export based clusters in India and South America.

Porter (1998) further stressed that local competition creates incentives to emulate best practice and boosts pressures to innovate, while also connects the strengths of competition with the virtues of selective cooperation. The concept of clusters was related to the competitiveness of industries, regions and nations. Hence he formulated the definition of clusters as follows: "Clusters are a geographically proximate group of interconnected companies and associated institutions in a particular field linked by commonalities and complementarities. Clusters encompass an array of linked industries and other entities important to competition…including governmental and other institutions – such as universities, standard setting agencies, think tanks, vocational training providers and trade associations." (Porter, 1998) Porter thus believed that clustering was largely an organic bottom-up process driven by the market.

Traditional advantages of the agglomeration phenomenon are predominantly static. Increased efficiency of the transactions of goods and services provide benefits for firms located in agglomerations. This strong focus on the efficiency and intensity of local arms length transactions has lost importance in current cooperation models. The much theorized business links among agglomerated firms has proven to be weak. In today's global economy a large proportion of firms have few or no trading links with other local firms in the same cluster, even when there is a strong spatial clustering of a particular industrial sector. But such clusters continue to play an important role without any significant local input-output relationships. Sustained competitiveness is increasingly explained by capabilities leading to dynamic improvement than by achieving static efficiency (Porter, 1990). In this context clusters are not solely fixed flows of goods and services or production inputs, but rather dynamic arrangements based on knowledge generation and innovation in a broad sense. Innovation, knowledge generation and transfer have become primary explanatory factors of the new agglomeration types, the dynamic clusters.

Thus, clusters are made up not only of physical flows of inputs and outputs, but also by intensive exchange of business information, know-how, and technological expertise both in traded and non-traded forms. While Porter was mainly concerned with the existence and reproduction of clusters with technologically related firms, latest attempts are targeted at the analysis of learning abilities and creativity of spatial agglomerations. Instead of specialization and spatial clustering of related industries, emphasis is placed on the presence of a regional variety of skills and competencies, where the interaction among different actors leads to new and often unexpected ideas. The concept of the dynamic clusters was elaborated and introduced by Sölvell *et al.* (2003) and Sölvell (2008). This concept is very much in line with current developments of the production factors engaging technology and skills intensively with the increasing knowledge content of traded goods, and services becoming more pervasive.

Growth and prosperity today crucially depend on the ability of individuals and organizations to generate access and utilize knowledge and information. Information and communication technologies play the role of a generic-purpose technology, the production and use of which provides pervasive driving force for productivity growth. International exchange is further boosted by the intertwined influence of liberalization and globalization of goods and factor markets. Large scale investments in human capital and intensified learning process are also important elements of the new growth trajectory. From the viewpoint of our topic organizational changes in the new environment are of paramount interest. In particular, the significance of its connection to human interactions and innovation has to be underlined. Studies have explicitly demonstrated the influence of organizational change on the use of skills, technologies and economic performance, or the emergence of learning organizations. One of the relevant research areas in this vain is the focus on clusters. Here the roles of interactions and mutual adjustment to relationships are linked to proximity and the idiosyncratic features of a place. The interest in clustering (most importantly dynamic clusters) has been boosted by the coinciding disappointments with other policy approaches, the appreciation of innovation in academia as well as business and policy circles, and innovation's perceived links to clustering process and dynamic clusters. Though benefits and usefulness of agglomerations and static clusters is widely acknowledged yet, innovativeness is a key aspect of dynamic clusters that policy mainly concerned with today.

The emphasis on the outstanding role of knowledge generation, innovation and information exchange in dynamic clusters in contrast with traditional clusters means that this is one of their most important functions. Information sharing and innovation also occur in traditional clusters but their most important function is enhancing regular trading contacts and production via various economies of scale and scope. Hence, in the further analysis of empirical facts we treat innovation and the exchange of information among other features as important functions of both static and dynamic clusters. Dynamic clusters are however, differentiated by their closer specialization on technology intensive branches of production, and cooperation aimed at knowledge generation and innovation rather, than on economizing in arms length business contracts. Needless to say, both types of clusters have their place under the sun. However, their roles as well as the means of their promotion are largely different.

2. Characteristic features of clusters

Spatial concentration

Spatial concentration has been central to the cluster idea from the outset. Even though some approaches have tried to disprove or query the importance of physical agglomeration, there are many aspects that remain at the core of the cluster concept. Venables (2001) proved that the "death of distance", i.e. the extensive use of modern ICT technologies and other technological achievements do not necessarily weaken agglomeration effects. The impact is rather mixed: some effects are weakened, but many others became stronger. Hence, the structure of balance of centrifugal and centripetal forces in agglomerations probably changed, and so did the structure and functions of agglomerations. But agglomerations and clusters remained strong features of regional development.

The hard facts underpinning the importance of geographical concentration which we described in the previous section remained largely unchanged since the seminal works of Marshall (1890) though their weight and importance changed over time. Thus, for example, availability of specific natural resources as a reason for co-location has lost importance as the knowledge content of traded goods increased and material intensity diminished. This means, that clusters with specialization on natural resource intensive activities were outweighed by other types of clusters. Some of them remained in place; others changed profile (like the already mentioned Pittsburgh area in the US). Economies of scale and scope achieved by sharing infrastructure and information, as well as by the proximity of suppliers, factor markets and demanding customers continue reducing transaction costs of arms length business. For these reasons firms may experience that their belonging to a set of inter-related actors which can in the given region enhance efficiency, supports productivity growth, raises innovativeness, especially due to better access to knowledge, ideas and skills. From this set of potential advantages access to specialized factor markets deserves special attention. It enables companies concentrating on their core competencies and allows outsourcing auxiliary activities to specialized suppliers. Increased flexibility is achieved through the use of cooperating production networks, which is in most cases based on a dense population of firms with inter-related activities. This type of networking lies at the heart of many successful clusters (Third Italy, Baden-Württemberg) that became a kind of benchmark. Networks operating within clusters may enhance cooperation on various other issues as diverse as training, finance, technological development, product design, marketing, export or distribution.

Specialization

Clusters are usually viewed as organizations or networks of participating actors linked together via a kind of core activity, which provides clear emphasis on the same markets and processes. Traditional clusters showed activity specialization patterns. Various studies have found however, that many clusters have limited business transactions among firms within the cluster. The attention has gradually shifted to the significance of knowledge spillovers and to the dynamic clusters. Hence, specialization in these clusters is primarily not expressed in co-location of business entities of a given sector and their dense business contacts. Dynamic clusters' specialization is not viewed as necessarily limited to a given product or industry category. The dynamic cluster may go beyond relations within a specific sector and its value-chain. In this vain effective clustering needs a strong element of complementary specialization between actors, a common denominator. Actors focusing on core business can couple at these common denominator useful linkages, important synergies in a learning process engaging various organizations. Examples of such inter-sectoral specialization areas are telematics, biotechnology and many other technology areas utilizing interdisciplinary approach in their innovation process.

Cluster actors

Essential to clusters is pluralism. Successful clusters constitute of various kinds of actors, not just firms. In the absence of such pluralism an agglomeration is no more than an enlarged enterprise (a network of companies in which one has the prime role). In such conditions smaller companies may merely serve as subcontractors or clients of the main entity. Recent cluster mappings (e.g. Commission, 2003) report that most clusters comprise mainly of a fairly large number of SMEs. Clusters may also encompass intensive links and alliances with various institutions like universities, research institutes, public authorities, consumer organizations, think tanks, and others. Sölvell et. al. (2003) argue that four main categories of actors are vital and normally present in clusters: companies, governments, the research community and financial institutions. Of importance for cluster initiatives are also the so called Institutions for Collaboration (IFCs), defined as formal or informal actors to promote interest in the cluster initiative among the actors involved.

The various actors are attracted into the cluster by diverse incentives. Their capabilities and roles may vary according to national context and may also evolve over the course of the cluster life cycle. In some countries for example public sector plays the initiative role in the early stage of the cluster life cycle. In others private actors dominate from the outset. In certain countries with strong regional government mandates cluster initiatives are launched by local governments. In other countries relevant decision making is more centralized. In most economies there is a tendency for regional and local authorities to become more active in clustering initiatives, and gain importance relative to national governments in this respect. Nonetheless, national authorities still need to be engaged in cluster policies due to inherent vested interest, and the link to a number of other policy areas which are managed by national authorities.

When the cluster concept was first introduced, the focus was clearly on firms. But as attention has gradually shifted to the challenges of sharing knowledge and skills and to dynamic clusters, a systemic approach emerged which underlines the interplay and interdependence of different actors. The role of universities for example has attracted much attention. Universities are important not only because of their natural missions in education and research, but also because of their potential to serve as nodes for entrepreneurship and science-industry interplay. The extent to which they are able and willing to fulfill these tasks varies country by country. In some transition economies for example, universities have accumulated great strengths in traditional sciences but are not accustomed and open to meet their roles in the context of broader social needs and functions e.g. in the innovation process.

Competition and cooperation in clusters

Connections between cluster actors are characterized by simultaneous competition and cooperation. Competition remains important element of the market also in clusters. It delivers important drivers for improving corporate performance: reduce prices, increase quality, reliability, search for new products and markets, boost innovations. Clusters are not about reducing the importance and extent of competition. Clusters should not serve as an elite club thus trying to ensure privileges for incumbents either, but they should be open to new entrants. Open entry may also provide new impetus a source of new technologies and knowledge for incumbents.

At the same time actors in a cluster may cooperate around a core activity using their competencies to complement each other. When operating in tandem firms may also be able to attract fresh resources and services that would not be available to isolated participants. By pooling resources and risks and by developing complementary functions firms achieve economies of scale and scope. Central to the quality of cluster operation in terms of information exchange and knowledge flows is trust and recognition. In this sense trust is about sharing a vision and belief in mutually fruitful relations. Building trust means people enabling other people to believe in their mutual long-term benefit. This may be demanding at first contact, especially when new actors enter new markets. It is strongly present in exchanges between people with diverging history and practices. Yet, because the establishment of social capital and trust carries features of a public good, there is a tendency for under-investing in committed relationships. Traditional face-to-face exchange hinges on a spectrum of cultural, institutional and practical means to build security and trust.

Critical mass

Inner dynamics can be achieved only if numerous actors participate in the cluster. The critical mass is necessary for the realization of various scale and scope economies. Multiple interactions are conditional for these, and so are variety of possible combinations, sufficient pool for choice, as well as learning by doing. The presence of critical mass may also support industrial restructuring in a cluster, fostering linkages and complementarities between flexible SMEs and larger corporations. Critical mass may serve as a kind of buffer and make cluster resistant to exogenous shocks and pressures, including the loss of important companies, even if they were regarded as key companies. The absence of critical mass can in turn make a region or a cluster vulnerable to the loss of specific resources and skills, which are essential building blocks of cluster development. Due to path dependence also the likely hot spots of economic development are likely to be in places, where there is a critical accumulation of assets and skills today. Of course, there is no precise description what should be the sufficient level of critical mass, not even the exact measures are applicable. Most likely these variables shall be different in each single location, and dependent on sectoral characteristics, and the constitution of the clusters. In case of industries like nuclear science, pharmaceuticals, motor vehicles, achieving critical mass is likely to be more difficult.

Cluster life cycle

A further important element of the cluster is the mode of organization, the way how actors are linked together. Cluster organization usually undergoes changes during the different periods of cluster life cycle. Clusters are not temporary solutions for acute problems, but have a sense of direction and inner stability over time. However, their structure is not rigid or static, and experience shows that they have development stages. The stages may not be identical, neither is the pace of development similar. Still, there is an inherent logic to the way how clusters develop, which makes it possible to find some characteristic patterns.

The first stage (or pre-cluster stage) is the simple co-location of various market actors with potential albeit not institutionalized cooperation activities. Second stage is the emerging cluster, in which a number of actors of the agglomeration start to cooperate around a core activity realizing common opportunities through their linkages. The third stage developing cluster attracts new entrants through the positive experiences of collaborating. They may be engaged in the same or related to the core activities, and present in the geographical vicinity of the developing cluster. Formal or informal IFCs may start their activity as organizers of cluster activity. The outside appearance of the cluster becomes established in the form of a label, website, etc. A mature cluster has reached critical mass in the long term stable sense. It has also developed relations outside the cluster to other clusters, activities and regions. There is an internal dynamic of new firm creation through start-ups, joint ventures, spin-offs. The mature cluster is in the last phase transformed into new cluster organizations. As time goes by, markets, technologies and processes change thus, the core competencies of firms and that of clusters also change. In order for a cluster to survive, be sustainable and avoid stagnation, it has to innovate and adapt to the changes. This can mean transformation into one or several new clusters that focus around new core activities (SRI International 2001).

The impact of size

In the first approach, the impact of size can be approached from a national level. Country size impacts the conditions for clustering because of its influence on critical mass and diversity in domestic markets, and thus on international trade and resource flows. Large economies have multiple strongholds in R&D, attracting financial and human resources and FDI. They can also afford more experimentation; are able to devote more financial means for business promotion and are less dependent on export markets or inward-FDI. But they are less exposed to competitive pressures. Current technological change combined with deregulation and liberalization reduced some of these advantages and experience rising costs from failure to enhance flexibility and adjustment process. France, Germany or Italy have been hosts to many pioneering clusters that were leaders in international competitiveness but which have weakened recently just mirroring the slow-down of their overall economic background.

Small economies on the other hand are more dependent on access to global markets. They may have fewer clusters, less resources, narrower spectrum of specialized workers. They may be more dependent on foreign investment companies' activities and face high costs in maintaining institutions in education or in science that cover a broad range of subjects. Innovators can find less receptive firms and competent financiers for commercializing new ideas. On the other hand, the cluster concept may fit well with small countries, since the above mentioned bottlenecks call for prioritizing and for opening towards external markets in order to gain scale economies. Strong incentives are delivered for specialization. Small countries' innovation systems are more focused on capturing the benefits of technology inflow. Countries like Finland, Ireland or Korea have benefited from being relative latecomers in terms of heavy technology-based institutions, further reducing their inertia to adjustment and facilitating their reorientation towards new priorities.

The second aspect of size relates to firms. Large companies usually enjoy advantages over SMEs in a number of areas, including market power, access to capital. They have access to a deeper pool of human resources and more strategic expertise. They are also more likely to undertake greater investments in R&D and tend to be more international especially in their market reach. In contrast, the vast population of SMEs is greatly heterogeneous and their broader scope for more radical innovations coupled with higher levels of risk-taking, flexibility and entrepreneurship. This advantage of innovative SMEs can be complemented by clustering with other firms that may provide them with the crucial means to compensate for their lack of economies of scale at firm level. Success in this respect requires conditions that allow for a strong presence of complementary factors, such as supportive business services, effective provision of seed and venture capital.

Economies with predominantly large companies tend to obtain stronger impetus from these in cluster initiatives. Focusing on the development of already established core business large firms can be expected to be highly selective and demanding, in shaping external linkages, in order to keep their prices down and transfer development costs to their suppliers. Countries and regions where the majority of firms are directly linked to one company may therefore not be well suited for developing cluster strategies. Chances for success will be improved by private sector business organizations that take the role of establishing trust while maintaining SME integrity.

Special features in transition economies

Though transition economies have experienced fundamental changes since 1989, their economies are still characterized by many important features that differ from more developed traditional market economies. They are still marked by their history of strong public ownership and state dominance over resource allocation. Another important trait is the existence of accumulated investments in basic science, education and training, whereas access to some specific skills used to be withheld. There is also the common heritage of massive past expansion of heavy industries, with underdeveloped consumer goods and electronics production.

The classic weakness experienced by SMEs tends to be particularly pronounced in transition economies. This applies for example to the reliability of transactions, to the underdeveloped supply of professional services in marketing, logistics, technology absorption, etc. Fundamental institutions of a market economy may still be underdeveloped or weak, enforcement of contracts or even property rights may be problematic. The reasons are partly related to regulatory deficiencies, but also to the way bureaucracy is maintained. Many officials still lack the skills and training that would allow for effective reforms and institutional support of market mechanisms. Moreover, the commercial mentalities and cultures of transition economies have not dramatically changed thus allowing state bureaucracies to be replicated in the form of private bureaucratic practices, slowing down innovation and strategic flexibility. Changes in government often bring unexpected alterations in the rules of the game. Traditional value systems and attitudes continue to account for misallocation in education and training. Less diversified financial markets sharpen resource and liquidity constraints.

Transition economies have a marked history of adverse sentiments in regard to entrepreneurship, although it existed and sometimes even flourished under harsh circumstances. Today's entrepreneurs in these countries carry that heritage. To some extent they comprise the survivors of the old regime others constitute younger generations whose practices contrast sharply with the old ways. In both cases entrepreneurs may confront widespread suspicion in broader society. This has strong implications for trust and networking, and the viability of top-down versus bottom-up approaches of cluster development.

3. Empirical evidence: cluster mapping surveys

In this chapter results of cluster mapping efforts are discussed. While the origins of clustering included mostly bottom-up organizations, increased interest in cluster development as policy tool resulted in large numbers of clusters that did not have traditional or organic spatial development roots. Many times it was governments that boosted the organization of cluster initiatives. In many cases general purpose tools and public funds were used without specific regional or sectoral targeting. Hence, cluster initiatives might have started functioning wherever local or regional actors could organize themselves for this purpose.

In the previous chapter we defined some of the specific features of the clusters. First was spatial concentration, second specialization on some core competence. It is rather obvious that in the case of a top-down initiative these characteristics can be controlled in advance. It is therefore quite surprising, that cluster mapping has not become a general practice by governments. Up till 2005 it was only the USA, where nationwide effort was made in the late 1990's. The measurement methodology was developed by Michael Porter's "Competitiveness Center" at Harward Business School (for details see: http://data.isc.hbs.edu/isc/index.jsp). And while many governments started to support cluster initiatives the first comparative surveys of existing cluster organizations and mapped spatial concentrations showed no convincing overlap. The first attempts at calculating spatial concentration measures were carried out in the mid 2000's but even these efforts were not always given the right attention by policy makers. For example, in Hungary, there was such an effort in 2003, but it was conducted when the cluster promotion program has already been opened for applications (Ravn and Petersen, 2005). An *ex-post* survey compared the identified clusters with the list of existing cluster initiatives. Only 10 of the then 22 Hungarian cluster initiatives matched the hot spot map, that identified 24 examples of above average spatial concentration of industries (Gecse, 2004).

The above mentioned weak result of match by actual cluster initiatives and statistically registered spatial concentrations raises the question of how to explain this failure? Was it the inappropriate analytical framework that created distortions in the mapping procedure? Or rather, it was due to a high number of "virtual cluster initiatives"? Or maybe, and most likely, do both explanations contribute an overall explanation?

Without going into detail, a brief overview of methodological problems is due here. The cluster mapping procedure tries to identify spatial locations where the representation of certain industries or economic activities is higher than average, i.e. where they seem to concentrate. The logic is simple, in these places there must be some kind of a competitive advantage that is perceived by economic actors, and they tend to co-locate. There are three types of industries that have different reasons to co-locate. A large number of manufacturing branches and even more service providers (typically personal services) are located right at their markets. The dispersion of such industries is roughly even in all regions. Per capita measures for example are very close to each other in the various geographic regions of a country. Natural resource based industries on the other hand tend to concentrate mainly at the location of the valuable asset. These industries may serve the global market, but they do not have much location choice. The third group of activities is most important for us, these are industries that concentrate at locations, hence, they choose among many potential sites. These industries are regarded as cluster-industries. In the case of the US economy their proportional share in employment was close to one third, but they recorded higher than average wages, productivity and innovation (Ketels and Sölvell, 2005).

Ketels and Sölvell (2005) run a comprehensive statistical survey of cluster mapping in the 10 new member states of the EU. Their methodology was based on the methods of a survey that was conducted at the Institute for Strategy and Competitiveness at Harvard Business School led by Michael Porter. The European survey used the amended American industrial classification method when identifying those business activities which belonged to cluster-industries. Spatial concentration was calculated for the European NUTS-2 level regions. Only employment data was readily available at this level of both sectoral and geographic dis-aggregation (38 businesses), and for two more recent comparative years (2000 and 2004). Thus, concentration was measured with this single data set. However, the authors calculated three different measures, in order to limit some of the distortions stemming from the special features of employment data. They wished to obtain a balanced picture of regions reaching sufficient specialized critical mass to develop the type of spillovers and linkages that create positive economic effects and can serve as a base for cluster initiatives.

The first measure expressed the size, if employment reached a sufficient absolute level that may trigger strong economic effects of clusters. This level was set for each NUTS-2 region and every of the 38 branch at 15000 employees at a location. The second measure expressed specialization, if a region was more specialized in a specific cluster category than the overall economy across all the regions, this was thought to provide enough strength for the regional cluster to attract related economic activity from other regions. This notion was operationalized by regarding fit those concentrations that reached a specialization quotient of more than 1,75, i.e. which had at least 75% more employment within the given cluster, than the average of all regions would suggest given their size. The third measure expressed dominance, if branches employ a high share of the given region's overall employment. The measure was set at the level of 7% of overall regional employment. The level of all three measures were set to separate the highest 10 percentile of all regional clusters.

As expressed also by the authors, the measurement method had several shortcomings. First being the usage of solely employment figures, this created bias towards labour-intensive sectors. Another problem is the level of disaggregation in both dimensions. The 38 activity groups or businesses contain many that are rather heterogeneous. A deeper level of disaggregation was not possible, since the original grouping pattern (which was based on more detailed surveys of the US economy) could be transformed from the American SIC classification structure to European NACE only at this level.

As concerns NUTS-2 regions, they are also too big in at least some countries and for some activities. In Hungary, for example, NUTS-2 regions were artificially created as requested by the EU, but they consist of usually 3 former counties which used to be the integrating geographic and administrative unit historically. The new NUTS-2 regions are so young that their economies could hardly amalgamate. On the other hand, there is no convincing evidence on clusters spreading according to administrative borders either. Thus, maybe some clusters escaped mapping because they spread over two or even more NUTS-2 regions.

Ketels and Sölvell's survey found nevertheless interesting results. We summarize them in the following. 367 regional clusters met at least one of the three hurdle rates for absolute size, specialization and dominance. They represented 5,86 mn employees, about 58% of total employment in the cluster sector of the 10 new member states. The capital regions of the largest countries lead the ranking of regions by cluster portfolio strength: Budapest first, Warsaw second, Prague fourth place. The largest seven cluster categories were food processing, heavy construction services, transportation and logistics, financial services, hospitality and tourism, metal forming, and building fixtures, equipment and services, and accounted for 50 % of all cluster sector employment across the EU 10. As is seen, it is mainly labour intensive branches with relatively lower level of productivity: a clear indication for sample bias (automotive or ICT employed much less people, albeit they used to be considered as leading sectors for many clusters).

The research confirmed existing hypotheses concerning the development gap between developed country and transition member states in the EU. The EU 10 economies had a specialization profile distinct from more advanced economies. Specialization was found to have far stronger natural resource driven sector (20% share in employment) than developed countries. Within the cluster sector (32% share in employment) there was a stronger bias towards labour intensive and manufacturing driven cluster categories, while these countries were relatively weak in advanced services and knowledge intensive cluster categories. Exceptions were the strongest clustering centres around capital cities. Also, in case of the Hungarian clusters, the above mentioned bias was less pronounced and specialization towards high value added services and industries was stronger (see the attached list below).

Strong regional clusters and their specialization 2004
(Clusters qualifying for the top 10% in all three measures)

Regions	Field of specialization
Czech Republic	
Liberec	Automotive
Liberec	Textiles
Ostrava	Metal manufacturing
Praha city	Education and knowledge generation
Praha city	Entertainment
Praha city	Financial services
Praha region	Automotive
Hungary	
Győr	Automotive
Szeged	Food processing
Székesfehérvár	Information technology
Lithuania	Apparel
Latvia	Entertainment
Poland	
Gdansk	Transportation and logistics
Katowice	Automotive
Lodz	Apparel
Warszawa	Financial services
Wroclaw	Automotive
Slovakia	
Bratislava	Financial services
Kosice	Apparel
Kosice	Metal manufacturing

Source: Ketels and Sölvell, 2005 pp. 62-65.

There may be several factors affecting the results of the above table, which seems to be rather rigorous. For example no Slovenian cluster qualified itself in all three dimensions. Ketels and Sölvell (2005) found convincing evidence on the correlation of spatial concentration and economic performance using the data of developed countries. However, spatial concentration had different historic reasons in practically all the EU-10 countries, and these traditions seem to have much weaker causal link to economic growth and performance today. For example, in the case of the strong position of the Kosice region in the Slovak Republic we must not forget that this is one of the poorest regions of the EU-25. The Kosice steel mill and very few other industrial facilities are the single most important employer of the region where unemployment rates are extraordinarily high. Thus, we may observe cases when spatial concentration of business is the result of an overall meltdown of business activity in some regions, and not the beneficial outcome of deliberate co-location decision of independent cluster actors.

It is perhaps more useful to look at regional centres' overall clustering performance. The next table contains the list of regional centres that attracted the largest cluster portfolio, i.e. businesses that qualified in one or more aspects of cluster measures.

Regional clusters with strongest portfolio in EU-10, 2004

Region	Total number of qualifications	Average qualification per regional cluster	Share of qualified clusters in total regional cluster employment (%)
Budapest	23	1,53	77
Warsawa	22	1,38	77
Katowice	21	1,40	81
Praha city	19	1,90	78
Lithuania	19	1,58	70
Krakow	18	1,29	68
Liberec	17	1,55	62
Lodz	16	1,60	71
Wroclaw	16	1,45	60
Poznan	15	1,15	72
Nitra	14	1,40	60
Bydgoszcz	14	1,27	58
Slovenia	14	1,27	56
Olomouc	14	1,40	45
Latvia	13	1,44	62
Gdansk	13	1,44	59
Praha region	13	1,63	43
Bratislava	12	1,50	65
Brno	12	1,20	56
Miskolc	12	1,09	51
Kosice	12	1,71	45

Source: Ketels and Sölvell, 2005 p. 26.

There are large differences within the EU-10 across regions and cluster categories regarding their level of specialization and spatial concentration. These countries show much lower specialization on specific regional clusters within regions and much lower spatial concentration on specific regions within cluster categories than the original benchmark US economy. If as is suggested by the authors, higher levels of specialization and concentration enable higher productivity and innovation, this is a serious concern. The same concern arises with regard the EU-15 countries in comparison with the US, which is fully consistent with the performance gap relative to the United States.

In Hungary Gecse (2004) calculated the first locational quotients. He was commissioned to compare spatial endowments (especially the density of business) with the regional distribution of cluster initiatives that received state support in the period 2000-2002. This was the first attempt in Hungary to measure regional concentration of activity using official statistical figures. The main finding of the paper was that in many cases rent seeking could be detected: cluster initiatives formally met weakly defined support qualification requirements without having sufficient background to meet the long term goals of the projects. In some cases applicants obviously had no intention to do so at all.

The following table shows all Hungarian clusters that obtained more than one stars:

Cluster mapping results of Hungary (2004)

Region	Branch	Evaluation
Nyugat-Dunántúl	automotive	***
Dél-Alföld	food	***
Közép-Dunántúl	information technology	***
Közép-Magyarország	business services	**
Közép-Magyarország	entertainment	**
Közép-Magyarország	financial services	**
Közép-Magyarország	building fixtures	**
Közép-Magyarország	information technology	**
Közép-Magyarország	paper and publishing	**
Közép-Magyarország	transportation	**
Észak-Alföld	food	**
Észak-Alföld	construction	**
Nyugat-Dunántúl	food	**
Nyugat-Dunántúl	information technology	**
Észak-Magyarország	metal	**
Közép-Dunántúl	food	**
Közép-Dunántúl	building fixtures	**
Közép-Dunántúl	metal	**

Source: Ketels és Sölvell (2005)

As far as methodological aspects are concerned, Gecse's exercise suffers all the usual shortcomings of the method. He only used employment data, observed mainly NACE 2 digit level regions comparing them to the national average concentration levels as a benchmark. Also Gecse used threshold levels, but they were much lower than e.g. in case of Ketels and Sölvell (2005). His threshold level was only 2000 employees, but he went in many cases even below this choosing in one case a branch with just 1149 employees as likely for clustering. A third shortcoming of his calculations was that unlike Ketels and Sölvell (2005) he could not use Porter's original classification method of "traded clusters", but used just the standard NACE 2 digit level categories instead. The very strong aggregation at this level, as well as the completely different content (mixing tradable and non-tradable activities) deteriorated the quality of his results substantially. There was a further problem with the statistical recording of economic activity: most statistical data of the Hungarian Statistical Office records economic activity using the location of the headquarters of firms instead of the place where activity is carried out actually. Hence, in the very much centralized Hungarian economy much of the country-side economic activity is registered for the capital city Budapest. This further increases the dominant economic position of Budapest even further.

Evaluation of Hungarian clusters (2007)*

All regional clusters in Hungary 1,2 and 3 star regional clusters								
Region	Cluster category	Employees	Size	Spec.	Focus	Stars	Innovation	Exports
Kozep-Magyarorszag	**Transportation**	50163	0,81%	1,23	4,00%	**	High	Weak
Kozep-Magyarorszag	Education	44476	1,00%	1,89	3,00%	**	High	N/A
Del-Alfold	**Food**	34101	0,68%	2,89	7,00%	**	Low	Weak
Kozep-Magyarorszag	**IT**	30735	1,00%	2,26	2,00%	**	High	Strong
Kozep-Dunantul	Automotive	17091	0,66%	2,85	4,00%	**	Low	Strong
Nyugat-Dunantul	**Automotive**	16741	0,64%	2,98	4,00%	**	Low	Strong
Kozep-Magyarorszag	Biopharma	14197	1,00%	2,61	1,00%	**	High	Weak
Kozep-Dunantul	**IT**	12535	0,61%	2,64	2,00%	**	Low	Strong
Kozep-Dunantul	**Building Fixtures**	11702	0,50%	2,17	2,00%	**	Low	Strong
Nyugat-Dunantul	**IT**	10995	0,54%	2,47	2,00%	**	Low	Strong
Nyugat-Dunantul	Lighting	6888	1,00%	6,17	1,00%	**	Low	Very strong
Kozep-Magyarorszag	Lighting	6832	1,00%	2	0,56%	**	High	Very strong
Del-Dunantul	Leather	3086	1,00%	10,32	0,95%	**	Low	Weak
Kozep-Magyarorszag	**Finance**	43439	0,61%	0,92	3,00%	*	High	Weak
Kozep-Magyarorszag	**Entertainment**	28559	1,00%	1,96	2,00%	*	High	Very strong
Eszak-Alfold	**Food**	22460	0,45%	1,73	4,00%	*	Low	Weak
Eszak-Alfold	**Construction**	18230	0,28%	1,07	3,00%	*	Low	N/A
Kozep-Dunantul	**Metal**	17403	0,44%	1,92	4,00%	*	Low	Weak
Kozep-Magyarorszag	**Publishing**	16886	1,00%	1,55	1,00%	*	High	Weak
Eszak-Magyarorszag	Food	16116	0,32%	1,51	4,00%	*	Low	Weak
Kozep-Dunantul	Construction	16020	0,24%	1,06	3,00%	*	Low	N/A
Eszak-Magyarorszag	Construction	15650	0,24%	1,11	3,00%	*	Low	N/A
Kozep-Dunantul	**Food**	15246	0,31%	1,32	3,00%	*	Low	Weak
Nyugat-Dunantul	Food	14718	0,29%	1,36	3,00%	*	Low	Weak
Del-Dunantul	Food	14374	0,29%	1,63	4,00%	*	Low	Weak
Del-Alfold	Construction	13783	0,21%	0,89	3,00%	*	Low	N/A
Eszak-Magyarorszag	**Metal**	13190	0,34%	1,57	3,00%	*	Low	Weak
Nyugat-Dunantul	Construction	12918	0,20%	0,91	3,00%	*	Low	N/A
Kozep-Dunantul	Transportation	12078	0,20%	0,85	2,00%	*	Low	Weak
Nyugat-Dunantul	Hospitality	11702	0,32%	1,47	2,00%	*	Low	Strong
Del-Dunantul	Construction	11151	0,17%	0,96	3,00%	*	Low	N/A
Del-Dunantul	Finance	9012	0,13%	0,72	2,00%	*	Low	Weak
Eszak-Magyarorszag	Chemical	6130	0,64%	2,97	1,00%	*	Low	Weak
Eszak-Magyarorszag	Communications	5910	0,74%	3,47	1,00%	*	Low	Very strong
Kozep-Dunantul	Communications	5890	0,74%	3,21	1,00%	*	Low	Very strong
Nyugat-Dunantul	Heavy Machinery	5341	0,64%	2,97	1,00%	*	Low	Weak
Eszak-Alfold	Heavy Machinery	4362	0,52%	2,02	0,92%	*	Low	Weak
Del-Dunantul	Communications	4333	0,54%	3,09	1,00%	*	Low	Very strong
Del-Alfold	Constr, Materials	3863	0,64%	2,72	0,89%	*	Low	Weak
Nyugat-Dunantul	Communications	3475	0,44%	2,01	0,87%	*	Low	Very strong
Kozep-Magyarorszag	Jewelry	3445	1,00%	1,75	0,28%	*	High	Weak
Eszak-Magyarorszag	Lighting	3357	0,65%	3,04	0,85%	*	Low	Very strong
Eszak-Alfold	Lighting	3084	0,60%	2,3	0,65%	*	Low	Very strong
Eszak-Alfold	Footwear	3066	0,70%	2,71	0,64%	*	Low	Weak
Del-Alfold	Oil and Gas	2372	0,67%	2,84	0,55%	*	Low	Weak
Del-Dunantul	Fishing	1369	0,38%	2,16	0,42%	*	Low	Weak
Eszak-Alfold	Leather	1167	0,69%	2,65	0,24%	*	Low	Weak
Nyugat-Dunantul	Leather	1041	0,61%	2,83	0,26%	*	Low	Weak

* A brief description of the calculation method is provided in the text. In case of the size one star was given to clusters that belonged in this regard to the top 10% of all clusters in the EU concerning this feature. The % figure in this table shows the actual share of the given Hungarian cluster in Europe's total (total employment in the given sector in all European clusters). In the case of specialization values over 2 earned one star. For the notion of focus those clusters got one star, which belonged to those 10% of clusters that contributed the most to total local cluster employment. The % figure in the table shows the actual share of the cluster in employment of the region. Those clusters that also appeared in Ketels and Sölvell's 2004 table are bold.
Source: http://www.clusterobservatory.eu

The European Union picked up Porter's idea and its extension by Sölvell and addressed dynamic clusters (in EC terms "innovative clusters") one cornerstone of the more concrete and operative implementation plan of the Lisbon targets by the mid 2000's. The emphasis on cluster development via European means gave new impetus for cluster research as well. Based on previous works at the Stockholm School of Economics new research institutions were created. The European Cluster Observatory started to work in 2005. One main research output of this institution is its cluster mapping database (http://www.clusterobservatory.eu). The database contains employment data broken down according to Porter's original categorization of "traded clusters" for the European NUTS 2 level regions. The same types of measures are calculated than what was used in Ketels and Sölvell (2005). Thus, the problem of using only one indicator (employment), as well as the too broad and rather rigid separation of regions still remained also in this database. Nevertheless, the availability of methodologically comparable data for the whole territory of the EU is an important new feature in cluster research. Also, the database contains some basic evaluation of the registered clusters' exports and innovative activities that helps readers identifying the "true innovative clusters".

As far as the actual results are concerned, data of the observed Hungarian clusters are summarized in the next table. As is seen, none of the spatial concentrations in Hungary qualified in all three measurement aspects in 2007 (in 2004 there were three). The number of two-stars clusters also declined. Some of the 2004 two stars clusters lost one star, but in two cases (building fixtures and business services in Central Hungary) the 2004 clusters were not mentioned in the 2007 table. On the other hand, 6 "new" two star clusters appear in 2007 table. They are certainly not new in the sense that these spatial concentrations have been rather known, since they used to have rather solid and traditional background, and qualified from one to two stars level.

Looking at the 2007 list of Hungarian clusters, we can observe the still strong positions of traditional sectors. This is despite of the less favorable development tendencies during the 1990's and 2000's. Strong path dependency is observed here. Despite of massive foreign investments in some global industries, like automotive, electronics and communication technology, important features of the Hungarian economy prevailed: food industry, construction, light industry still retained important positions despite of heavy contractions during the past 15 years.

Another important message of the table is that innovation was found strongest mainly in sectors that did not export much and did not belong to traditional high technology activities. The loose relationship of high-technology, innovation and exports calls for caution when designing cluster promotion tools aiming at "export-oriented innovative clusters", which is at the heart of the current Hungarian but to some extent, also the European innovation policy (see for example EC 2008a, 2008b, European Cluster Observatory, 2007). Porter stressed the importance of innovation in cluster activity, but never mentioned that clusters were "reserved" for high-technology activities, or for export-oriented industries. Heart of his concept is joint action for increasing regional competitiveness in general. One tool of this strive is supporting innovative cooperation in a wide range of industries and activities.

Equally important in the cluster concept is its basing on traditional regional sources and areas of competitiveness. These should be promoted by cluster cooperation. Clusters should not be regarded as means of “capitalist industrialization”.

As a conclusion we can suggest further research in mapping spatial concentrations of business activity in the “traded cluster” sectors. It seems to be necessary to use alternative indicators like sales turnover, investments or paid salaries (instead of the number of employees). Also, strict administrative boundaries of NUTS 2 regions should be treated more flexibly to allow the observation of “cross-border” clusters, or less spread spatial concentrations that “disappear” from calculations when comparing them with aggregated figures of larger areas. Such refinements in methodology will enhance a more reliable comparison of functioning cluster organizations and their background. Which in turn would also contribute to a better formulation of cluster policies.

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ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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RELOCATION OF INDUSTRIAL ACTIVITY – CONCENTRATION, SPECIALISATION AND CHANGES OF MANUFACTURE STRUCTURE IN EU COUNTRIES•

This paper analyses the labour intensive industries relocation in EU-27 by exploring the industry concentration, specialization and countries competitiveness. The analysis is based on NACE classification data, Division from 15-37 for EU countries. It has been studied the structural adjustment of the industrial composition and the spatial distribution of the labour intensive industries over time by using various economic indicators and cluster analysis.

It has been found that the relocation process leads to specific spatial location of Labour intensive sector in the EU framework. It is argued that the formed countries clusters concerning employment and trade composition of the manufacture industries is not expected to undergo significant changes in the near future as the observed one in the last decades. The potential benefits for the different participants in the delocalisation process are discussed. Possible future scenarios and prospects are foreseen.

JEL: F14, P52, R12

Introduction

The purpose of this paper is to analyse the processes of concentration, specialisation and manufacture composition changes by sectors in EU countries. These changes can throw more light on the relocation process of certain industrial activities since both sectors' and countries' specificities have an important and interrelated influence on the typical characteristics of these processes, (Kalogeris and Labrianidis, 2007). The first main question that the study puts forward is what the patterns of change of the industrial structure across EU countries are; which are the economic drivers of these changes. The second is to what extent these changes can be attributed to the relocation of the Labour intensive industries (LII).

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There is one issue that arose during the research: what will the concept of "Labour intensive industries" be. There is no common understanding of which manufacturing branches can be specified as "labour intensive". This particular study deals mainly with the specific analytical dimensions relating relocation of the industrial activities to the patterns of changing of the manufacture structure by countries; changes that are mainly linked with the distribution of industries traditionally recognised as labour intensive – like textile, clothing, leather and footwear industries. This understanding can be accept as well-founded since the analysis outlines that countries clustered by industrial branches depending on the participation of traditionally recognised LII.

In order to obtain a more distinctive picture of industrial composition changes a specific classification of the manufacture branches by sectors is used. This classification groups the manufacturing branches according to the OECD (1987) classification and uses the categories for the scale return branches proposed by Pratten (1988).[3]

Dynamic, Concentration and Specialisation of LII

The Dynamic of LII

The dynamic of EU-15 employment in the manufacturing sector is showing a steady decline that began in the late 70-ties when a long-lasting tendency of decreasing the share of the secondary (manufacture) sector from the total gross value added (GVA) started, Figure 1. The smoothening of the decline of the GVA in given periods can be attributed to the positive effect of relocation activities with low labour productivity – the decline in those employed in the Labour intensive sector (LI sector) is sharper than for manufacturing as a whole, (see the changes of the shares of the GVA and employed in the Labour intensive sector, Figure 1).

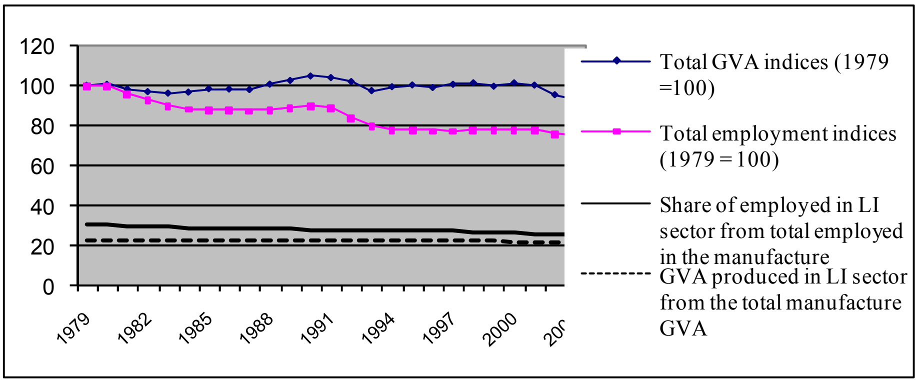
For the period after 1991, the first step of massive relocation of labour intensive activities from the EU-15 started with shifting part of the production processes to Central European Countries. Looking at the most recent data of employment composition in the EU-27, it appears that the Baltic countries as well as Bulgaria and Romania are showing a tendency to increase the share of GVA and employment in the Labour intensive sector in the last several years.[4] However, the decline of those employed in the Labour intensive sector in the Visegrád countries (Central European new member states) for the last several years is even higher than the decline in the EU-15.

[3] See the five groups (sectors) – "Labour intensive"; "Resource intensive"; branches with "Different factor intensity" (different economic of scale); branches related with "Increasing economic of scale" and "Science intensive branches", Table 1.

[4] Eurostat data for manufacture branches NACE classification, Division 15-37 (not included NACE Division /23: Manufacture of coke; refined petroleum). As new member states (NMS) all countries that joined the EU after 2004 are considered (Malta is not included). In the EU-15 Luxemburg is not included.

Figure 1

EU-15 manufacturing dynamic and share of Labour intensive sector *



Sources: Groningen Growth and Development Centre, 60-Industry Database.
* For Labour intensive sector, see Table 1.

The Concentration and Specialization of LII

The employment data analysis revealed a number of important observations with respect to the process of location and specialization as well as to the type of structural adjustment under way, Table 1 and Table 2. The Herfindal indexes measuring absolute concentration and specialization are higher for the LII and less developed countries, mainly the new member states (NMS); the indexes increase in the period 1995-2004.[5]

The most significant increase is in the index of relative concentration of the Labour intensive sector, whose level was also the highest for 2004 (0.26). Next is the Science intensive sector (0.23), Table 1. Concerning the countries' specialization, it can be definitely outlined that the specialization in Labour intensive sector is negatively related with the countries' level of economic development; countries with different shares of this sector have different levels of economic development and specific spatial location within Europe, see Figure 2.

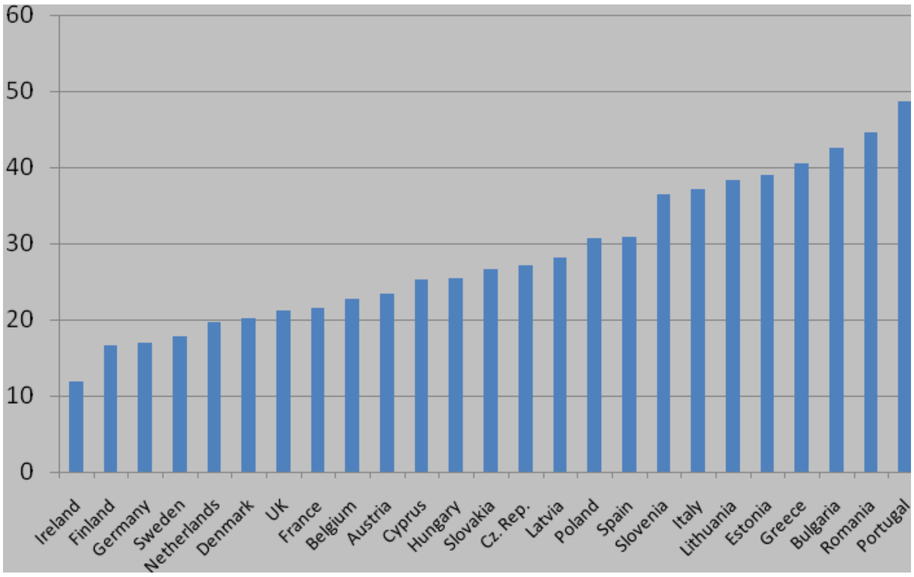
The coefficient of correlation between the specialization in LII and the GDP per capita in PPS is negative and significant. This result proves the validity of the relation between LII specialization and the level of economic development. The analysis also outlined that this relation is stronger for the EU-15 countries. So one can maintain that there is a clearly expressed process of specialisation in the less developed countries due to an increase in the share of the Labour intensive sector, a process that leads to a divergence in the industrial structures of EU countries.

[5] The Herfindal index measures absolute concentration and specialization, while the Krugman index is estimating the relative concentration and specialisation, (Totev, 2008).

The analysis outlined also that the industries concentration geographically clustered, (Krugman, 1991). This is valid specifically for the LII, whose distribution within the EU-15 and later within the EU-27 countries is an example of the concentration in given countries that have a similar geographical location– mainly South and South-Eastern countries, Figure 2.

Figure 2

Share of Labour intensive sector [%]



Sources: Eurostat

Patterns of industrial structural changes

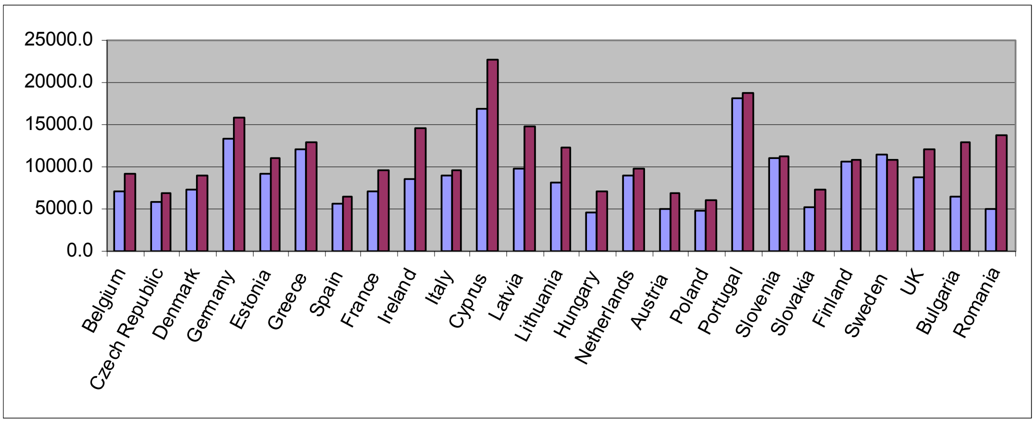
Analysis of the SSD (sum of square differences) indexes

A more detailed picture concerning the industrial changes of the EU countries can be observed by estimating the SSD indexes, Table 3. A number of specific features distinguish the changes in the industrial structure. The first observation is that the NMS have quite a similar structure in 1995, which is close to one of the well-industrialized EU-15 countries, (see Table 3, column 'three countries with closer structure 1995'). Secondly, a well-expressed process of diverging of the industrial structures within countries is observed, Figure 3. This is valid mainly for the less developed NMS.

When using the classification presented in Table 1 it is noticeable that in the last ten years part of the NMS approximate the structure of less developed EU-15 countries, while the other part of the NMS remain close to the structure of the more advanced EU-15 countries, Table 3 (see the columns with the 'three countries with closest structures 2004')**.** The three Central European countries, the Czech Republic, Hungary and Slovakia, have the closest manufacturing composition to the EU average for 2004. Since the higher changes of the structure are indicative of intensive structural adaptation, it appears that the newcomers Bulgaria and Romania are undergoing such a process, Table 3. This adaptation is realised mainly due to relocation of LII from EU 15 countries to Bulgaria and Romania throw outsourcing (providing subcontracting). The fact that less developed countries like Bulgaria and Romania can realise competitive advantages in LII, lead to an approximation of the structures of Bulgaria and Romania to those of Greece and Portugal, Table 3 (see the columns with the 'three countries with closest structures 2004').

Figure 3

Sum of SSD [6] of given country with all other countries (1995 - blue columns, 2004 - red columns)*



Sources: Own calculation based of SSD results

* When estimating the sum of SSD by countries is used the five group classification, see Table 1.

Cluster analysis

In order to specify the countries distribution by groups with similar industrial structures cluster analysis was applied, (Huberthy, 1994). The following parameters have been used for that purpose: [7]

- Relative concentration measured by using the Herfindal indexes, Table 1 (five sectors);

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[6] $SSD_t = \sum_{i}^{n} (a_{it} - b_{it})^2$, where [a, b] is a pair of countries, i = 1, … 21 is the number of industries; t are time periods, Table 2.

[7] The Discriminant analysis (Huberthy 1994) shows that higher predictor ability what concerns the industrial composition have the chosen parameters.

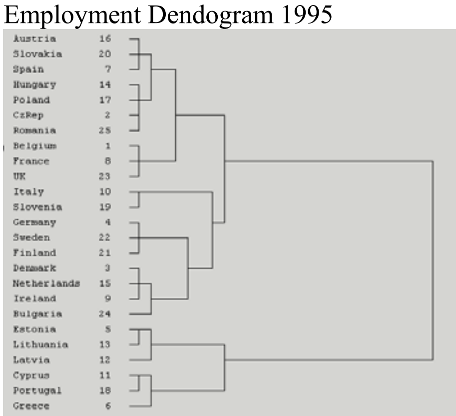
- Share of the Labour intensive sector in the total manufacture employment (see table 2);

- SSD indexes between given country and the EU-27 average (see table 3);

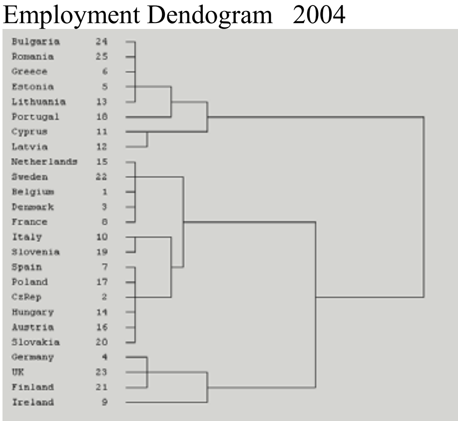
- The ranks of the SSD indexes (see table 3).

Figure 4

Employment Dendogram 1995



Employment Dendogram 2004



Sources: Eurostat and own calculations

The conducted cluster analysis for 1995 divides European countries in two main clusters – see Employment Dendogram 1995, Figure 4. The first includes Greece, Portugal, Latvia, Lithuania and Estonia – countries that mainly undertake subcontracting up until 1995. One can see the results of the structural adaptation in these countries influenced to a certain extent and from the relocation process – they have a much higher industrial specialisation and larger shares of those employed in the Labour intensive sector, Table 2. The Herfindal indexes calculated over the separate LII for this cluster have an average value of 0,6 while for the other cluster it is 0,3. The SSD indexes show that the structure of employment for the countries in this cluster is quite different from the typical composition in EU-15 as well as in EU-27.

The larger cluster (rest of the countries) is far from homogenous. There are countries giving subcontracting as well as countries not actively involved in the relocation process. The differences in this cluster rise significantly with the industrial structural adjustment over time, influenced by the changes of the involvement of the countries in the relocation process in the last decade. This forms a new picture of division in 2004.

The analysis for 2004 specifies three clusters.[8] The group of Greece, Portugal, Latvia, Lithuania and Estonia is joined by Bulgaria and Romania. Bulgaria and Romania have undergone quite serious changes in their industrial structures as can be seen from the SSD indexes for 1995 and 2004, Table 3; changes that in this particular case are the result of relocation processes.

One can see a new cluster formed of the four countries with the lowest shares of LII in 2004 – Germany, Finland, UK, and Ireland. These countries have undergone a moderate structural change mainly by increasing their positive specialisation in the branches with increasing economies of scale and the Science intensive sector (see table 1).

The third cluster positioned between the above two does not have a homogenous structure. On the one hand, there are countries, which do not form a clearly distinctive sub-cluster – Belgium, Denmark, France, Netherlands and Sweden. The share of employment in the Labour intensive sector in these countries did not change much during 1995-2004 (this means no intensive participation in the relocation processes).

On the other side of this cluster, one can find both the EU-15 and NMS. The EU-15 countries from this group are Italy, Spain and Austria. Italy and Spain have high shares of Labour intensive sector and it can be expected that their role as countries providing subcontracting will remain unchanged in the future. Austria also plays a certain role in the relocation processes, which can be attributed to the proximity of the country to the South Eastern European countries. The NMS (Czech Republic, Hungary, Poland, Slovenia and Slovakia) within this group of the cluster had less or more exhausted their relocation potential as countries undertaking subcontracting in the Labour intensive sector. One can maintain that there is a different tendency for the NMS. Some of them approximate the EU-15 average structure, while the others approach the structure of the less developed EU 15 countries, (Table 3).

Intra regional location – enterprise survey results[9]

It is typical to observe higher levels of industrial location in lagging regions for countries featuring a relatively lower stage of economic development; those are usually peripheral, less urbanized regions with relatively low GDP per capita. In these countries, the process of industrial location takes place throw the industrial structural adaptation of the lagging regions, which can realise competitive

[8] In Cyprus, the manufacturing sector does not play the same important role in development as for the economies in the other countries. This is why the conclusions and generalization based on the estimated variables will not have the same validation for Cyprus.

[9] Results from enterprise survey provided under the MOVE Project – 750 respondents from EU enterprises. The survey is provided in five countries: Bulgaria, Estonia, Greece, Poland and UK. The examined enterprises are equally spread in four labour intensive sectors: Clothing, Footwear, Electronics and Software. The results on regional level is analysed mainly for Poland and Bulgaria. The distribution of data for Estonia, Greece and UK is not allowing the regional analysis to make interpretation for all indicators.

advantages mainly in the LII, (Totev, 2008). These areas as a rule feature small industrial diversity; therefore, they are not flexible to the changing economic conditions. The relocation of the LII is distributed mainly in areas, which have low cost competitive advantages (Regional Centre -- NUTS III and Other towns and villages), this is obvious for Bulgaria and even more obvious for Poland.[10]

A different picture is observed of benefiting (profits) after delocalisation by regions. For Bulgaria, we have high figures for the 'Capital' and the 'Other towns and villages'. Similar distribution can be observed in Poland between NUTS II centres and 'Other towns and villages'.[11] The profit progress after delocalisation is in conformity with the observed regional distribution of the FDI, (Totev, 2005). Part of the FDI are attracted more by better communications, infrastructure and market potential of the urbanized regions than the cheaper labour force of the less developed regions – wage-cost competition does not play an important role for regional reallocation of these FDI inflows. Other FDI flows are directed to regions where factor endowments, such as wage-price cost play the main role in attracting them. The regional delocalisation of the LII is following the same patterns.

If we look at the picture for all four investigated branches in the Enterprise survey, we will observe a similar distribution but not so clearly expressed. This distribution is obviously related with the possibility to take advantages of the regional specificity; in other words, delocalisation process is oriented to two different kinds of regions – well-urbanized regions and lagging regions. The process is closely related with the higher possibilities of making profits in these specific areas.

The firms participating in the relocation process feature quite different economic characteristics – those in the urbanized areas and the ones in the lagging regions. Probably, the only matching point is that the profits in these two groups are higher compared to the companies' profits in the other area. The companies in lagging regions are focused mainly in producing labour intensive products because of their competitive advantages. Their production is less diversified what makes them less flexible to the changing conditions and more dependent of their partners.

The share of LII is increasing mainly in the less developed regions; respectfully the increase of the levels of industrial specialization is much higher for them. One cannot speak for forming regional clusters of firms in given branches. However, a number of mainly unskilled LII that were initially spatially distributed have become more concentrated in the lagging regions.

The peripheral regions are facing serious difficulties with the maintaining of their industrial structure. The rising share of the LII in these regions hide serious danger since the competitive advantages of the LII can be loosed and this way these regions will face the problems with so called "no future industry". In branches where it is

[10] The regional analyses is done on four regional levels – Capital, Regional centre (NUTS II); Regional centre (NUTS III) and Other towns and villages.

[11] In Poland, the NUTS II centres as agglomeration are quite bigger than Bulgarian NUTS II centres.

not expected changes of the competitive advantages the specialization can has long run positive economic effect. However, most of the LII cannot be associated as such.

Summary

The relocation processes intensively influence the changing of the industrial structures; the changes are leading to a general divergence of the industrial structures of the EU countries. These changes lead to countries clustering by industrial structure in the EU space. Countries belonging to the same clusters tend to converge their industrial structures.

In the short-term perspective within the EU, some intensification in the relocation activity in the Labour intensive sector cannot be expected. Intensive relocation such as that observed in the last decade in Europe now can be expected to shift to countries outside the EU. There appears to remain some scope for further relocation of the LII, which will be related to the future specialisation and location of LII to a few countries on the EU periphery – mainly Bulgaria and Romania. For most Central European countries, one can maintain that they already are not attractive for the relocating labour intensive activities. The comparison of the industrial structure and export structure reveals that the relocation possibilities are exhausted for these countries. The increase in labour costs in the Central European NMS leads to them losing the position that they gained in the beginning of the 90's.

Specialisation under subcontracting relations, relations as a rule are not stable and long lasting. Convergence processes within the EU will lead to loss of competitiveness of the LII for lagging countries. Faster economic development means increasing labour costs, which means a problem with the competitiveness of the typical LII in the NMS, and especially for the seriously lagging Bulgaria and Romania. That can create problems mainly to lagging regions in these countries where labour intensive activities are mainly relocated.

Following the new geographical economic theory concerning the location after-effects and the results of cluster analysis it can be expected that the relocation processes may have a certain negative impact on a few EU-15 countries. These countries appear to be Portugal and Greece, which have similar industrial structures to Bulgaria and Romania.

Table 1

Relative and absolute concentration indexes

Five groups of branches (sectors)	Concentration index	1995				2004			
		Relative		Absolute		Relative		Absolute	
Labour intensive sector	Man. of textile	0,43	0,20	0,09	0,21	0,45	0,26	0,09	0,20
	Wearing apparel	0,60		0,09		0,86		0,10	
	Footwear	0,71		0,13		0,86		0,15	
	Furniture	0,24		0,09		0,30		0,09	
	Fabricated metals	0,22		0,12		0,18		0,11	
	Recycling	0,51		0,13		0,44		0,12	
Resource intensive sector	Food & beverages	0,23	0,14	0,09	0,20	0,24	0,11	0,09	0,21
	Woods & wood prod.	0,33		0,08		0,37		0,07	
	Paper & paper prod.	0,26		0,10		0,22		0,09	
	Non-metallic production	0,21		0,09		0,25		0,09	
	Man. of basic metals	0,37		0,09		0,25		0,10	
The sector of branches with Different factor intensity	Manuf. of machinery	0,25	0,14	0,12	0,23	0,30	0,18	0,13	0,24
	Electrical mach.	0,26		0,14		0,33		0,13	
	Medical & optical	0,39		0,16		0,37		0,15	
The sector of branches with Increasing Economic of Scale	Publishing; print.	0,35	0,20	0,11	0,24	0,30	0,21	0,11	0,24
	Manuf. of chemicals	0,20		0,11		0,30		0,12	
	Rubber & plastic	0,24		0,13		0,18		0,11	
	Motor vehicle	0,46		0,18		0,47		0,19	
	Transport equip.	0,31		0,10		0,35		0,11	
Science intensive(sector	Office mach; computers	0,50	0,24	0,14	0,24	0,60	0,23	0,13	0,23
	Communication equip.	0,36		0,10		0,41		0,10	

Sources: Eurostat

Table 2

Relative Specialization indexes and share of employment of LII from total manufacture

Country	Relative_95	Relative_G95*	Relative_04	Relative_G04*	Share – 95*	Share – 04*
Belgium	0,30	0,18	0,34	0,21	23,7	22,7
Cz. Rep.	0,30	0,21	0,25	0,11	31,0	27,1
Denmark	0,36	0,12	0,36	0,17	21,5	20,2
Germany	0,39	0,28	0,39	0,29	18,1	16,9
Estonia	0,58	0,40	0,55	0,43	38,2	39,0
Greece	0,57	0,47	0,58	0,49	42,1	40,5
Spain	0,22	0,19	0,21	0,19	29,5	30,8
France	0,24	0,11	0,27	0,15	23,8	21,6
Ireland	0,48	0,21	0,61	0,28	18,2	11,9
Italy	0,28	0,26	0,30	0,26	38,5	37,1
Cyprus	0,69	0,59	0,64	0,54	43,9	25,3
Latvia	0,60	0,34	0,70	0,45	25,6	28,1
Lithuania	0,58	0,38	0,68	0,48	32,1	38,3
Hungary	0,33	0,14	0,27	0,14	28,5	25,4
Netherlands	0,37	0,19	0,36	0,18	19,6	19,6
Austria	0,27	0,16	0,26	0,17	27,2	23,4
Poland	0,29	0,20	0,29	0,24	29,3	30,6
Portugal	0,58	0,47	0,57	0,47	49,2	48,6
Slovenia	0,35	0,26	0,32	0,26	38,8	36,4
Slovakia	0,28	0,14	0,32	0,15	27,1	26,6
Finland	0,45	0,31	0,46	0,31	15,2	16,6
Sweden	0,39	0,24	0,37	0,17	14,7	17,8
UK	0,22	0,14	0,26	0,18	24,1	21,2
Bulgaria	0,43	0,23	0,56	0,40	27,4	42,5
Romania	0,38	0,22	0,56	0,38	31,7	44,5

* Estimated on the bases of the five groups of branches (Labour int.; Resource int.; Branches with different factor intensity; Branches with increasing economic of scale and Science intensive branches – see Table 1)

Table 3
SSD indexes and some derivative indicators estimated on the basis of five groups of branches (see Table 2)

	SSD Same country 1995-2004 *	SSD Same country 1995-2004	SSD 95 Sum Rank	SSD 04 Sum Rank	Country 1995 - EU (1995)	Country 2004 - EU 2004	The three countries with closer structure 1995			The three countries with closer structure 2004		
Belgium	11,7	4,9	16	18	85,3	117,7	France	Netherlands	Spain	France	Netherlands	UK
Czech R.	55,2	47,3	19	22	100,3	34,4	Romania	Slovakia	Austria	Slovakia	Hungary	Austria
Denmark	15,5	7,3	15	19	47,3	82,3	France	Sweden	Netherlands	Sweden	Austria	Check R.
Germany	2,5	3,6	3	3	188,3	219,1	Czech R.	Sweden	UK	Sweden	UK	Denmark
Estonia	74,1	1,1	9	11	348,3	399,4	Greece	Lithuania	Cyprus	Lithuania	Greece	Bulgaria
Greece	6,4	5,9	4	8	478,5	488,7	Cyprus	Estonia	Portugal	Lithuania	Estonia	Bulgaria
Spain	21,4	8,2	20	24	92,4	69,8	Poland	Belgium	Hungary	Poland	Belgium	Check R.
France	9,5	11,5	17	17	39,7	70,5	UK	Netherlands	Belgium	Netherlands	UK	Belgium
Ireland	57,1	54,6	13	5	135,6	307,6	Sweden	Netherlands	Finland	Finland	Sweden	Netherlands
Italy	16,2	5,4	10	15	190,5	167,7	Slovenia	Romania	Czech R.	Slovenia	Romania	Check R.
Cyprus	328,5	574,1	2	1	740,6	985,4	Greece	Estonia	Portugal	Latvia	Lithuania	Poland
Latvia	105,1	28,7	8	4	369,5	602,7	Lithuania	Poland	Bulgaria	Cyprus	Lithuania	Poland
Lithuania	162,2	66,6	14	9	311,8	491,0	Estonia	Bulgaria	Poland	Estonia	Greece	Bulgaria
Hungary	+65,9	35,8	25	21	38,5	54,7	Austria	Poland	Slovakia	Check R.	Slovakia	Austria
Netherlands	4,3	1,0	11	16	106,9	91,5	France	Belgium	UK	France	Sweden	UK
Austria	13,7	25,2	23	23	69,2	72,7	Hungary	Slovakia	Poland	Slovakia	Hungary	Czech R.
Poland	62,8	11,8	24	25	72,9	97,2	Romania	Austria	Hungary	Spain	Austria	Czech R.
Portugal	21,4	1,4	1	2	704,6	690,1	Greece	Estonia	Cyprus	Romania	Bulgaria	Estonia
Slovenia	8,5	10,2	6	12	233,1	181,7	Italy	Czech R.	Hungary	Italy	Check R.	Slovakia
Slovakia	32,8	9,1	21	20	55,4	68,6	Austria	Hungary	Czech R.	Check R.	Austria	Hungary
Finland	33,3	19,5	7	13	252,0	215,3	Ireland	Sweden	Netherlands	Ireland	Denmark	Austria
Sweden	25,5	18,7	5	14	192,0	107,2	Netherlands	Ireland	Denmark	Netherlands	Denmark	France
UK	24,7	29,2	12	10	68,1	123,5	France	Netherlands	Denmark	France	Netherlands	Sweden
Bulgaria	266,7	303,1	18	7	174,9	441,4	Austria	Poland	Slovakia	Romania	Estonia	Portugal
Romania	173,7	222,4	22	6	88,6	434,0	Czech R.	Poland	Hungary	Portugal	Bulgaria	Estonia
EU-27	**6,9**	**1,8**	-	-	**0,0**	**0,0**	**Hungary**	**France**	**Denmark**	**Czech R.**	**Hungary**	**Slovakia**

* Estimated based on NACE classification, Division from 15-37 (not included NACE Division 23: Manufacture of coke; refined petroleum)
Sources: Eurostat

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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DELOCALISATION PROCESS AND CHANGES OF COMPETITIVE ADVANTAGES – A SURVEY OF ENTERPRISES•

The aim of this paper is to examine the link between the industrial delocalisation and the changes of the competitive advantages based on results obtained from a Survey of 756 enterprises in five EU countries. The study is enriched by providing cross-country analysis based on some secondary data indicators. An attempt is made by comparing the results from the Enterprise survey and the secondary data analysis to summarize the findings and to outline the specific features and effects of the delocalisation processes on the competitiveness of the EU countries and their firms. Patterns of development of labour intensive industries, their trade performance and countries competitiveness are related to the delocalisation processes.

The study revealed that both sides participating in delocalisation processes, gain in terms of increasing their competitive advantages and profits. However, for countries like Romania and Bulgaria the delocalisation process can bring to problems in their future development due to their low profitability of working under subcontracting.

JEL: D21, F21, O52

Introduction

All theoretical formulations predict increase of the industrial specialisation and intra-industry trade as a result of EU enlargement and trade liberalisation that leads to significant changes in the EU countries competitive advantages, (CEC, 2003). The growth of intra industry trade between developed EU-15 countries and the less developed new member states (NMS)[3], especially in the typical labour intensive industries (LII) like footwear, clothing and textiles can be attributed to the delocalisation processes and more specifically to outsourcing activities, (Falk and Wolfmayer, 2005).

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[3] New member states (NMS) – all countries that joined the EU after 2004.

The aim of this paper is to examine the link between the industrial delocalisation and the changes of the competitive advantages based on results obtained from a Survey of enterprises in five EU countries done in the framework of the Move Project. The study is enriched by providing cross-country analysis based on some secondary data indicators.

Delocalisation and trade competitiveness

One clear indicator of delocalisation activity is the intensification of the vertical intra industry trade, (Hoekman and Djankov 1996). This is confirmed also by the fieldwork analysis prepared under the MOVE project, which verified the interrelation between subcontracting and the intensification of intra industry trade. The analysis proved that there is significant[4] dependence between involvement in delocalisation and the purchasing of intermediate products, as well as for the position in the production chain and subcontracting of labour intensive products.

Looking at the trade performance of EU countries with labour intensive products (Table 3) there can be drawn some important observations. In general, a process of losing comparative advantages in the EU countries is observed. This is valid for the EU-15 countries as well as for the NMS. Secondly, it is clear that the intensity of losing position in labour intensive products is higher for the Central European NMS compared to that of the EU-15. The third observation is the existing of a clear relationship between the EU countries industrial structure and their trade specialisation.

In order to explore this relationship, the countries are distributed in groups according their industrial structures by using cluster analysis[5] with the following parameters (having their values for y. 2004) Relative concentration measured by the Herfindal indexes; Share of the Labour intensive sector in the total manufacture employment; SSD (sum of square differences) indexes between given country and the EU-27 average; Ranks of the SSD indexes[6]. On the next stage the cluster analysis was implemented again yet this time with the characteristics of international trade for the y. 2003 (specified by the indicators for revealed comparative advantages and trade specialization, (Table 3, columns 1, 2, 3 and 7, 8, 9).

[4] The Spearman's rank correlation coefficients are estimated for the clothing and footwear industries. They are statistically significant and approximately high (around 0.5) for the mentioned couples of variables.

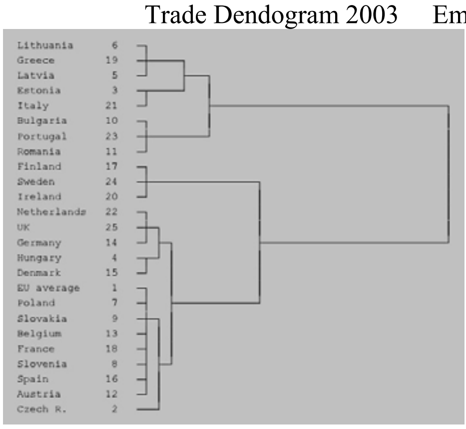
[5] The Discriminant analysis (Huberthy 1994) shows that higher predictor ability what concerns the industrial composition have the chosen parameters.

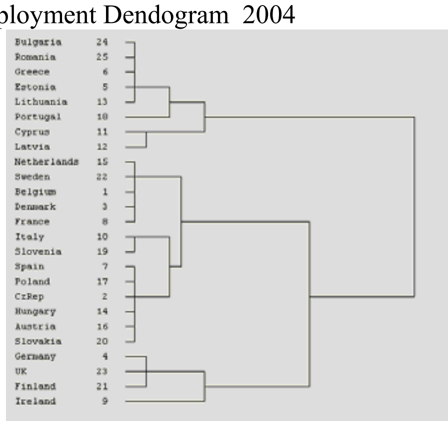
[6] $SSD_t = \sum_i^n (a_{it} - b_{it})^2$ where [a, b] is a pair of countries, i = 1, … 21 is the number of industries; t are time periods

The comparison of the obtained dendrograms, shows that there is an almost full overlap between the top-positioned corresponding clusters (Bulgaria, Romania, Lithuania, Latvia, Estonia, Portugal, and Greece).

Figure 1

Trade Dendogram 2003 Employment Dendogram 2004





Sources: UNCTAD/WTO data Sources: Eurostat and own calculations

The cluster from the Trade Dendogram can be characterized as the one containing the countries with the higher export of labour intensive products (it can be conditionally referred as the *High labour intensive cluster from the Trade Dendogram*). The only discrepancy with the corresponding cluster from the Employment Dendogram is the presence of Italy in this group.

On the other extreme of the Trade Dendogram, there are located countries with less covered export of labour intensive products. These are Sweden, Finland and Ireland. The corresponding cluster from the other Dendogram includes Finland, Ireland but also the UK and Germany. The last two countries did not fall into the corresponding Trade cluster and the explanation of this fact is that the mirroring of the production and trade structures is valid mainly for the small countries, which are supposed to have open economies and for which it is expected that the composition of production should reflect the composition of exports (Landesmann, 1996).

In between these two clusters, there is one that is not homogenous. It can be divided into two sub clusters. The first one is close to the High labour intensive countries, so this cluster can be referred as the *High to medium labour intensive cluster from the Trade Dendogram*. It includes Poland, Slovakia, Belgium, France, Slovenia Spain, Austria and Czech Republic. The export of labour intensive products plays a certain role in these countries and most of them are involved in the delocalisation process in both sides – i.e. providing and undertaking subcontracting.

The other sub-cluster from this group includes the Netherlands, UK, Germany, Hungary and Denmark. This cluster can be specified as the Low to medium labour intensive cluster from the Trade Dendogram. For these countries, the export of labour intensive products is declining and they are closer to the group from the Low labour intensive cluster.

Further analysis revealed that the divergences between the Trade and Employment Dendogram concerning the forming of clusters decreases in the course of time. If one compares the same Dendograms for the year 1995 it can be noticed that there is a quite different picture within them. It shows that the structural adjustment processes was very intensive in the beginning of the observed period, yet now they are calming down. One cannot expect such intensive delocalisation processes in the near future as the ones observed in the last decade. The formed clusters are not expected to undergo significant changes in the future. Verification for this statement is the tight similarity between the Trade cluster and Employment cluster in 2005 that came as a result of the process started near 1995, when such a similarity was not observed (Landesmann, 1996).

Intra industry trade is usually related to trade relations within developed countries. The intensity of the delocalisation process changes somehow this understanding because in the last decades the vertical intra industry trade has increased significantly between well-developed and less developed countries. Since the mid-90's, the vertical intra industry exchange between Western European countries and NMS (see Hoekman and Djankov,1996) is playing significant part with the well established practice of transferring the inputs from the European Union (EU-15) suppliers to the NMS manufacturers, and export of the produced goods later back to the EU-15.

Specialization and competitiveness – the case of footwear industry

Countries specialization

The footwear production is one of the most typical branches of the labour intensive industries. The process of delocalisation of footwear industry is indicative for the relocation if the LII. A simple comparison by countries of the GVA, labour productivity and employment dynamics for this industry would show that the specialization here can be attributed to the delocalisation process mainly as a result of relocating of the low value added part of the production processes out from the EU-15 countries to the countries with cheap labour force, such as Romania and Bulgaria. In parallel, the shifting of the low value added part of the production from the EU-15 leads to increasing the share of the more high-quality products, which results in relative stronger decrease of the lower segments of the value chain. One finding from the Enterprise survey[7] analysis is that there is a significant negative Spearman's rank correlation coefficient (minus 0.6) between the indexes showing

[7] The survey (done under the MOVE Project) covers 750 respondents from European enterprises spread in five countries that participate in the delocalisation process. The examined enterprises are spread in four labour intensive industries: Clothing, Footwear, Electronics and Software.

the position in the production chain and the intensity of undertaking subcontracting of labour intensive products.

In the case of footwear industry one can see that the specialization measured by the share of the employed in the sector from the total employed in the manufacturing industries, is related to the level of the economic development. The comparison of this indicator with the GDP per capita in PPS (Purchasing power standard) yields a reverse relation, i.e. the linear correlation coefficient is minus 0.60, (Table 4, columns 4 and 5).

When one estimates this relation only for the EU-15 countries, the coefficient of correlation is rising significantly to reach minus 0.82. These figures are showing that, among the EU-15 countries, those featuring lower level of development are specialised as a rule in footwear industry. This relation is quite weak measured for the NMS only – the ratio drops to minus 0.20. Still, the specialization in footwear industry for NMS cannot be directly related with the level of economic development. However, the change of specialization in NMS shows that, in the near future, this indicator can be also indicative of the level of development of the NMS.

It is interesting to compare this correlation coefficient with the estimated one for the specialization in the industries with constant return to scale (CRS) [8] and the GDP per capita in PPS (Table 4, columns 1 and 5). The correlation coefficient is minus 0.77, which is quite significant. This coefficient is approximately the same for the separate estimations of EU-15 and NMS. These results show that the specialization in the industries with CRS is closely related with the level of economic development, which also proves the validity of the relation between footwear specialization and the level of economic development from one side, and from the other – the validity of the prediction that the share of the employed in the footwear industry in the near future will be also indicative for the NMS level of development.

Countries Competitiveness

The indicator GVA/personal cost for the EU-15 shows that the figures for the UK are significantly above the average (UK 1.8 – EU average 1.3), Germany is slightly above the average 1.4; France, Italy and Spain are close to the average level, while Portugal and Greece have the lowest figures for EU-15, (Table 4, column 3).

Some interesting conclusions can be drawn by observing of the differences between labour productivity for all manufacture branches and footwear industry, (Table 4, columns 6 and 7). The variation for the footwear industry is significantly higher than for the total manufacture branches – the standard deviation for the footwear industry is 1.4, while for the manufacture sector as a whole is two times less (0.7). It shows that the productivity varies in wider than the average ranges for the footwear

[8] Industries with constants return to scale (mainly low technological processing industries/labour intensive industries) from the NACE Division 15-37 are: Textile; Wearing apparel; Footwear ind.; Food ind.; Leather ind.; Wood ind.; Pulp and paper; Furniture; Metal prod; Other branches.

industry as a result of higher disposition to delocalize the low value added activities, (Falk and Wolfmayer, 2005). For example, the distinction of labour productivity in Romania and UK is 1:15 for the total manufacture productivity, while for the footwear industry is 1:36. The results of the Enterprise survey are in the same direction – 77 per cents of the UK companies point the differences in labour cost as the main reason to get involved in subcontracting/outsourcing activities. There is a very strong correlation between the question “Does your company give subcontracting” and the higher labour cost of production – the Spearman’s rank correlation coefficient is 0.8.

Countries trade specialisation

Despite the strong competition from low-wage countries (from Asia, above all) EU still preserves its strong position in the international footwear trade. The indexes of revealed comparative advantages (RCA) for the footwear industry in many countries remain higher than 1.0 (Romania 6.62; Portugal 3.95; Italy 3.67; Bulgaria 2.89; Slovakia 1.72 and Spain 1.51 – see Table 3, column 3).

The countries most specialized[9] in the footwear export among the EU countries are: Romania - 7; Portugal - 14; Italy - 16; Bulgaria - 21; Slovakia - 36; Spain - 38, (Table 3, column 9, Figure 2). It is possible to add also countries like Estonia - 42, Slovakia - 45, Hungary - 47 and Poland - 55, but all of them are losing position in the course of time what concerns their rank specialization index.

The intra industry trade is significant what concerns trade between developed countries (mainly Italy) and less developed NMS (mainly Romania and Bulgaria). Most EU-15 export to Romania and Bulgaria is actually due to parts of footwear that are used for the fabrication of further parts or finished products destined for export to the EU-15.

The increase of the intra industry trade can be attributed mainly to the delocalisation. Hoekman and Djankov (1996) outlined that there is a strong interdependence between the RCA indexes, intra industry trade and FDI from one side and the delocalisation process from the other. The gradation of the intensity of intra-industry trade is confirmed by the dynamics of the average share of the intermediate products purchases that come from abroad. These variables are higher for all countries that undertake subcontracting. At the same time, Spearman’s rank correlation coefficient shows significant interdependence between the destination point of product parts and undertaking of subcontracting.

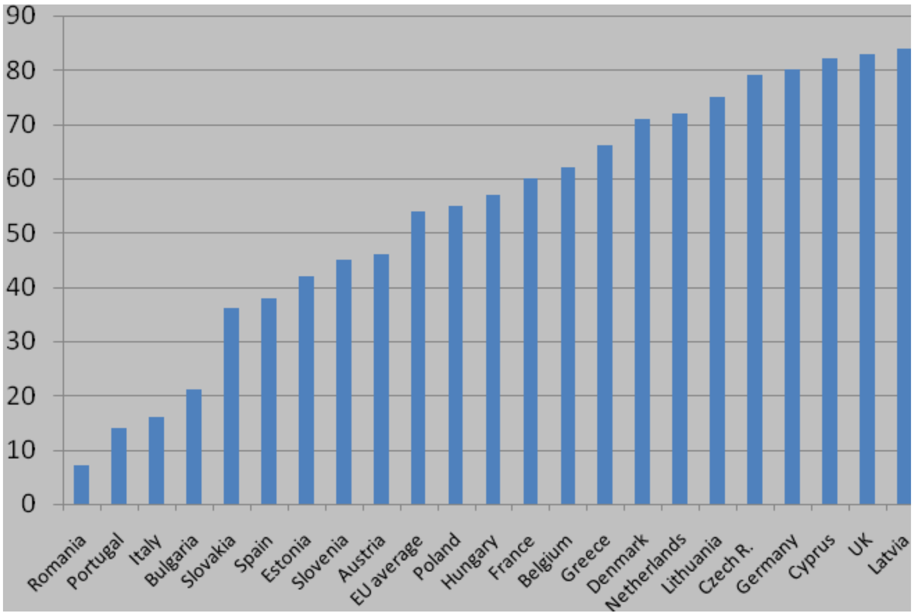
The export and import between Italy, on one side, and Bulgaria and Romania, on the other side, is mainly in the low cost segment of the value chain. The share of the Romanian export to Italy in 2005 reaches up to 71 per cents from the total export and the share of the import from Italy is 63 per cents; these figures for Bulgaria

[9] The countries are ranged by the rank specialization of the export. Rank 1 indicates that the country has the highest specialization index in the world for the sector under review – highest share of the specific product in its export.

respectfully are 73 per cents and 36 per cents.[10] The analysis of trade specialization revealed that it is higher for the NMS and this specialization is due to the delocalisation processes. The more developed is one NMS, the less focused is its intra industry trade and the less intensive is the delocalisation processes in the footwear industry there.

Figure 2

Rank Specialisation by Countries



Source: Table 3, column 9

Enterprise survey of the competitive advantages **Table 1** presents the changes of competitive advantages for the footwear industry as a result of the delocalisation process. The balance in comparative advantages (CA) is positive for Bulgaria and Poland. Actually, these are the countries that attained obvious increase of CA – Poland by 47 percentage points and Bulgaria by 16 percentage points. None of the other countries has negative balance. Comparing the results for footwear industry with those for all branches observed in the survey reveals that the delocalisation process in all branches results in higher increase of the number of CA than for the footwear industry.

The increase in percentage points for Bulgaria and Poland is approximately the same for footwear industry and all branches. Comparing the gain/loss ratio one can see that for all branches the gain of CA is always higher than for the footwear industry.

[10] Sources: UNCTAD/WTO

Table 1
Changes of competitive advantages by countries after starting delocalisation process (the first figures are percentage of changes – the one in the brackets are the numbers)

Footwear	BG	EE	GR	PO	UK	Total
No→Yes	39% (17)	9% (1)	0% (0)	82% (28)	82% (18)	54% (64)
Yes→No	23% (10)	9% (1)	0% (0)	35% (12)	73% (16)	33% (39)
BALANCE /Percentage points/	16% (7)	0% (0)	0% (0)	47% (16)	9% (2)	21% (25)
Ratio Gained/Loosed	1.7	1.0	--	2.3	1.1	1.6
All Branches						
No→Yes	30% (60)	67% (134)	79% (63)	83% (166)	84% (63)	64% (486)
Yes→No	15% (30)	33% (65)	10% (8)	24% (49)	68% (51)	27% (203)
Balance/Percentage points/	15% (30)	35% (69)	69% (55)	58% (117)	16% (12)	37% (283)
Ratio Gained/Loosed	2.0	2.0	7.9	3.4	1.2	2.4

Source: Enterprise survey

UK and Poland are the countries where the economic environment has been changed a lot with the delocalisation processes. In these countries, significant shifts in CA are observed – UK gains 82 per cents of some of the CA but loses 73 per cents in other positions. The figures for Poland are accordingly 82 per cents and 35 per cents. Significant decline of the number of employed for the last years in those countries is also observed, (Table 4, column 2).

Another question related with the CA is whether the companies are principally threatened by 'Low cost' or 'High quality' products, (Table 2).

Table 2
Threatening in principally from Low cost or High quality products (in per cents)[11]

	Footwear		ALL Branches	
	Low cost products	High quality products	Low cost products	High quality products
Bulgaria	95.3	4.7	86.7	13.3
Poland	77.4	22.6	65.4	34.6
UK	40.0	60.0	36.6	63.4

Source: Enterprise survey

The first conclusion that can be drawn is that the results for the footwear industry are similar to the figures for all branches.[12] In principle, the footwear industry is more threatened by 'Low cost products' than the other branches. If we accept that the competition of 'Low cost products' and 'High quality products' corresponds to the place occupied by the firms in the value chain, the result can be interpreted in sense that Bulgaria is at the lower end of the value chain, Poland is also at a lower end but a little bit upper than Bulgaria, while the UK is at a much higher level.

[11] Greece and Estonia are not included because the answer to this question is probably disturbed for different reasons.

[12] In the case of Greece, the number of the unanswered to this question is enough higher to bias the result; therefore, figures for Greece are not presented.

Another confirmation of this conclusion is that the companies from Central Europe (in our case in Poland) occupy a higher position in the production chain than those in Bulgaria, where 86 per cents of the respondents declare that they occupy low or intermediate levels of the value chain against 60 per cents for Poland.

Summary

Specialization and trade orientation in footwear industry (and generally in the Labour intensive sector) is accepted as risky since the branch (sector) is producing low added value products and the production can not be easily diversified – has limited possibility of redirecting to new products. However, the analysis definitely reveals that, in the framework of the EU, so far the delocalisation process is a win-win process in terms of economic development for both sides. The Enterprise survey revealed that both sides participating in delocalisation processes (providers and undertakers of subcontracting), gain in terms of increasing their competitive advantages and profits, yet the later ones (those undertaking of subcontracting) gain a little bit more by participating in this activity.

As main "negative" effect for providers of subcontracting can be accept the drop in employment, although featuring quite high negative rate it is not drastic in absolute figures. This is due to the fact that in the main producer countries, such as Italy, Spain and Portugal, the drop in employment is not high. The situation in the NMS is the same; there, the drop in employment does not entail dramatic social consequences.

A real problem may be faced by countries like Romania and Bulgaria where the number of employed in the footwear industry (Labour intensive sector) is high, on the one hand, and on the other hand, it is a result of working mainly under conditions of subcontracting. Due to the low profitability of working under subcontracting, the possibilities to develop other activities are quite limited. This is valid mainly for the lagging regions in these countries where the footwear industry location is significant. However, this process cannot be qualified as negative even for countries like Bulgaria, since at this stage this is possibly the only alternative for economic growth and solving social problems in these regions, (Totev and Sariiski, 2005). At the same time, the analysis shows that, quite often, subcontracting can be the first step to higher forms of business cooperation; it might help to upgrade domestic production.

Table 3

EU-27 Revealed Comparative Advantage and Rank specialisation indexes[13]

	RCA – (1999-2003)			RCA (1999-2003) minus (1996-2000)			Rank specialization index (1999-2003)			Rank specialization index (1996-2000) minus (1999-2003)		
	Textiles	Clothing	Footwear and Leather	Textiles	Clothing	Footwear and Leather	Textiles	Clothing	Footwear and Leather	Textiles	Clothing	Footwear and Leather
	1	2	3	4	5	6	7	8	9	10	11	12
EU average	0,98	1,35	1,41	-0,27	-0,31	-0,11	49	72	54	-1	-4	-3
Cyprus	0,89	0,82	0,34	-2,01	-1,41	n.a.	45	75	82	n.a.	-36	-49
Czech R.	1,32	0,43	0,36	-0,31	-0,25	-0,34	31	89	79	-1	-9	-9
Estonia	1,52	1,44	1,26	-0,22	-0,27	-0,24	27	60	42	2	-3	-2
Hungary	0,5	0,99	0,84	0,03	-0,41	-0,46	78	66	57	0	-5	-14
Latvia	2,09	2,44	0,31	-0,14	-0,54	-0,08	19	46	84	-2	-8	-1
Lithuania	1,64	3,31	0,46	-0,51	-0,64	-0,64	25	35	75	-5	-4	-22
Poland	0,84	1,14	0,86	-0,18	-0,8	-0,36	47	62	55	-4	-12	-7
Slovenia	1,19	0,78	1,11	-0,13	-0,66	-0,39	36	77	45	-1	-17	-6
Slovakia	0,85	0,95	1,72	-0,26	-0,78	-0,34	46	68	36	-7	-13	-1
Bulgaria	1,32	6,14	2,89	0,18	0,69	-0,3	30	27	21	7	-2	2
Romania	3,40	8,61	6,62	n.a.	n.a.	n.a.	9	1	7	n.a.	n.a.	n.a.
Austria	0,84	0,47	1,06	-0,12	-0,11	-0,22	48	86	46	-2	0	-1
Belgium	1,08	0,63	0,74	-0,28	-0,02	-0,13	37	82	62	-3	0	-1
Germany	0,7	0,41	0,35	-0,13	0	-0,05	58	93	80	-6	-1	2
Denmark	0,69	1,07	0,59	-0,09	-0,11	-0,06	60	64	71	-4	2	1
Spain	0,92	0,67	1,51	-0,1	0,12	-0,42	43	81	38	2	7	-2
Finland	0,3	0,13	n.a.	0,03	-0,01	n.a.	93	115	-	5	-3	n.a.
France	0,79	0,58	0,8	-0,09	0,02	0	51	83	60	-1	4	4
Greece	1,83	3,94	0,66	0,09	-1,68	-0,12	23	31	66	5	-7	0
Ireland	0,17	0,12	NA	-0,08	-0,01	n.a.	110	116	-	-9	-2	n.a.
Italy	1,84	1,66	3,67	-0,14	-0,1	-0,73	21	56	16	3	-2	0
Netherlands	0,61	0,44	0,5	0,06	0,03	0	68	88	72	7	5	4
Portugal	2,23	3,1	3,95	-0,47	-0,55	-1,5	14	37	14	-1	-3	-1
Sweden	0,38	0,25	n.a.	-0,01	0	n.a.	88	104	n.a.	-4	-1	n.a.
UK	0,56	0,43	0,34	-0,01	0	-0,1	72	90	83	1	1	-4

Source: COMTRADE data and own calculations
http://www.intracen.org/countries

[13] The RCA index measures the country's revealed comparative advantage in exports according to the Balassa formula. The rank specialization index indicates the specialization that the country have in the trade of given product -- Rank 1 indicates that the country has the highest specialization index in the world for the sector under review, in other words the share of the given product of the countries trade is the highest compared with the shares for this product in the other countries.

Table 4

Main indicators of the EU

Indicators	Share of Branches with CRS	Employment changes 2003/1999	GVA)/personal cost	Specialisation (Labour)	GDP per Capita (in PPS) / EU=100/	Labour productivity / EU=100/	
Columns	1	2	3	4	5	6	7
	Total manufacture	Footwear	Footwear	Footwear	Total	Total manufacture	Footwear
Measures	%	%	-	%	-	-	-
EU	0.39	83	1.31	2.2	100.0	1.00	1.00
Austria	0.49	-	-	1.2	124.1	1.33	2.21
Belgium	0.42	71	1.31	0.3	119.4	1.70	-
Cyprus	0.67	-	-	1.7	84.3	0.60	-
Czech R.	0.42	58	1.04	1.5	78.3	0.26	0.45
Germany	0.36	86	1.35	0.4	109.9	1.28	2.84
Denmark	0.44	-	-	0.4	127.8	1.30	-
Estonia	0.61	-	1.27	2.0	66.2	0.22	-
Spain	0.51	86	1.27	2.7	99.9	0.93	1.19
Finland	0.46	81	1.31	0.7	117.5	1.74	3.46
France	0.43	83	1.32	1.2	109.2	1.29	1.71
Greece	0.66	78	-	2.4	85.1	0.84	2.11
Hungary	0.51	80	1.06	2.9	65.0	0.31	0.45
Ireland	0.43	57	1.59	0.3	141.8	3.42	-
Italy	0.50	92	1.28	4.7	102.3	0.93	1.75
Lithuania	0.70	40	1.29	1.2	57.6	0.13	-
Luxembourg	--	-	-	-	223.0	1.50	-
Latvia	0.70	71	-	0.4	53.9	0.26	-
Malta	--	-	-	-	72.0	0.56	-
Netherlands	0.41	78	1.30	0.3	126.6	1.35	4.35
Poland	0.58	70	1.24	2.0	53.2	0.59	0.75
Portugal	0.66	89	1.23	7.2	70.1	0.49	0.64
Sweden	0.29	87	-	0.2	118.2	1.20	-
Slovenia	0.44	-	1.42	3.6	84.3	0.37	-
Slovakia	0.57	-	-	4.6	60.6	0.25	0.34
UK	0.39	51	1.80	0.5	118.9	1.38	4.02
Bulgaria	0.72	103	1.14	3.7	35.1	0.08	-
Romania	0.66	123	1.53	7.2	37.8	0.09	0.12

Sources: Eurostat, UNCTAD/WTO; http://www.intracen.org/countries/; (CEC, 2005 p. 9)

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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WHERE IS THE BULGARIAN CORPORATE GOVERNANCE MODEL HEADING TO?

The paper critices two hipothetical trajectories for development of the Bulgarian corporate governance model (BCGM) as not feasible, and offers a different solution. The first opposed variant assertsthat BCGM would imitate a converging model, which follows the convergence of the two global CG systems. Its alternative strategy is formulated as adapting the corporate governance system to our national specific with its inherent cultural and political norms. The paper insist that both of the above models are discarding important national features of the BCGM; when taken into account they will reveal a quite different picture for that model, one of lagged model, with charackteristics already overcame in the present day developed countries. Respectively the trajectory it has to follow is quite different from those of the two critisesed hypothesses.
JEL: G30, G38

Introduction

The study discusses possible trajectories of the Bulgarian corporate governance (CG) and model, criticizing two premised theses and offers a different solution. The criticized theses are as follows:

1. The strategy of corporate governance system in Bulgaria can *imitate a converging model*, which follows the convergence of the two global CG systems.

2. The alternative strategy is *to adapt* the corporate governance system *to our national specific* with its inherent cultural and political norms.[2]

The first one includes two moments – the existence of convergence between the two global corporate governance models in general; and the second one, the opportunity to imitate this convergence model in Bulgaria.

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[2] See more in Corporate Governance Models. Convergence or Divergence. – In: Mintchev, V., R. Petkova, P. Tchipev and V. Boshnakov. Public Companies and Stock Exchange Development in Bulgaria. "Marin Drinov" Academic Publishing House, 2007, Sofia, p. 50-77 [in Bulgarian].

The second thesis suggests that no matter which global corporate governance system develops in Bulgaria, its implementation will be adapted, to the local conditions.

Here, as in most cases, attacking an issue from diametrically posed positions is based on a deep and sincere misunderstanding of the problem. Moreover, and regrettably, our problem, despite its whole complexity, turned out so actual, that we can easily call it modern. Before discussing in essence the construction of the problem, it is needed a:

Short reconstruction of the corporate governance problem

The reconstruction's goal is to set the problem in its actual context, since often you "cannot see the forest for the trees", by the fortunate expression of Hegel.

The theory of modern corporation is based on the concept that the separation of ownership from control precipitates a fundamental problem or conflict of interests between owners and managers of a firm. The same problem can be thought as a problem between majority and minority owners, or even between the bigger and smaller voting packages in a certain corporation. In short, it is the problem ***who*** appropriates the so-called residual income in the firm and who determines (i.e. ***whose interest***) the strategic long-term development of the firm. In less developed countries, which have weaker protection of property rights and/or of minority interests, the problem can increase to a degree of complete expropriation of this residual income by the managers (or the majority owners) on the account of the small owners. It can lead even to a complete erosion of the ownership, or, to say it other way, of the investment, made by the weaker presented economic agents.

This problem is far not just a problem of the public (nor only of the large) companies. On the contrary, it exists also in the private companies and even in other forms of legal company organization, like limited liability companies for instance. I will remind of a case from the Bulgarian economic life few years back, when two of three partners in a daily newspaper company, agreed and threw out the third one based on a legal formality, eliminating completely his economic interest, or if we choose the other expression – expropriating completely his investment in time and money, thus setting the beginning of a heavy long legal process with uncertain end.

Set in this context, the problem of corporate governance constitutes to a problem of finding an adequate mechanism of ***control*** over the managers (respectively over the majority owners), or even over the ***politically empowered*** owners, who can use their status to abuse the interests of the other owners or investors groups. In this sense, the contemporary corporate governance theory distinguishes two principally different mechanisms of exercising such governance – *an Anglo-Saxon and a German (Japanese) one*. The first one is based on developed stock exchanges, mostly in USA and UK, and the second one – on active involvement of the bank system in Germany, Japan and to a smaller extent in the other part of continental Europe.

That is the problem and those are the existing systems for its solution, which with certain variations and prevalence of one or the other form, constitute the picture of all market economies.

We have to state one more issue – the studied problem has many dimensions: it is revealed as a matter of the source of corporate financing, as well as a matter of the legal system, revealing information, construction of corporate boards, etc., but essentially it always remains the same problem. Respectively, the mechanisms for corporate governance remain the same.

From a first glance this triviality actually turns into a very serious trip-stone for the expressed above theses, since they are based on some deeply false formulations, which I will discuss briefly here:[3]

a) *Classification of the corporate models by different way of financing*

Already more than 10 years ago Colin Mayer, a leading economist on the matters of corporate governance (CG), destroyed in many articles the thesis of the different financing in Anglo-Saxon and German models.[4] Based on corporate financing data in 8 countries, he writes: "In all countries the self-financing from profits is firmly and definitely the most important resource of financing: in UK in certain analysis it is responsible for over 100% of the capital expenditures of the corporate sector (revealing the fact that the British corporations are net receivers of financial resources); where external resources are used, they come first from the bank sector. For the last 20 years (the middle of 1970s to the middle of 1990s, *author's note)* the banks are an especially perceptible source of financing in Japan. Surprisingly, though, the German banks contribute only a ***modest*** (*author's italic)* proportion to the total German corporate financing from other sources. … The stock markets are relatively minority source of financing in ***all*** (*author's italic*) countries. Financing from stock markets reaches only less than 10% of all gross sources in all countries, and in many countries it is significantly under this level."[5] And again there: "Therefore the traditional division between bank and market sources of financing is misleading." I presented this long citation exactly for this misleading, which is recreated in Bulgaria 10 years after its discrediting. The conclusion is clear: there is no reason the corporate governance models to confront each other based on difference in financing – both models are principally based on equal ratios between the different sources – self-financing from own revenues is always the main one.

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[3] Ibid, p. 61.

[4] See an article as if deliberately written for our debate: Myths of the West: Lessons from Developed Countries for Development Finance. World Bank DP, 1990; Financial Systems, Corporate Finance and Economic Development. – In: Hubbard, G. (ed.) Asymmetric Information, Corporate Finance and Investment. Chicago: NBER, 1990.

[5] Mayer, C. In the Image of the West: Creating Financial Systems in Eastern Europe. World Bank DP, October 1992, p. 4.

b) *Division of CG mechanisms as "market ones" (Anglo-Saxon) versus "hierarchical ones" (German)[6], [in another context A-S mechanism is seen as based on wider diversification of ownership plus developed capital markets and the G mechanism - as based on less developed capital markets]*

The absurdity of these statements is obvious to everybody who knows better the German model. It is neither hierarchical, nor with concentrated ownership. Just 2 figures to confirm my statement: they are from Nunnenkam and are based again on studies of Colin Mayer from 1995. "However, their (the banks', *author's note)* role as direct stakeholders remains significantly under what can be expected from the so-called bank-oriented system."[7] – here a figure shows that in 1990 the banks hold only 10% of the whole shareholding ownership in Germany. And again there: "… and the banks are even more insignificant as large stakeholders (they number less than 6% of the shareholding packages, sized over 25% of the firm capital)."

The conclusion is similar to the one for the previous formulation – both CG systems develop in the conditions of developed stock exchanges and diversified ownership of the public companies. Of course, one can argue which one is more or less diversified, but most certainly a 10% package is not a concentrated ownership. Even if we assume that the Anglo-Saxon model can be determined as a market one, since it is realized through the securities market, this by no way makes the German model a hierarchical one, since the small size of the bank involvement in the capital of the German firms does not give them hierarchical opportunities for control.

c) *The raising of the role of the* ***stakeholders*** *or the so-called resource-providers to* ***a dividing principle*** *between CG models.*

Here, a strong objection arouses again. The objection is against the suggestion that the market model does not count for stakeholders, while the bank model does. Their role is strongly vulnerable in both cases. We can state neither that the Anglo-Saxon system totally denies the right and opportunity to take into consideration the interests of a wider circle of people in defining the residual income pretenders, nor that the German system accepts them. It is a fact that the co-determination system in Germany allows in decision-making the notions of the representatives of the employees in the firm, but it is too far from effective considering their interests equally to the owners' interests.

So, as a rule, the claims of the stakeholders should be considered rather in the light of improving the CG practices ***regardless*** the model, than as defining principle for the model.

[6] Mintchev, V., R. Petkova, P. Tchipev and V. Boshnakov. Public Companies and Stock Exchange Development in Bulgaria. "Marin Drinov" Academic Publishing House, Sofia, 2007, p. 63. [in Bulgarian]
[7] Nunnenkam, P. 1995, p. 8.

d) *The **division of the models on the basis of the legal systems,**[8] which is developed as another type of classification of the models, is also arguable.*

In reality it is the same as the division to Anglo-Saxon and German-Japanese or continental one. It is a fact that the countries with common law have higher protection of the outsiders, and it is a fact that it is significant to the preferred CG model, but this emphasis on the legal system in no way changes the character of the already adopted classification of the models.

The most controversial statement in this sense is that the legal definition of the corporate governance models sets the question of their convergence, since it rests on the presumption of the common law converging to the European continental legal systems, deriving from the Napoleon code. This convergence of the legal systems is not only observed as undesirable, historically unacceptable for the two large groups of countries, following different legal philosophy, but it is also impossible, since the sources of the law in them are diametrically contradictory. Even if we assume that both CG models converge, this convergence will be based on implementation mechanisms and not on convergence of the legal systems between the common and constitutional law.

The question of the convergence of the models

is in the basis of the whole discussion and deserves more attention by itself.

It is a fact that part of the contemporary researchers speak of a "pressure" for convergence of the legal frame for corporations functioning. The enormous efforts of both World Bank and OECD to develop codes for a good corporate practice are also a fact.

With many doubts we can also accept the statements that the American system starts to resemble the German one, since the share of the insiders ownership expands – in reality such practices have always existed.

It is even harder to accept the statements from the mentioned project that the "cross ownership, characteristic of Germany, begins to disintegrate".[9] At least the evidences by Marco Becht and Colin Mayer (2001) are not such. These authors determine substantial commitment of the power towards building complex systems of controlling sets of voting rights in the shareholding assemblies of the corporations in continental Europe.

The problem, however, is not in the facts, but their interpretation. Whether the codes for good practices for corporate behavior increase or decrease and whether the cross ownership grows or not in Germany is not a problem, which addresses the main question of the discussion – whether there is or not a convergence between the

[8] Mintchev, V. et al., op. cit., p. 65.
[9] Ibid, p. 67.

models. Because the good corporate practices, as well as the ways, in which the rules of disclosing information and the rules of defining the voting blocks and the "unified" requirements for the corporate boards; all they concern the question of a better functioning of the corporate governance systems. The question of more effective matching of the interests of large and small stakeholders, of stakeholders and managers and not the issue **which institution and in what way** implements the rules of good corporate governance.

And the latter is exactly the issue for the convergence. There is some "convergence" process there, as far as both models strive to improve their efficiency through similar governance and control mechanisms. Although, both models differ from one another not by the question, which one gives better results, but by that, how much the banks are active, what are the existing mechanisms of voting by proxy, of accumulating many votes of outsiders and their forming into big voting blocks.

The difference is in the whole philosophy of interrelations between the agents in both models. The Anglo-Saxon model is based on the so-called hostile takeover, while in the German one the hostility is rather an exception, which is applied after exhausting the other means. And, of course, the legal systems, in which this division is realized, and for which we say it is impossible to converge to one another; they suggest different behavior, different motivation of the economic agents, even though usually this is not outlined enough.

The question is quite wide and complex to be addressed sufficiently in details in such presentation, so I will stop here. Moreover, essentially, there is no importance and influence for the current

corporate governance issue in Bulgaria,

whether the two systems diverge or converge in a global and European perspective, since its specifics are such that it cannot enter the context of the European and global model of contemporary corporate governance. These are features, which are present in Bulgaria and which do not allow its inclusion in any of the analyzed so far systems. They are the following:

First and most important: the **Bulgarian ownership is over-concentrated**. The many carried out studies by Bulgarian authors after the mass privatization show that initially set goals for diversification of the ownership are not reached. On the contrary, there is a process of continuous concentration,[10] which leads to predominating establishment of private majority owners in the public companies.

[10] See Tchipev, P. Corporate Control Structure in Enterprises, Privatized after the Mass Privatization. – In: Tchipev, P. and M. Prohaska. Corporate Control Establishment on a New Emerging Market: Bulgaria. Centre for Study of Democracy, 2000, No 8; Tchipev, P., R. Petkova and V. Mintchev. Corporate Control Structure in Mass Privatization Enterprises. – Economic Studies, 2000, No 1; Petranov, S. Capital Concentration in the Public Companies, Protection of the Investors on the Capital Market in Bulgaria: 1997-1999. – Economic Thought, 2000, No 4.

Second, this concentration **crowds out the minority and small owners** and effectively isolates them from any participation in the ownership. Essentially, this is the reason for the next national specific.

Third, **lack of liquidity and scope** of otherwise formally well-regulated stock exchange and trade in stock.

Fourth, bank system **isolated** from the governance processes of the corporations due to lack of substantial legal mechanisms, as well as due to inherited negative past and lack of sufficient interest in such involvement.

Even just these specifics are sufficient to state that *in Bulgaria* ***was established*** *a corporate governance model, which is common neither with Anglo-Saxon, nor with German-Japanese model of corporate governance*. It is a model of family concentrated ownership, which was characteristic of Europe and the world in the first half of the 20th century. This model cannot converge to neither of the known models before it overcomes its internal restraints and develops the necessary additional features.

In short, it is the development of the necessary legal mechanisms for involvement of banks. It is a necessary but not sufficient condition, since they will still remain aside until more or less *stable* ownership structure is formed.

And second, it is the forming of certain, even though limited, critical mass of public companies, which assets will overcome the existence of liquidity market.

Even this is not enough, since direct or indirect *choice* between the two models will still be necessary. It is something, which today is deliberately avoided by all political powers.

These arguments are sufficient also for formulating the weakness of the second of the mentioned at the beginning theses – of the national specific. Bulgaria does not face the necessity to make a specific national choice in the way we have always done it – in a semi-European, semi-Balkan way. Bulgaria has to overcome the imposed primitive model of concentrated ownership and choose one of the global systems.

Whether the country is completely free in thus formulated alternative is another issue?

Whether both opportunities are equidistant from us and whether it is a matter only of governance choice which one to be chosen.

The problem how to overcome the inherited model is even more complex. Really, it is impossible to seriously believe that those, who concentrated their ownership with so many efforts, will voluntarily give up their power by dividing their control packages. It is even more unserious to think of some administrative measures for dividing this ownership. It is obvious that there is a need for complete and well-thought system of measures, which will make the registering as a public company acceptable for the corporations; the financing through the stock exchange enticing and beneficial; the good treating of the minority stakeholders – prestigious.

However, at least declaring the direction, which the government bodies will strive to follow, is necessary. Because it is not possible to work simultaneously in both directions. For now, though, there are neither discussions, nor seeking for solutions. There is reliance on the hypothetical convergence, which will solve the problem by itself, and the natural European choice we face even only due to our recent accession to EU, is neglected.

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES
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CORPORATE GOVERNANCE TENDENCIES IN BULGARIA: REPORTING ON CORPORATE SOCIAL RESPONSIBILITY (CSR) BY THE 40 LARGEST LISTED COMPANIES

The paper aims at revealing the corporate governance tendencies in Bulgaria as of 2007 and its findings are based on a country survey on Reporting on Corporate Social Responsibility (CSR) by the Forty Largest Listed Companies in Bulgaria, conducted by the Economic Policy Institute (Sofia) during the same year.
The research steps on internationally applied methodology by focusing on the annual reports and websites of the forty largest companies by market capitalization listed on the Bulgarian Stock Exchange (BSE) - Sofia. It sought to document the existing disclosure practices in the following specific areas – Corporate Governance, Environmental and Social Policy and last but not least to identify best practices in reporting by Bulgarian listed companies.
JEL: M14

In 2007 the Economic Policy Institute (Sofia), aiming at revealing the present corporate governance tendencies in Bulgaria, conducted an inaugural country survey on *Reporting on Corporate Social Responsibility (CSR) by the Forty Largest Listed Companies in Bulgaria.* The Survey was held thanks to the support of the Partners for Financial Stability (PFS) Program[2] and it is part of its ongoing regional initiative.

This inaugural survey analyzes the annual reports and websites of the forty largest companies by market capitalization listed on the Bulgarian Stock Exchange (BSE) - Sofia. It sought to document the existing disclosure practices on this issue and to identify best practices in reporting by Bulgarian listed companies. The research was designed to determine the extent to which the top largest listed Bulgarian enterprises reveal to the public and to potential investors specific information on corporate

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[2] The United States Agency for International Development (USAID) established the Partners for Financial Stability (PFS) Program in 1999 as a public private partnership to help complete reforms necessary to have market-oriented, sound and well-functioning financial sectors in the eight Central and Eastern European (CEE) countries that have since joined the European Union. In 2005, the geographical focus of the program shifted to South East Europe (SEE). The goal of the PFS Program is to work with CEE and SEE countries to accelerate financial sector development and reform based on best practices as well as international standards, promoting integration into the European and international economic systems.

governance, social policy and environmental policy. The primary purpose of the survey is to enable each company in the peer group to **benchmark** its disclosure practices against its peers. A broader goal of this exercise is to contribute to the process of raising awareness on the importance of transparent public reporting on corporate governance and corporate social responsibility issues.

1. Introduction

There is not a commonly accepted definition of the term Corporate Social Responsibility (CSR). One of the most frequently implemented is the definition found in the European Commission's Green Paper on Employment and Social Affairs dated of July 2001 which states that CSR is a concept whereby *companies integrate social and environmental concerns into their business operations and in interactions with stakeholders on a voluntary basis.*

When analyzing this term it is reasonable to use the following points of departure:

- The European Parliament resolution of 1999 calling a binding code of conduct to govern European Union (EU) companies' environmental, labor and human rights compliance worldwide;

- The international initiative the Global Compact of 31 January 1999. It addresses business leaders and contains ten principles related to human rights, working conditions, environment and anti-corruption

- The Lisbon Agenda, of which CSR became part of in 2000;

- The European Commission's Green and White Papers on CSR of the early 2000s, which put CSR on the agenda for the EU institutions. The setting up of a European Multistakeholder Forum (MSF) enabled a debate to take place amongst stakeholders.

There is evidence that companies which incorporate CSR in their management policy are between the most successful firms in the world, since: on the one hand, in most of the cases the customer behavior is influenced by the company's CSR behavior and on the other hand, CSR represents a competitive advantage of the company's activities in the globalization process.

2. **CSR in Bulgaria**

In the recent years, the interest towards Corporate Social Responsibility issues in Bulgaria increased considerably. As a part of the so-called *New Europe,* the state and the Bulgarian business in particular, began to pay more attention on how companies manage their impact on the environment and how they contribute to the society as a whole. Gradually, the Bulgarian business has become more conscious of the importance of implementing CSR's principles and policies which have a direct impact not only on business competitiveness, but also on social cohesion, transparency and trust among the stakeholders – employees, suppliers, clients, partners, state institutions and non-governmental organizations (NGOs).

During the past years, the Bulgarian companies started to realize the necessity of conducting a socially responsible business policy and behaving in conformity with a Code of Business Conduct or Code of Ethics. Sponsorship by businesses has deep roots in the economic history of Bulgaria. This practice reemerged after the changes of the political system. The community patronage/ sponsorship programs and the employee benefits policies evolved from not so coordinated activities to more precisely directed corporate policy. Thus, the modern conception for charity and social affairs has founded a response in more and more Bulgarian leading companies. The business is seeking options to manifest its commitment towards the employers, concrete society's problems/concerns and the environment. More than 40 % of the Bulgarian companies are declaring to be engaged in charity and social activities as a part of their business conduct and corporate policy.

According to Bulgarian legislation listed companies should prepare their documents following the transparency directives set by the Financial Supervision Commission.[3] The Commission implements its policy mainly on the basis of the Law on Public Offering of Securities.[4] The primary function of the institution is to assist - through legal, administrative and informational means -the maintenance of stability and transparency of the investment, insurance and social insurance markets. Furthermore, in July 2007 the National Corporate Governance Code, prepared by the BSE - Sofia, was finalized. At present it is in a process of approbation by the managers of the Bulgarian companies listed on the BSE - Sofia.

3. Survey on "Reporting on Corporate Social Responsibility (CSR) by the Forty Largest Listed Companies in Bulgaria"

3.1. Methodology of the survey

The survey on: *Reporting on Corporate Social Responsibility (CSR) by the Forty Largest Listed Companies in Bulgaria* analyzes companies' disclosures in Bulgarian and English (in the annual reports and company website) during the time period **March-June 2007** in three specific areas:

- Corporate Governance;

[3] Financial Supervision Commission Act - Promulgated State Gazette issue 8 of 28 Jan., 2003 in effect as of 1 March, 2003; amended issue 31 of 4 April, 2003; amended and supplemented issue 67 of 29 July, 2003; amended issue 112 of 23 December 2003; amended and supplemented issue 85 of 28 September, 2004; issue 39 of 10 May, 2005.

[4] Law on Public Offering of Securities - Promulgated State Gazette issue 114 in 1999; amended iss. 63 and 92 in 2000; iss. 28, 61, 93 and 101 in 2002; iss. 8 31, 67 and 71 in 2003; iss. 37 in 2004; iss. 19, 31, 39, 103 and 105 in 2005; iss. 30, 33, 34, 59, 63, 84 and 86 in 2006.

- Environmental Policy;
- Social Policy

The record date for the disclosures is June 15, 2007.

The survey consists of two integral components: 1) report of the survey results aggregated by sections and 2) a database containing a report (spreadsheet) on each company that indicates whether or not the company discloses the information and includes a hyperlink or hyperlinks to the specific disclosure(s). Via hyperlinks, one can move from the database directly into a company's website and/or annual report to read what specific information is disclosed and where.

The survey takes into account and analyzes the following 15 questions:

Corporate Social Responsibility

Corporate Governance

- Does the company disclose details on its corporate governance structure?
- Does the company report in compliance with a Corporate Governance Code?
- Does the Company disclose audit relation information?
- Does the company disclose its policy on shareholder rights?
- Does the company disclose and report on its internal Code of Business Conduct/ Code of Ethics?

Environmental Policy

- Does the company state whether it complies with industry-specific, national and/or international regulations regarding environmental standards?
- Does the company disclose the names of individuals (management and/or board members) or the department responsible for environmental management and compliance?
- Does the Company report on energy and water use?
- Does the company report on its environmental performance, including efficient use of resources, emissions and waste?
- Does the company integrate environmental aspects into its supply chain management policy?

Social Policy

- Does the company disclose compliance with industry-specific, national and/or international regulations regarding human rights and/or labor standards?
- Does the company report any community patronage/ sponsorship programs?
- Does the company disclose its employee development or employee benefits policies?
- Does the company list its health and safety policy?
- Does the company disclose its employment policy?

3.2. Companies surveyed

An increasing number of Bulgarian companies promote their corporate social responsibility strategies as a response to a variety of social, environmental and economic challenges. They aim to send a signal to the various stakeholders with whom they interact - employees, shareholders, investors, consumers, public authorities and NGOs. In doing so, companies are investing in their future and they expect that the voluntary commitment they adopt will help to increase their profitability.

The corporate social responsibility concept is mainly driven by large companies, even though socially responsible practices exist in all types of enterprises, public and private, including small - and medium-sized enterprises (SMEs). The survey analyzes the 40 largest listed companies on the BSE - Sofia according to their market capitalization as of March 1, 2007. [5]

The selected companies in the research account for approximately 83% of the market capitalization on the BSE – Sofia and 71.6% of the BSE turnover for March 2007.

The list of the 40 largest companies by market capitalization listed on BSE -Sofia as of 1st of March 2007 presented in descending order:

1. Bulgarian Telecommunication Company - Sofia (BTC)[6]
2. Chimimport AD – Sofia (CHIM)
3. Sopharma AD – Sofia (SFARM)
4. Economic & Investment Bank – Sofia (BRIB)
5. Bulgarian American Credit Bank – Sofia (BACB)
6. DZI Insurance & Reinsurance Plc. – Sofia (DZI)
7. Central Cooperative Bank – Sofia (CCB)
8. Petrol PLC – Sofia (PET)
9. Albena AD – Albena (ALB)
10. Druzhba Staklarski Zavodi AD – Sofia (DRUPL)
11. Bulstrad Insurance and Reinsurance PLC – Sofia (BSTR)
12. Lead and zinc complex Plc. – Kardzhali (OTZK)
13. Kremikovtzi – Sofia (KREM)
14. Bulgartabac Holding AD – Sofia (BTH)
15. Bulgarian River Shipping – Ruse (BRP)

[5] The Economic Policy Institute is grateful to „Trading, Surveillance & Market Data" Department, BSESofia for providing necessary data.
[6] BSE Code.

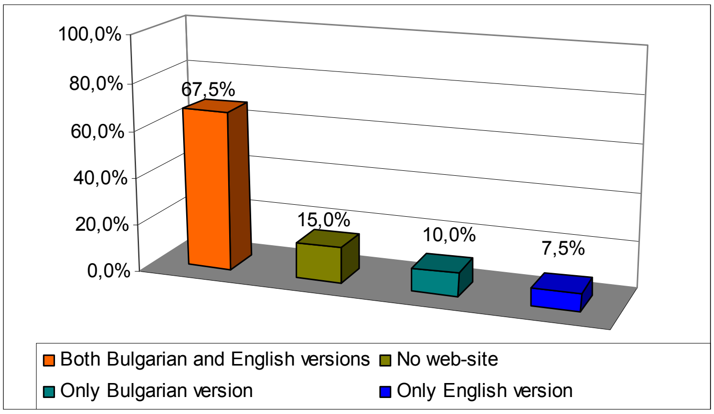
16. Alcomet PLC – Shoumen (ALUM)
17. Duropack Trakia Papir S.A. – Pazardzhik (PAPIR)
18. Blagoevgrad-BT Inc. – Blagoevgrad (BLABT)
19. Industrial Holding Bulgaria – Sofia (IHLBL)
20. Eurohold Bulgaria PLC – Sofia (EUBG)
21. Monbat PLC – Sofia (MONBAT)
22. Energoremont Holding – Sofia (ERH)
23. Synergon Holding PLC – Sofia (PETHL)
24. Holding Company Roads PLC – Sofia (HDPAT)
25. Toplivo AD – Sofia (TOPL)
26. Neochim PLC – Dimitrovgrad (NEOH)
27. Biovet PLC – Peshtera (BIOV)
28. Oil & Gas Exploration & Production AD – Sofia (GAZ)
29. Dominant Finance AD – Sofia (DOMIN)
30. Riviera Holiday Club – Varna (RIVR)
31. M+S Hydraulic – Kazanluk (MCH)
32. Euroterra Bulgaria JSC – Sofia (TERRA)
33. Moststroy PLC – Sofia (MOSTS)
34. Sopharma Properties REIT – Sofia (SFI)
35. Albena Invest Holding AD – Albena (ALBHL)
36. ODESSOS Shiprepair Yard S.A. – Varna (ODES)
37. Doverie - United Holding Plc – Sofia (DOVUHL)
38. SS Constantine And Helena Holding AD – Varna (SKELN)
39. Sofia-BT AD – Sofia (SOFBT)
40. Zlatni Piasaci PLC – Varna (ZLP)

4. General survey information

Figure 1 presents the percentage of companies surveyed that have a Bulgarian-language website, a website in English or both versions of website. Twenty seven of the companies (**67.5 %**) have both a Bulgarian and an English version of their website. Four companies have a website only in Bulgarian and three have only in English. Thus, the data suggests that most Bulgarian listed companies are aware of the importance of disclosing information on the company website.

Figure 1

Available Websites



4.1. Corporate governance

The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. Of particular relevance is the relation between corporate governance practices and the increasing international character of investment. International flows of capital enable companies to access financing from a much larger pool of investors.

Corporate governance is only a part of the larger economic context in which firms operate, that is a component of the CSR framework. The corporate governance outlines also depend on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and social interests of the communities in which a company operates can also have an impact on its reputation and its long-term success.

While a multiplicity of factors affect the governance and decisionmaking processes of companies, and are important to their long-term success, the current section is focused on the effective governance that is strongly connected with the separation of ownership and control. However, this is not simply an issue of the relationship between shareholders and management, no matter that it is indeed the central element. In some jurisdictions, governance issues also arise from the power of certain controlling shareholders over minority shareholders. In other countries, employees have important legal rights irrespective of their ownership rights.

The current "Corporate Governance" section of the inaugural survey provides some initial insights into the reporting of the forty largest listed Bulgarian companies on this issued. Broad generalizations can not be made, and there is no possibility to compare with previous periods. The survey analyzes the following five questions in the field of corporate governance, entitled as Component I, II, III, IV & V:

- **I Component:** *Does the company disclose details on its corporate governance structure?*

- **II Component:** *Does the company report in compliance with a Corporate Governance Code?*

- **III Component:** *Does the Company disclose audit relation information?*

- **IV Component:** *Does the company disclose its policy on shareholder rights?*

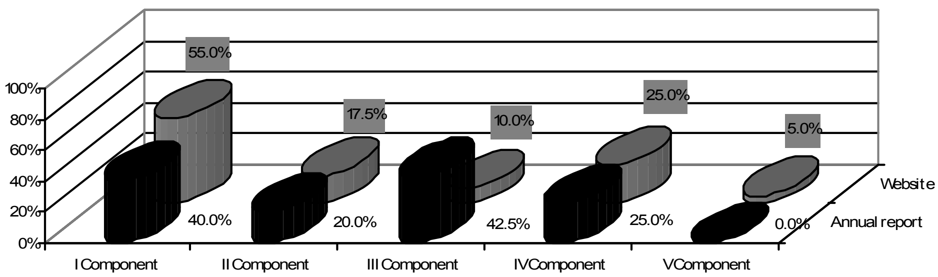
- **V Component:** *Does the company disclose and report on its internal Code of Business Conduct/ Code of Ethics?*

The two graphs below (See Figure 2 & Figure 3/I Component) show that the majority of the companies publish more information about their corporate governance structure on the Bulgarian/English website than in the Bulgarian/English annual report. The Bulgarian-language version of the website contains slightly more information than the English-language version. Furthermore the analysis show that annual reports available on-line in English present almost twice less information on the issue than the Bulgarian versions.

Figure 2 (Component II) shows that the highest number of the companies surveyed (**20%**) disclose in their annual reports in Bulgarian compliance with Corporate Governance Code.[7] Disclosures on the local language version of the website could be found in **17.5%** of the companies. The data presented in English (See Figure 3/II Component) reveals the following – **7.5%** of the companies report in the annual report, while **12.5%** disclose on the website.

Figure 2

Reporting on Corporate Governance in Bulgarian



A significant percentage of companies surveyed (**42.5%** in Bulgarian and **25%** in English) present in their annual reports a full audit report and the name of the institution that conducted the audit. (See Figure 2 & Figure 3/III Component.)

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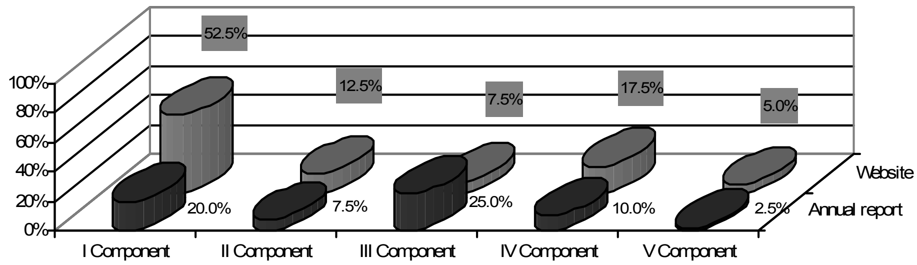
[7] The final version of the Corporate Governance Code was prepared and approbated by the Bulgarian Stock Exchange Sofia in July 2007

Figure 3

Reporting on Corporate Governance in English



Another important aspect of the corporate governance is the relationship among participants in the governance system. Controlling shareholders, which may be individuals, family holdings, bloc alliances, or other corporations acting through a holding company or cross shareholdings, can significantly influence corporate behaviour. As owners of equity, institutional investors are increasingly demanding a voice in corporate governance in most markets. Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management.

On the growing capital market in Bulgaria leading public companies realize the importance of comprehensive overview presenting the rights of their shareholders on-line. In this regard the survey shows that many companies publish this sort of information on their website or in the annual report in Bulgarian. However in the English version the research recognized more examples of disclosures on the website rather than in the annual report. (See Figure 2 & Figure 3/IV Component.)

Two companies disclose information about an internal code of business conduct on their websites in both English and Bulgarian, while one company reports only in the English version of the annual report. (See Figure 2 & Figure 3/V Component.)

4.2. Environmental policy

Bulgarian listed companies gradually pay more attention on the fact that the “responsibility”, as a part of CSR has relation not only to the environment inside of the companies, but to this one in which they operate.

In Bulgaria, the incorporation of the environmental policy in the companies’ management is comparatively a new practice. In spite of the low starting levels presented in the figures bellow, it must be said that in the forthcoming future there is room for serious improvement, especially having into consideration the fact that Bulgaria joined the EU at the beginning of the current calendar year. Improvement can be expected also if the positive experience of other countries from CEE in the past few years is taken into account.

As noted above, the data presented here does not allow broad generalizations. There is also no possibility to compare with previous periods, since this is an inaugural country survey.

The second section of the survey "*Reporting on Corporate Social Responsibility (CSR) by the Forty Largest Listed Companies in Bulgaria*" considers the following five questions:

- **I Component**: *Does the company state whether it complies with industry-specific, national and/or international regulations regarding environmental standards?*

- **II Component**: *Does the company disclose the names of individuals (management and/or board members) or the department responsible for environmental management and compliance?*

- **III Component**: *Does the Company report on energy and water use?*

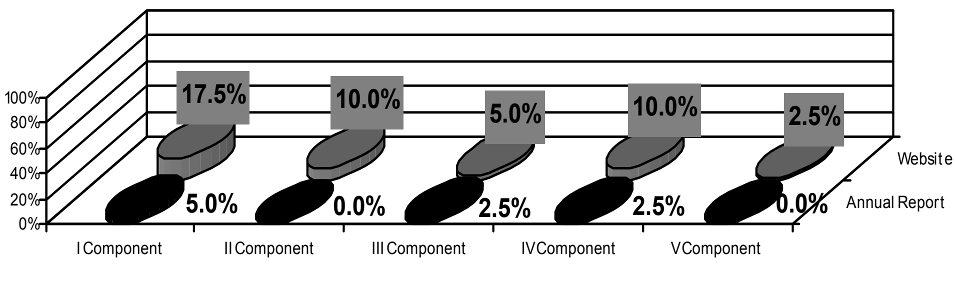
- **IV Component**: *Does the company report on its environmental performance, including efficient use of resources, emissions and waste?*

- **V Component**: *Does the company integrate environmental aspects into its supply chain management policy?*

As noted in the Figure 4 above, **17.5%** of the companies surveyed report on their website about compliance with industry-specific, national and/or international regulations regarding environmental standards (Component I) **10%** of the companies surveyed disclose on their websites the names of individuals (management and/or board members) or the department responsible for environmental management and report on their environmental performance, including efficient use of resources, emissions and waste. In general, more detailed information on environmental policy could be found out on the website.

Figure 4

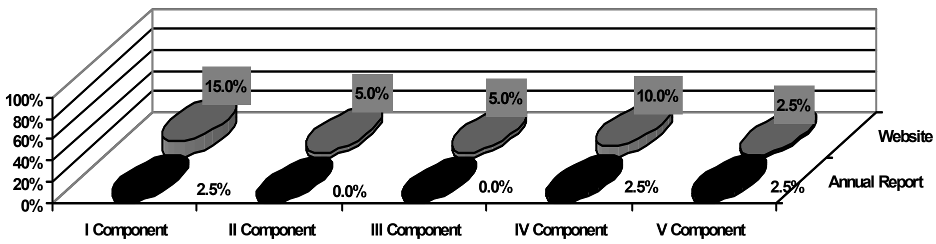
Reporting on Environmental Policy in English



A similar tendency to those of the previous chart (See Figure 4) is related to the difference between the information provided on the websites and respectively in the annual reports of the surveyed companies. The figure above (See Figure 5) illustrates that between **2.5%** and **15 %** of the companies surveyed disclose this data in the Bulgarian-language version of the website. In comparison, the annual reports present less data; between 0 and **2.5%** of the companies surveyed disclose this information in the annual report.

Figure 5

Reporting on Environmental Policy in Bulgarian



4.3. Social policy

In the increasingly globalised economy, the awareness of the Bulgarian business with regard to the social conditions of workers is constantly growing. In the past years, the leading companies in the state started to publicly manifest their interest and concern in issues related to investing in human capital, employment benefits policies and sponsorship programs. The business is currently strictly following various principles and guidelines in the areas of employment, training, working conditions, and industrial relations.

The following two figures (See Figure 6. and Figure 7.) present the practices of the 40 companies surveyed in reporting activities in the field of social policy, they are providing. The five considered components correspond to the below listed questions and their publishing on the companies' websites or as a part of their annual reports:

- **I Component:** *Does the company disclose compliance with industry-specific, national and/or international regulations regarding human rights and/or labor standards?*

- **II Component:** *Does the company report any community patronage/ sponsorship programs?*

- **III Component:** *Does the company disclose its employee development or employee benefits policies?*

- **IV Component:** *Does the company list its health and safety policy?*

- **V Component:** *Does the company disclose its employment policy?*

Figure 6 shows that the highest number among the surveyed companies report in Bulgarian on community patronage and/or sponsorship programs - **15%** of the companies disclose this information on the website, while **5%** report on this in the annual report. Fewer companies provide data on the website (**12.5%**) and in the annual report (**5%**) related to the employment policy. **7.5%** of the surveyed companies disclose information on the Bulgarian-language version of the website about compliance with specific national/international regulations and about employee development or employee benefits policies. Almost no companies report on their health and safety policy.

Figure 6

Reporting on Social Policy in Bulgarian

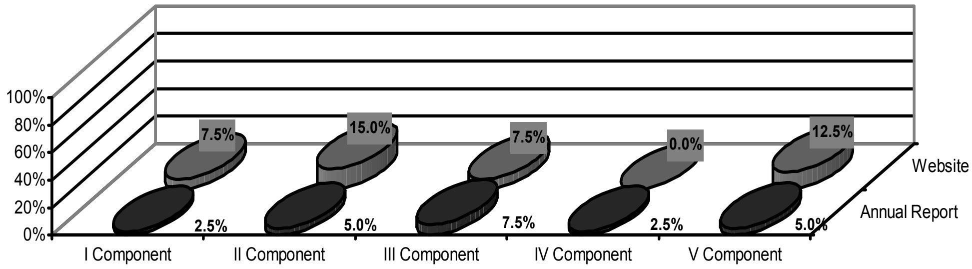
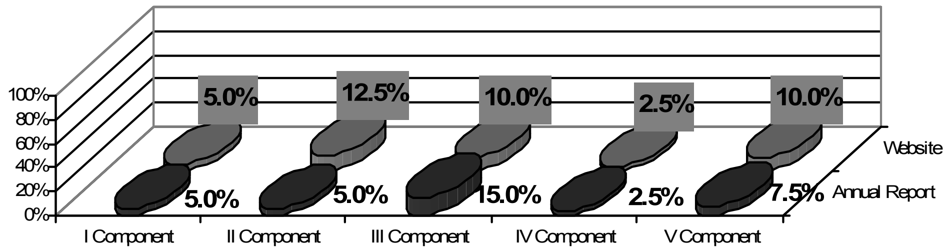


Figure 7

Reporting on Social Policy in English



In general, the company website provides more information than the respective annual report. Based on the generally low levels of disclosure, a general observation may be made that the overall level of reporting on social policy should be improved in the years to come.

A comparison between the reporting on social policy in English and Bulgarian shows a better disclosure of information in English, which may be explained with the ambition of the companies to present themselves in a positive light to their foreign partners. The provided data, however, reveal the same tendencies as described above.

5. Conclusions

Increasingly CSR becomes a competitive advantage for the companies in the process of searching for capital, customers and employees. This inaugural survey: "*Reporting on Corporate Social Responsibility (CSR) by the Forty Largest Listed Companies in Bulgaria*" analyzed the current disclosure practices of this peer group and presents current best practices. It allows each enterprise in the observed group to compare its CSR disclosing practices with the disclosures of the rest of the survey's peers and to draw conclusions on the essence of the companies' data and information provided in the Bulgarian/English annual reports and websites.

It is to be observed that the companies surveyed disclose more information on corporate governance than on environmental and social policy. This could be partially explained by companies familiarity with the corporate governance principles espoused by the Organization for Economic Cooperation and Development (OECD) and the many initiatives in the field conducted during the past decade. As a result of all of these, Bulgarian business understands the necessity of corporate governance disclosures.

Survey findings might be summarized as follows:

- <u>GENERAL</u>: **75%** of the companies surveyed disclose information in Bulgarian/English in at least one component of all three categories.

- <u>CORPORATE GOVERNANCE</u>: **72.5%** of the companies surveyed disclose information in at least one of the five different components of the "Corporate Governance" section in the Bulgarian/English annual report or website. Of these, **96.6%** report on the corporate governance structure; **68.9%** disclose audit related information and **55.2%** disclose information about company's policy on shareholder rights.

- <u>ENVIRONMENTAL POLICY</u>: **27.5%** of the companies surveyed disclose data (in the Bulgarian/English annual report or website) about at least one of the five questions of the "Environmental Policy" section. Of these (**72.7%**) report on compliance with industry specific, national/international regulations.

- <u>SOCIAL POLICY</u>: **42.5%** of the companies surveyed present information in at least one of the components of the "Social Policy" section in the Bulgarian/English annual report or website. Of these, **58.8%** disclose information about employee development and employee benefits policies whereas **41.1%** disclose information on community patronage/ sponsorship programs.

INTEGRATION POLICIES OF HUNGARY AND BULGARIA IN THE CONDITIONS OF EU MEMBERSHIP

Bilateral Meeting

27-28 October 2008, Sofia

Institute of Economics, Bulgarian Academy of Sciences (BAS)
Institute for World Economics, Hungarian Academy of Sciences (HAS)

ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES
ГОДИНА XVIII, 2009, 1

András Inotai[1]

THE GLOBAL FINANCIAL CRISIS AND ITS MACROECONOMIC IMPACT ON THE EUROPEAN UNION[2]

The financial crisis started in the United States spread over to Europe and, for the first time after 1945, it developed to an overall macroeconomic crisis in the entire developed world. Social and ideological consequences of the deep recession are expected to follow. The article focuses on the impacts of the crisis on the European Union, with special regard to the economic policy answers on nation-state and community levels. It is stressed that the unprecedented challenges represent both a high risk of stopping or fragmenting the integration process and, at the same time, a unique chance to deepen and upgrade the European integration, as a key player of the changing global economic (as well as political and institutional) system. The answers to be given in 2009 will fundamentally shape the future of Europe in general, and that of the European Union, in particular.
JEL: E60, F02, F15

The financial crisis that started to evolve in mid-2007 in the United States has already captured the world financial system in general, and the European Union, in particular. This crisis differs in several points from previous financial turbulences in various parts of the world we could witness in the last decades (mainly in Latin America, in the Far East and in Russia).

First, for the very first time the crisis definitely originates in the most developed country with the most sophisticated (deepest) financial structure of the world. Also its spread to other countries predominantly hit other developed economies, while developing countries generally characterized by a „shallower" financial system became, at least for the time being, less affected by the contagion (excepting stock exchange development that shows very similar features all over the world). Second, the crisis is not a special currency crisis, many times experienced in several, generally less developed countries in the past. In contrast, after a sharp decline, the US dollar representing the US economy and financial systems in serious trouble, started to appreciate against all currencies, particularly against the Euro (with an apparently stronger and healthier economic background).Third, and most importantly, the current crisis is literally a global one, reflecting the outstanding

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[2] This manuscript has been closed on December 09, 2008.

global character of international financial transactions.[3] In consequence, any turmoil appearing in one country's financial community is likely to spread immediately to other countries. For trust and confidence are basic elements of the financial sector, the loss of these features in one country's financial system rapidly generates the same impact in other countries, irrespective of the „health" of the financial system there. The fact that banks and financial institutions are globally intertwinned only underlines the speed of declining confidence not only in the US financial community but from Europe to East Asia, across all major financial centres as well. Either in institutional or in psychological terms, confidence and trust are indivisible in the current global framework.

This paper is structured in four parts. The first section deals with the origins of and lessons from the financial crisis in the United States. The second addresses its spread to Europe and the emergency actions taken both in the US and in the EU. The third section provides an overview over the macroeconomic impacts on the European integration, with likely consequences in the coming period. It concentrates on issues and policy areas that are expected to seriously challenge the current structure of the „European construction". In addition, some remarks on the new member countries, with special reference to Hungary, will be added. The final section concludes and puts forward some basic questions for the future global economic order.

1. Origins of and lessons from the financial crisis of the USA

The crisis of the financial sector of the USA reveals three features that became manifest within a very short time. First, an asset crisis emerged, once it turned out that the lion's share of the assets of the financial sector do not represent „real assets". Shortly after the „bubble" became evident, banks started to stop crediting each other. As a result, a supply-side or liquidity crisis developed. Finally, a general institutional and confidence crisis appeared.

The pre-crisis situation was characterized by liquidity abundance and very low interest rates, as a result of a deliberate policy of the Federal Reserve (FED) to revigorize growth in the American economy. Very low interest rates both enabled

[3] In the last decades of rapid globalization, all major production factors became part of this process. However, the speed and scope of „getting global" remained rather different. Trade in commodities could be substantially liberalized (in several groups of countries, and in many bilateral relations, free trade became the standard, with its most developed form in the European Union). Also trade in services experienced substantial liberalization, even if some obstacles have still remained (both between developed and developing countries as illustrated by the failure of the Doha Round of trade negotiations, and even within the EU committed to the full implementation of the „four freedoms"). Also technology flows became global, with a rapidly declining part of „non-transferable technology", due partly to comparative advantages and market domination by mainly large international firms, and partly as a result of international and bilateral agreements on restricting the free transfer of military technology. Much less progress was made in the free flow of labour across national boundaries, both due to factors on the side of the potential labour-exporting countries and to serious administrative restrictions applied by potential host countries. In contrast, capital flows became fully liberalized, without practically any restriction.

banks to lend money at favourable conditions, while abundant liquidity encouraged them to provide large sums of credits. On the other side, and not surprisingly, there was a huge demand for „cheap" money in the US society, since the savings rate, as expressed in GDP, was very low, but steadily increasing stock market indices (where most Americans used to deposit their savings) appeared to provide sufficient guarantee for the repayment of „cheap" credits.

However, the problem is rooted much deeper. It started with the dramatic decoupling between the amount of value produced by the „real economy" and the amount of money traded in the global financial system. Up to a certain degree such a „gap" is even desirable in order to smoothly finance international transactions. But the financial market started to become fully independent of real processes, so that much more money was created than the creditworthy demand would have been able to absorb it. In addition, banks developed a large number of new „financial products" without any clear origin of the money, let alone the the amount of bank deposits that could have guaranteed the solvency of the bank in case of non-repayment of the credits. As a result, „bundled credits" became to a large parte „toxic assets". The lack of international regulation encouraged the financial institutions even more to lend rapidly expanding liquidity to clients. In order to get rid of „surplus liquidity" (a large part of which was just „bubble"), not only low-interest credits were massively given. This could still have been understood looking at the very low interest rates established by the FED. What is less clear, is why credits were provided without any documentation (income of the credit taker, collaterals, etc.). Moreover, credits for construction (housing) were available covering the total costs, without requesting any co-financing of the credit taker.[4]

The behaviour on both sides (banks and credit-takers) was dominated by a short-term and short-sighted approach. Banks were confident that the liquidity would remain abundant and they would be able to finance credit-giving activities from the market over a long period, as it happened to work over more than a decade. Their privileged position was further strengthened by the continuous AAA assessment by all-mighty rating agencies. On the other side, credit-takers (consumers) started from two assumptions. First, that interest rates will remain low in the future, and second, that housing prices will keep on rising by 10 to 20 per cent a year, as it could be experienced in the last years. In this case, investment in housing at very low inerest rate offers a huge gain when the house will be sold in the future. Thus, demand for money to finance construction was much higher than real physical demand for a new (or a first) house. The housing market became the field of huge speculative investments that made itself largely independent of „real demand". Constantly increasing stock market prices added to this illusion. All in all, a „psychological bubble" developed and gave birth to an immense and unlimited process of „social infection".

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[4] Even more, several banks lent money at 120% of the housing costs, so that hundred thousands of citizens and families were able to finance extra holidays or durable consumer goods purchases from the credit taken.

To some extent, also the FED participated in the „bubble game”. Although several experts have been warning financial institutions, investors and consumers that the „heavenly” situation will not be continue for ever, and huge „bubbles” were already in the system that could explode any time, US macroeconomic indicators did not point to such a danger. Liquidity abundance should have resulted much earlier in accelerating inflation, a clear sign of overheating. However, inflation remained low, due to the rapidly increase of US imports from „cheap” countries, mainly China, but also other emerging economies (India, other Far Eastern countries, Latin America). As a result, cheap imports occupied larger and larger portion of the consumer basket and successfully compensated for higher prices of other commodities and services in the same basket.[5] Moreover, two basic items that could have call attention to relevant inflationary pressure are not included into the calculation of the consumer price index in the USA. Neither the rapid increase of housing prices nor the similarly important rise of shares on the stock market are represented in the consumer inflation index (the housing market is considered but not the price of selling the house but the price of renting, revealing the latter a much slower increase than the former).

The first signs of the looming financial crisis became obvious already in 2007. However, the difficult situation (including insolvency) of one (or some) US banks and financial institutions was considered as a special case, without affecting the whole system and to be managed in the form of „individual treatment”. Unfortunately, these „special cases” could not be separated from the entire system. First, the American (and the global) financial system is fundamentally interdependent that acts against „separate treatments”. Second, as already mentioned, trust and confidence are also global features that cannot be divided between „good” and „bad” banks. Thirdly, and most importantly, rather soon it became clear that it is not going about „special cases”, but just about the top of a huge iceberg that includes the whole global financial system.[6] In consequence, an unprecedented reaction (both in size and speed) occurred. Banks stopped financing each other and paralyzed inter-bank lending made a large number of banks suddenly bankrupt. Not less dramatic was the impact on credit-takers. As they were unable to pay the monthly instalment of the credit taken (partly due to higher interest rates, partly to the plummeting of stock market prices, and, as an antecedent of a deep crisis, as a result of losing their jobs), banks started to take houses back. However, the massive insolvency of house-keepers led to a collapse of the housing market, and prices were rapidly falling. As a result, the banks only could get back the assets incorporated in houses at a very low price. Moreover, these houses represent today a frozen asset, as they cannot be resold on the market.

[5] One of the main consequences can be identified in the rapidly deteriorating trade and current account balance of the US, with huge deficits that had to be financed by emitting US bonds that were mainly bought by Japan for a longer time, and by China more recently. On the positive side of the coin, US imports substantially contributed to higher global growth rates. A deeper analysis of these interdependent aspects, however, falls outside the topic of the current paper.

[6] Practically overnight it turned out that several US banks and financial institutions followed a bookkeeping correctly characterized by the statement of “nothing right to the left, nothing left to the right”.

The process is by far not finished, but some lessons can already be drawn. First: interest rates should not be kept for a long time at a very low level. Second: irresponsible crediting has to be stopped. Third: strict and transparent regulation has to be introduced without jeopardizing the global activities of financial institutions. In this context, both national regulation has to be improved and global rules have to be implemented, including a qualitative upgrading of cooperation among national financial supervisory authorities. Fourth: the re-rating of „omnipotent" international rating agencies cannot be avoided any more.[7]

2. The European Union and the financial crisis: from illusion to emergency policy steps

At the beginning, the European Union reacted with easiness to the unfolding American banking crisis. It was stressed that the crisis is due to the US subprime credits and the special features of the housing market (mortgage), as well as the consequence of low (or even negative) savings of the population with overwhelming reliance on the stock markets. Moreover, potential consequences for the European banking system were ruled out by emphasizing that the EU, very much in contrast to the US, did not accumulate huge current account deficits and enjoys good financial shape and strong macroeconomic growth potential able to keep adequate growth despite the declining US economy. In addition, it was pointed out that Europe's banks were prudent and had solid financial background. The simultaneously exploding Iceland bank affair was considered as a special case that nothing has to do with the European financial system.[8] Some weeks later, when the US crisis reached the banking system of the United Kingdom, the self-complacent „splended isolation" of the continent was even fostered by underlining that British banks are part of the Anglo-Saxon system that is fundamentally different from the structure of continental financial institutions. However, the contagion was already on its way to the Eurozone, not least to its most powerful economy, the German one.

The self-satisfaction of European banks and bankers was based on three erroneous assumptions. First, it was believed that it would be possible to separate „good" and „bad" banks in the period of globalization. European banks became global players in the last two decades, within a closely-knitted network dominated by American,

[7] In fact, rating agencies, with their highly irresponsible attitude, have substantially contributed to the creation of the „global financial bubble". The highest-level personal interlocking between rating agencies and financial institutions can also be blamed for the current situation. Interestingly, most analyses of the crisis still do not mention the very negative role of these agencies. (It is another topic, to what extent such „independent" agencies with their biased or fundamentally mistaken „ratings", have contributed to serious economic problems of individual countries.)

[8] In order to exploiting unique opportunities of globalization (and ignoring risks), three Icelandic banks started global operations with a total lending of 800 times the GDP of the country at the moment of collapse. Obviously, Iceland is not an EU member, even less belongs it to the Eurozone, but it should not be ignored that these activities were managed from Luxembourg, a central financial place of Europe. Also, interdependences due to the global character of financial markets, including links to the European financial community, should not be ignored.

European, Asian and Arab banks. American banks have been present in the European system at least from the end of World War Two, while European banks started to enhance their operations in the lucrative American market in the last decades. The European banking and financial system became absolutely global and, as such, the flagship of a supranational economic structure, probably one of the deepest chains of economic integration of Europe. Due to the global character of financial cooperation, different layers of intra-European and EU-USA linkages could not be either identified or (could have been) separated from each other. Second, once again the indivisibility of trust and confidence has to be underlined. Even without close American ties of the European banking system, the „psychological contagion" would have necessarily reached Europe. Third, and at a surprise of experts, it became clear that „toxic assets" are not a unique characteristic of the American banking system but can be abundantly found also in the European banking practice.

Thus, the moment of truth arrived in Europe. After some complaints and accusations (mainly by the German chancellor) addressed to the US, as the country that has to take full responsibility for the crisis, emergency measures had to be taken. Similar to the bailing-out of American (and British) banks by the governments (practically re-nationalization of leading banks by pioneering countries of private ownership and „free markets"), also continental European countries had to put together big packages and implement them urgently. Until October 2008, officially announced bailing-out actions amounted to USD 3,000 bn, or 20% more than the German GDP.[9] In the last weeks, the above sum substantially increased, since it became – finally – evident that it is not only the banks that have to be supported but also key sectors of the economy that started to suffer the chilly winds of serious economic decline (car industry, construction, small- and medium-sized companies).[10]

National bail-out attempts were accompanied by international efforts that, at least in the first and very critical period, remained inefficient. In order to revive inter-bank lending, huge amounts of money were pumped into the banking system. However, they landed in the safes of the banks as some kind of „last resort" but could not restore financial confidence. As another step, internationally coordinated reduction of interest rates was announced (excepting the already very low interest rate in Japan, but, for the first time, in cooperation with China that possesses the largest reserves in the world). In fact, international actions were taken in order to get or keep under control the global financial markets, but they did not provide meaningful support. Looking back to the last months, one can only guess whether these actions were too modest as compared to the size of the problem or they were taken too late when the crisis reached another (higher) level.

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[9] The US, after some Congressional opposition, started to implement a USD 700 bn project, while the United Kingdom made available Euro 384 bn, Germany Euro 480 bn, France Euro 460 bn. Also almost all smaller states of the EU had to take recourse to similar steps, from Belgium and the Netherlands over Austria to Switzerland with a financial system that historically had been considered as the strongest and the most prudent, therefore the least vulnerable.

[10] The US prepared a second project amounting to USD 800 bn, while, after some hesitation, also the European Union announced a Euro 200 bn plan of reviving the economy.

More success can be registered with national efforts, a clear contradiction to the global character of the financial crisis. Still, it seems more likely that, as a first step, confidence in the financial system can be attempted to be restored with more promise of success by national actions than by internationally coordinated projects (bottom-up approach). National bailing-out packages consist of three key elements. First, and with utmost urgency, banks in crisis have to be recapitalized with direct government intervention and affecting the national budget. Second, the government assumes full responsibility for managing the „toxic assets" by taking them out of the portfolio of the banks. Third, several countries announced a full-scale guarantee for private savings in (national) banks in order to prevent an atmosphere of panic and to appease citizens not to „storm" banks and take out their savings.[11]

It has to be underlined that the money financing bail-out actions is not necessarily fully lost or „disappeared". Obviously, the recapitalization of banks requires real money and its financial consequences will become fully visible in the budget of the given country. However, the loss of taking out „toxic assets" of the bank portfolios cannot yet be determined. The loss will be the difference between the price of bailing-out such assets and the price at which they can be resold on the market after a certain time. Most probably not all toxic assets are dead, however the rate of their depreciation may vary from country to country and even across time. Finally, the guaranteeing of private deposits can be considered more as a psychological appeasment than „real money" behind this element of the package.

Beyond the financial costs, the massive bailing-out initiatives have already had two crucial consequences, one global, and one European. In the global context, the philosophy and practical sustainability of the „neoliberal free market economy" became seriously questioned. Even more, it was discredited once pioneers of this philosophy and practice, as the United States and, shortly after the United Kingdom, decided that direct state interventionism cannot be avoided in order to save key banks of the system. Another implication, without any clear consequences for the time being, affects the European integration. Due to the urgency of the situation but also as a result of lacking community-level mechanisms, banks have been bailed out by interventions of the respective nation-states. Over decades, internationally active European banks were rightly considered as a key pillar of community-level or supranational development processes of the European integration. National governments could not influence the decision-making process of these banks. Now, with renationalization occurred, banks became subject to the economic and financial (or even social) priorities of the given national government. In other words, the national bureaucracy that lost control over the management of internationalized banks in the last two decades, could take revenge on the internationalized (globalized or even „Europenized") financial community. The consequences may be

[11] If such a situation happened, it would immediately turn out that the full guarantee of private deposits is another „bubble", since no bank and no country would be able to fulfill this promise. Private deposits in Western European banks amount to 5 to 6 times the aggregate GDP of the countries that made such a promise. This, certainly, would be the end of „modern economy".

far reaching, both within the evolving new power structure of the member states and, not less importantly, concerning the future of European integration.

However, the most relevant challenges originate in a different constellation. The financial crisis can just be considered as the first level of a global crisis. The evolving macroeconomic crisis represents the second level. Two other levels are likely to follow: a social crisis and a mentality and behaviour-related crisis with unknown (but frightening) consequences. In the first year of the financial crisis, practically no view was expressed on its connection with the future of macroeconomic development. Many experts considered it as a „pure" financial issue that would remain within the boundaries of the financial institutions. Only in the last months, policy-makers started to address the very serious macroeconomic implications. We are now at the threshold of a recession that would most hardly hit the developed countries in general, and the European Union, in particular. But this is not the end of the story. With deepening economic crisis, higher level of unemployment, growing uncertainty of entrepreneurship, widening budget deficit it is likely that social problems will be exacerbated. Finally, declining growth and living standard, hardship, social inequality, large-scale uncertainty about the future are a hotbed of demagogy, populism, nationalism and extremism. Each country, rich or poor, tends to produce populist and extremist politicians who promise big improvements without hard work, „light dreams" or omnipotent patterns of breaking out of the current negative growth spiral. These tendencies have to be strangulated and, as far as possible, eliminated already now, at the beginning of economic recession. Therefore, immediate crisis management and short-term anticyclical economic policies have to embrace social aspects and „ideological" considerations from the very beginning. If we fail to address the latter aspects, they will start their autonomous life and could not be reversed later, not even when economic growth restarts and business outlooks will be improving.[12]

3. Macroeconomic challenges for the European Union: new chances of integration from the crisis?

In its history of more than a half of century, the qualitative development (deepening) of the European integration was usually linked to crisis situations that were able to drive or just forced the member countries to develop new community-level policies by giving up part of their „holy" national sovereignty. The very birth of the integration was due to three pressures, two of them external ones: the threat perceived from the existence and growing influence of the Soviet Union, both in military, ideological, political but also to some extent socio-economic terms, the benign (or sometimes not so benign) pressure of the United States particularly in the first decade following World War Two, and the dramatic personal reminiscences of the war both on the side of the „winners" and of the „losers". Today, none of them exists any more. Still, external pressure did not stop in most periods of the European integration. However, they were either too mild to break through the status quo

[12] It has to be reminded that economic and social „cycles" do not overlap. In historical experience, social hardship culminates when the economy is already on the path of recovery. An even larger „time gap" exists between economic and „ideological" development cycles.

mentality or the unquestionable achievements of the „autonomous” integration process did not require additional external impacts for „quantitative progress”. In the last years, particularly around and after the historical enlargement of the Union from 15 to 27 member countries, the necessity of fundamental deepening of the EU became increasingly pressing. In fact, a number of factors, including the shifting core of economic growth, globalization and competitiveness, international terrorism, the new economic and security-related geography of Europe, rapidly growing migration waves, serious questions about the future of secure energy supply, environmental concerns, the possibility of channelling positive impacts of enlargement into new community-level policies, etc. started to push member countries and politicians of the integration towards more common actions. However, until most recently, these efforts were not able to substantially restart the engine of deepening of the integration.

Now, the global financial crisis and the emerging deep economic recession with its social (and partly ideological) implications appears to be the most important challenge. The European answers to this challenge will fundamentally shape the future of the integration. Today, returning to (or, better to say, sinking back into) renationalization by fragmenting even the achieved level of integration has at least as much chance as the seizing of the unique opportunity to achieve a qualitative breakthrough and, as a consequence, prepare the EU as a successful global player for tasks, opportunities and challenges of the 21st century.

The immediate answer to the banking crisis was definitely national. One member country after the other took measures in order to save its major banks, even if the latter were already highly globalized and only by names they remembered their „national origin”. More surprisingly, national actions characterized member countries of the Eurozone, having the same common currency. In this context, the birth failure of the Economic and Monetary Union, namely the discrepancy between a common monetary (exchange rate) policy and an unchanged framework of national fiscal policies became evident.

The same discrepancy was aggravated by the first macroeconomic answers to the rapidly worsening growth prospects and the unfolding reality of negative growth in the coming period.[13] Each country started to announce national plans how to minimize recessionary trends and counteract primarily negative impacts on the labour market. It turned out that the European integration did not dispose of a community-level economic policy in case of serious and across-member-country recession. This fact is best illustrated by the urgently outlined plan of mobilizing Euro 200 bn to reviving the EU economy by the European Commission. Obviously, the EU as integration does not have such an amount of money, for its always hotly debated common annual budget is about Euro 130 bn, or two-thirds of the sum

[13] International organizations (IMF, World Bank, OECD) and Eurostat started to change their growth forecasts to the worse within some weeks. In the summer of 2008, a downturn, but still with positive growth rates for 2009 and 2010 were predicted. In early autumn the figures were modified to zero growth, and in October to minus. However, most likely this is not yet the final stage. Key EU economies may experience a deep and long recessiion with negative growth rates of more than 2% in 2009 (and with highly uncertain outlook for the next period).

represented by the „recovery package”. The latter was tried to be sold (and communicated) as a genuine EU project, however, not less than Euro 170 bn are the adding-up of national figures expected to be released from the respective national budgets and not from EU financial sources. Euro 15 bn only is planned to be made available from the reserves of the common budget (non-paid or returned sums coming back from national governments) and another Euro 15 bn in the framework of the European Investment Bank (mainly for financing of small and medium-sized companies in the conditions of global economic storm).

It is another question, to what extent the urgently designed member country rescue (or recovery) plans can be integrated on the EU level. As a secondary step, but a consequence of the lack of adequate crisis management instruments on the community level, Brussels now tries to streamline national efforts in order to identify common priorities that should be financed from the national packages. Some key areas include the development of physical infrastructure, environmental projects (in principle, both expected to absorb part of the rapidly growing mass of unemployed persons), support to small and medium-sized firms, upgrading of selected issues of the Lisbon Strategy. For several reasons, more problematic seems to be the direct support promised to the car manufacturers, a core sector already started to be hit by the recession. On the one hand, it is not easy to differentiate between activities oriented towards future-oriented investments (structural change) and those aimed at just keeping jobs without any innovation. On the other hand, even more problematic is the connection between national state aid and the basic rules of community-level competition policies. The Commission has already raised a number of concerns about the implementation of member country „recovery plans” that seem to violate basic principles of free competition within the internal market, a basic pillar of the functioning of European integration.

Not less clear is the scope of member-country-driven plans on the level of integration. Not all member countries contribute to such a financial package, for about one-third of the members indicate serious budget deficits that constraints their ability to outline and implement recovery plans that would further deteriorate their budgetary situation. If, however, they do not contribute to the „common” package, will they be entitled to participate in the programs to be financed from this source? In addition, will member countries that are inclined to mobilize substantial resources from their national savings (or assuming higher budget deficits) be ready to share part of this sum with other members, or such financial resources will strictly be used to „national recovery”? If the latter happens, Brussels has to be satisfied with a „book-keeping position”, without any real intervention into the distribution of available resources. According to the current rules of the integration, the Commission does not have any right to collect national contributions and (re)distribute them according to community-level priorities. As a result, the danger of renationalization of European integration, and, in consequence, the fragmentation of the not yet fully functioning internal market, can hardly be considered to be prevented at the current stage of developments.

Beyond the accelerating negative growth path, the immediate impact of macroeconomic recession will become manifest in the labour market.

Unemployment will be growing, despite the potential mitigating impact of „recovery plans". The regulation of labour markets, however, belongs to the competence of member countries. Therefore, even if Brussels were authorized to conceive and implement community-level economic programs, it could not influence national labour market policies in a relevant way. What would be needed is not the creation of a common labour market (although one pillar of the four freedoms, namely the free flow of persons, points into this direction), but the substantial deregulation of national labour markets, as an open method of cooperation stipulated in the renewed edition of the Lisbon Strategy.

However, implications of the recession on the labour market do not end here. First, free circulation of labour between the EU-15 and the ten countries that joined in 2004 should be achieved in 2011, following a maximum seven-year transitional period (the same situation has to be reached by 2014 concerning Bulgaria and Romania that joined in 2007). It can already be predicted that the European labour market will be facing serious challenges just at this period (unemployment may reach its highest level just in 2011). Will, under such conditions, transitional measures be lifted by those countries that, until now, have resisted to open up their national labour markets? And how will those countries behave that liberalized intra-EU labour flows at times of positive growth but may enter an economic recession in the coming months? Second, increasing unemployment is likely to hit employees differently. Most vulnerable are those without strong political and social support, missing the counterbalancing power of trade unions and, in most cases, not having special skills. In this context, employees

in the construction industry, a major victim of recession, are in a particularly difficult situation. It is evident that workers that used to come to work in Western Europe from selected new member countries (mainly Poland, Bulgaria, Romania, but also Slovakia and the Baltics), will represent an above average share of newly unemployed people. Will they return to their home country, with contradictory impacts on the labour market (growing unemployment versus reducing the shortage of skilled workers, a growing problem in the last years in several „sending countries")? Not less importantly, and irrespective of the fact whether they will stay abroad (hoping for new job opportunities quickly) or whether they opt for returning, as unemployed people, they will not be able to transfer part of their income to the home country. This may not only affect family members that used to rely on remittances but also the macroeconomic balance of some countries. In the last years, remittances started to become one or just the most important revenue item in the current account balance (together with the inflow of foreign direct investments) that provided a large support to finance huge trade deficits and prevent the national economy from rapidly increasing external indebtedness and, finally, from insolvency.

Another impact of the crisis and of the already publicized „recovery plans" can be identified in the future development of national budget balances. The maximum 3% budget deficit defined as one of the key Maastricht criteria of qualifying for membership in the Eurozone is based on the assumption that member countries accumulate budget surplus (or at least have a balanced budget) during high growth periods. In this case, there is sufficient room for entering a budget deficit period during slow growth or even recession. However, if countries register budget deficit in „good" years, it is likely to be unable to keep the deficit within the Maastricht limit during recession. Excepting some Eurozone countries, budget deficits can be considered as the dominant feature already at the start of the recession. Moreover, the budget dieficit criterion did not consider the size of the negative impact of global financial crisis and unprecedented European (and American) recession. Thus, most probably several Eurozone (and EU) member countries will exceed the 3 per cent limit in 2009 and 2010 (or even for a longer period). This would be the result of recession exclusively. The budgetary impact of the bailing out of banks and of the „recovery plans" has to be considered as an additional deficit factor. As a result, some countries may be faced with huge budgetary deficits. Of course, there is a well-known instrument to reduce this deficit by starting to restructure the expenditure side of the budget. In most countries, such an exercise has been overdue for several years but, for obvious political and social reasons, no government dared to touch upon this issue. At least in principle, the current crisis offers a unique opportunity to break this deadlock and launch a coordinated EU-level plan of restructuring key items of the social welfare system(s) in the highly developed member countries. Obviously, budget deficits would drive countries into this direction. However, the decision depends on several factors. On the one hand, the „recovery plans" should be oriented towards future-oriented goals and sustainable competitiveness instead of keeping as much as possible of the status quo (protecting uncompetitive jobs and companies). On the other hand, this new approach would require the support (or at least the lack of open opposition) of the society accommodated to high-level social welfare in the last decade(s). If the EU wants to remain competitive and keep member countries together in a sustainable and successful framework of integration, a fundamental restructuring of the budgetary expenditures cannot be avoided. Of course, such a decision can be still delayed, but the status-quo-preserving approach would substantially delay the start out of the recession, it would prolong the recovery path and, at the end of the day, would force the member countries to similar steps but probably in a more difficult situation and without the „persuading pressure" of the current crisis, as well as the „perception maturity" of the societies.

Not only excessive budget deficits but largely diverging national instruments of „economic recovery" (see the obvious differences between the French and the German approach), as well as similarly different outcomes of the crisis on national level could seriously affect the future of the common currency. It has to be underlined that, until now, the Euro proved to be a solid currency in the first wave of global financial storms. After a period of strong appreciation against the US dollar (well above 1.50) that already threatened the export competitiveness of several Euroland economies, the dollar regained strength and the Euro-USD exchange rate stabilized at about 1.25-1.28.[14] The next challenge, however, is expected to come from inside of the Eurozone. Not only different and until now largely uncoordinated national „recovery plans", but also the coming export crunch will test the solidity of the monetary union. Exports, being one of or the main driving force of economic growth in the last decade(s) may seriously suffer from recession in the EU and the dramatic decline of global demand. Eurozone member countries may prove differently competitive in such an environment. In addition, differences in competitiveness had been accumulating over the last decade of the common currency, due to differences in real wage development and inflation rates across member countries. These differences will now become even sharper. Without a rebalancing (counterveiling) mechanism that is still missing in the Eurozone (e.g. some kind of compensation to the members with loss of competitiveness but deprived of the instrument of „independent" exchange rate policies), such a critical situation could result in the breaking up of probably the most important achievement of European integration in the last decade.[15] The establishment of an adequate mechanism would, however, need substantial financial resources to be channelled into the common budget and, not as the only but certainly a very powerful factor, it would give the necessary impetus to fundamental changes in the member countries' approach to the common budget and to essentially redraw the structure of the budget (increasing the national contribution from the current 1 per cent of GNI to a much higher level and changing the priorities of budgetary expenditures).

In addition, a more justified assessment ont he future of the monetary union can only be made after the current crisis will be over. The solid behaviour of the Euro until now is a promising sign, but the impact of the economic crisis and further turbulences in the international financial markets (mainly around the US dollar) can still substantially change the current evaluation. It has to be pointed out that despite the strong and solid position of the Euro, global confidence, as measured in the composition of international reserves, mainly remained with the US dollar.[16]

As most EU member countries have export-oriented economies, competition for external markets will be growing. The recession in (most) intra-EU markets will further strengthen the drive to extra-EU markets still with substantial growth

[14] The strengthening of the US dollar, despite the US crisis and the huge current account balance of this country, let alone the emerging and similarly huge budget deficit as a result of the bailing-out actions, needs a more detailed analysis. At first glance, it contradicts the basic and negative developments of the US economy. However, international political and economic factors (not least the Chinese attitude to the US debt and banking crisis), as well as psychological elements, a relevant determinant of the development of exchange rates and financial markets, have been, at least until now, able to counterbalance the adverse trends of the real economy in the USA.

[15] The United States, as a monetary union (plus, not less importantly, a political one) has such a mechanism of fiscal redistribution between mroe and less competitive States.

[16] In the last decade, the share of Euro in international reserves increased from about 20 to 28%. At the same time, the share of the US dollar lost about 6 to 8 percentage points (from near 70 to the current 60% level). Still, the difference between both leading currencies remains obvious.

potential. To be sure, growth will be declining from the previous high levels everywhere (from the new member countries through Russia, Ukraine, the Western Balkans to China and other Asian economies). Still, in most such markets growth rate will remain in the positive field (declines from 6 to 3 and in the case of China, from 11.5 to 8.5% have been anticipated). These markets will be definitely upgraded in the member countries' search for new export opportunities, and the most successful countries may be able to mitigate domestic and intra-EU recession by rapidly growing exports to other markets. Even more, because the difference between intra-EU and extra-EU growth rates will only moderately change, if at all. For instance, the pre-crisis growth difference between the Eurozone average and China was about 10 percentage points (1.5 versus 11.5%). There will be no meaningful change in the crisis period, by comparing minus 1.5 to 2% growth in Europe with plus 8 to 8.5% growth in China.

Of course, one very dangerous development, namely the contagion of trade protectionismm, as a result of economic recession and increasing social hardship and claim for protecting national markets and producers cannot be fully ruled out. This would generate additional problems and create a global negative spiral, even if the sustainability of the common trade policy of the EU were not seriously questioned.

More controversial seems to be the correlation between negative growth and continuous efforts to achieve the environmental (climate) goals of the EU set for 2020. At first sight, the priority of environmental goals clashes with the priority of growth. This conflict can be alleviated (even if not fully eliminated) in periods of relatively high growth and sustained global competitiveness (partly supported by rapidly increasing global demand). However, the conflict may be exacerbated in periods of negative growth (and constrained competitiveness). It would be good to believe that this „target conflict" can be solved and the EU (and the member countries) would not be forced to sacrifice, even temporarily, the priority of achieving the common environmental objectives, a key element of a sustainable world in the next decades and centuries. However, the policy and the main instruments leading to this goal in a critical period of serious recession are not yet clear.

Evidently, the current and deepening crisis will not leave unaffected companies, banks, the financial mechanism and credit activities as well as international capital flows, including direct investments. However, based on available statistics and experience, a more detailed analysis of these elements could not miss a large number of speculative considerations. Therefore, they will not be addressed. Similarly, the delayed potential inflationary impacts of the current crisis can only be identified in the next (may be, not too distant) period. However, at the moment the overwhelming fear in Europe is not inflation but recession accompanied by deflation.

Before finishing this chapter on some macroeconomic impacts of the financial crisis, two special remarks on the new member countries have to be made. One is related to their banking sector, the other to the export-oriented industries, both largely owned by foreign, and notably Western European banks and companies.

Transformation of the banking sector through massive participation of foreign banks is one of the most important changes in Central, Eastern and Southeastern Europe. Subsidiaries of foreign, mainly European banks became the dominant actor on the domestic financial market in the last decade. Most of them ranked among the most profitable subsidiaries worldwide.Their lending policy was less risky than in Western Europe, let alone in the United States, because credit-giving required collaterals and financing of apartment construction was accompanied by a substantial financial contribution of the credit-taker. At the same time, the share of consumer credits was rapidly rising, due to favourable conditions, abundant liquidity and the psychological (and partly economic) impact of catching-up of the citizens (sometimes beyond their own burden-taking capacity). With the financial crisis liquidity became short (or non-existent) and credits much less available.[17] The crisis in the headquarters automatically spread to the subsidiaries, irrespective of the structure of their financial products and of their profitability. However, the rescue actions were limited to the headquarters. Money made available to this purpose was strictly linked to domestic banks, and some politicians emphasized that taxpayer's money is not allowed to be used to bail-out subsidiaries. This, according to this view, should be the task of the governments of countries in which the respective subsidiaries have been located. To put it more bluntly: high profits of the subsidiaries could contribute, even if indirectly, to the taxpayers' income in recent years, buti t is forbidden to use German, Austrian or any other money to help out, in case of emergency, subsidiaries working abroad. Just the opposite, assets accumulated in profitable subsidiaries should be centralized and be used to improve the financial situation of the parent bank.[18]

At present, it is not yet clear how major transnational banks will behave. Their future competitiveness badly needs the profitable activities of their subsidiaries in the new EU member countries. However, the bailing-out of the parent banks that requires not only state support but also the centralization of assets available in their international banking network, may become a higher priority.

To some extent, a similar situation can be expected with the subsidiaries of transnational manufacturing companies, with special reference to the car industry. Declining demand and growing competition forces several companies to dismiss part of the employees and cut production volume. Several Western European car manufacturers have already applied for state subsidies, similar to the banking sector and against the basic competition laws of the European Union. In case they will get financial support, most probably it will be used for the survival of the parent company and for mitigating social problems arising from growing unemployment in the domestic economy. In this case, subsidiaries that in many cases are more

[17] Some experts argue that national financial authorities should have tightened the credit-giving activity of banks much earlier in order to avoid overspending of the population. In fact, the net outstanding debt of Hungary increased by Euro 10 bn in a year (from June 2007 to June 2008), and the increment was exclusively due to enterprise and consumer credits (government and national bank indebtedness did not changed at all).

[18] This happened to several banks in Hungary and the sudden selling of Hungarian bonds in order to increase the liquidity of the parent companies was one of the reasons of the financial crisis in the first half of October 2008.

profitable in the new member countries than in the old ones may be burdened with the largest part of the crisis. However, the final result would be the consolidation of (partly) outdated production structures and low level of profitability in the country of the parent company. Thus, after the crisis, these companies will hardly remain competitive. A burden-sharing ignoring competitive advantages within the subsidiary network would backfire and undermine the global competitiveness of the given company. It is not yet clear to what extent this consideration will be taken into account when relevant decisions for the future viability of big companies have to be made.

4. Concluding remarks

The financial crisis started in the United States not only reached Europe but gave rise to the deepest macroeconomic crisis of the developed world after World War Two. We have just entered the downward spiral of economic recession, with largely unknown consequences for the future of the European integration and of the individual member countries.

At the same time, the crisis offers a unique chance for the renewal of European integration and its fundamental deepening. As a result of the crisis, community-level policies should be elaborated and implemented, with special regard to the fiscal side of the economic and monetary union (including the future size and structure of the common budget). Also the decades-long work on the creation of a genuine internal market could be finalized (mainly in the field of financial services and energy). Obviously, the more federal structure of the integration requires substantial institutional reforms (more than contained in the current version of the Lisbon Treaty recently rejected in Ireland). However, the future of the European integration basically depends on the political and economic measures to be taken in the member countries and in Brussels facing the evolving economic crisis as well as its social and ideological repercussions in the next years (from the common migration policy over energy issues to the common foreign and security policy). On this development path, a clear definition of European identity and of the EU's mission in the rapidly changing world of the 21st century cannot be avoided or postponed any more. One can only hope that Europe and its nation-states will be able to cope with unprecedented challenges and Nietzsche's assessment formulated more than a century ago will become obsolete: „The time was ripe for Europe but Europe was not ripe for the time".

Finally, we should not forget that the current crisis raises some global questions far beyond European developments but requiring the active participation of the EU in the shaping of a post-crisis world.

First, the future of the international economic, and particularly, financial institutions is on the global agenda. Global capital flows need international regulation and supervision, without strangulating the free flow of capital, the most global factor of production. Beyond better regulation also shifts in economic and financial power have to be taken into account when international organizations will be restructured and transformed according to current and future requirements of the evolving new global order. Most importantly, largest international reserve holders (and savers) have to get an adequate place in the voting mechanism of key financial organizations (mainly China but also the energy-exporting countries).[19]

Second, the future role of the State has to be reconsidered. In the current crisis, failures and deficiencies originated in the neoliberal economic practice, had to be remedied in an unprecedented emergency manner by nation-states. Also the deepening of the economic (and later social) crisis may increase the desire and reliance of key economic actors and politicians on the „helping hand of Father State". Or, following the most important bailing-out activities, will nation-states willingly return to their previous non-interventionist role? Or will they be forced to do so by the more powerful global developments and actors?

Third, and finally, longer periods in economic history were usually characterized by a mainstream approach. Keynes and his econmic theory dominated several decades of the 20th century. As a response, neoliberal ideology became the leading economic practice in the last decade. As Keynesianism several decades ago, now neoliberalism is believed to be out of service, as a consequence of the global crisis. But will the crisis produce any new mainstream economic philosophy (and practice), or will we be living for a longer time in a period characterized by a mixture of different and rapidly changing approaches without any clear direction? Can we afford such a future in the century of globalization without catastrophic economic, social and ideological repercussions? The global financial and economic crisis has invalidated some key factors of the neoliberal ideology because it was not able to create the key regulators in and for a globalizing economy. Since, however, globalization will remain with us in all areas of our life, the only acceptable answer is not anti-globalization but better regulation and adequate international institutions accompanied by global dialogue between politicians, economic leaders and societies.

[19] It is more than paradoxical that China's voting share in the IMF is lower than that of the Benelux group.

ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES
ГОДИНА XVIII, 2009, 1

Garabed Minassian[1]

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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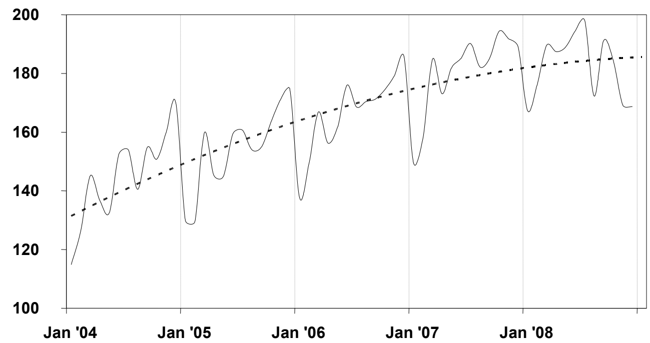
The monthly data about the industry sales can act as a barometer for the condition of the market and the market expectations. The sales index does not follow a smooth trend, but still it can be quite indicative (
Figure **1**). These sales possess a clearly outlined seasonal nature, typically with a 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.

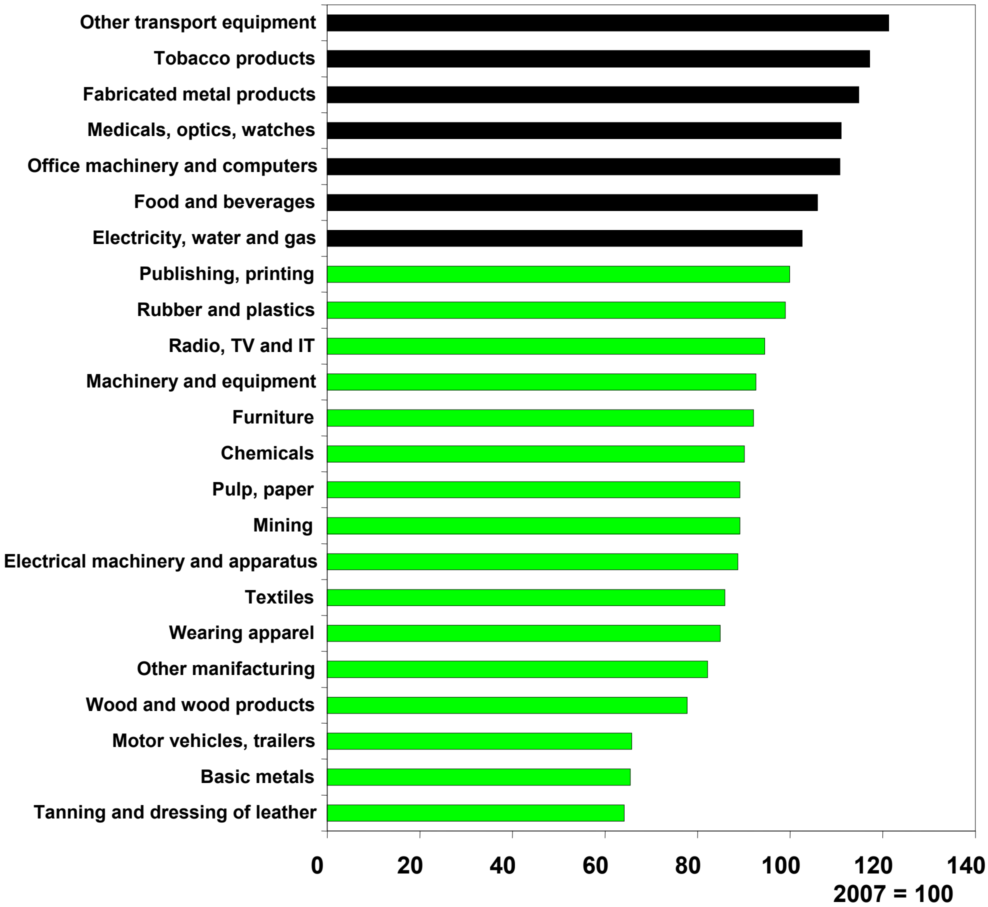
Industrial sales' indexes should not be overestimated. Their reliability is low and they are meant to give a preliminary (and simple) orientation about the nature of the processes taking place in industry. These indexes are based on the sample principle and therefore carry all the deficiencies of sample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

[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

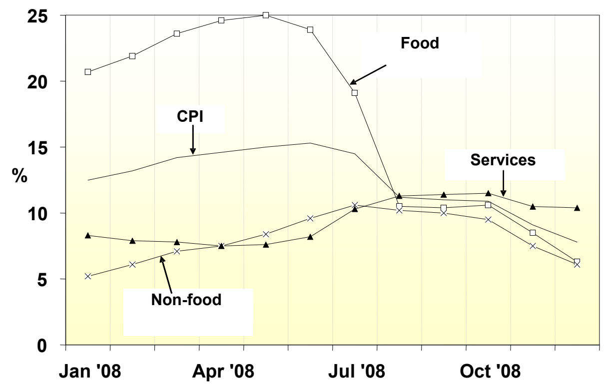


Developments in employment do not suggest any slump phenomena available. The registered unemployed in January 2008 were 273 000, dropped steadily to 215 000 in September and over the following three months leveled off at 232 000. The increase in registered unemployed at the end of the year could not 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

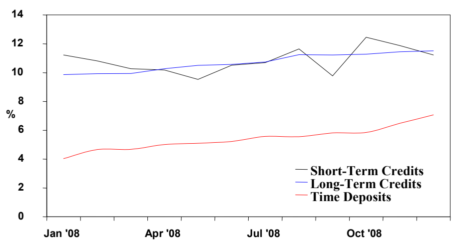
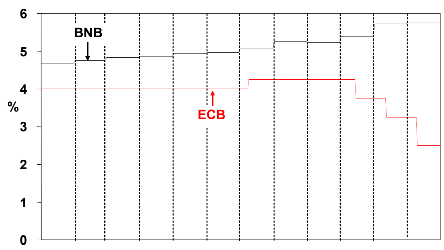


Figure 5
2008: ECB and BNB Interest Rates



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.

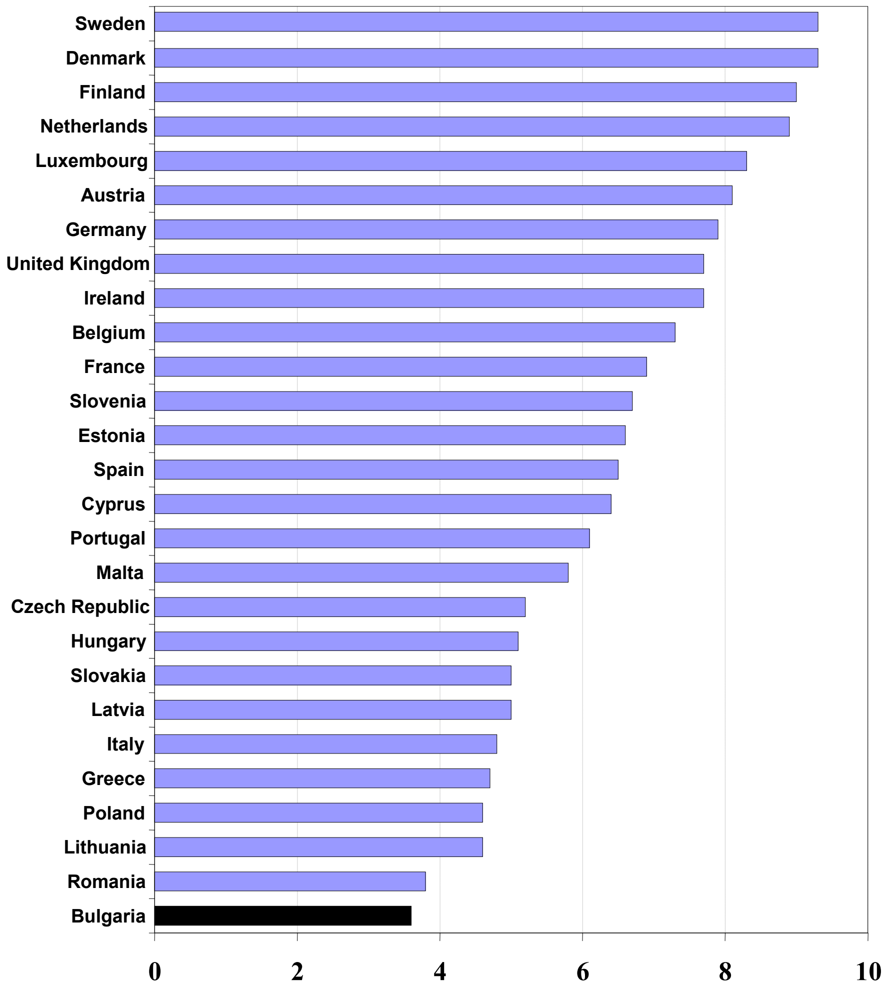
Macroeconomic management throughout the year has not been up to the modern requirements.

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]

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[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

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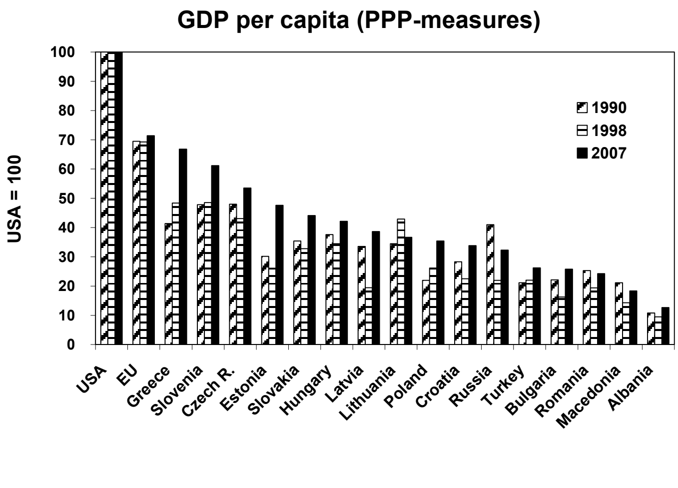
[5] Ivan Angelov, for example, admonishes that one should "*... remember the rule, proved by serious economic teaching a long time ago, that under a recession and depression aggressive stimulation is needed by using the tools of monetary and budget policies*", as well as that "*through additional direct 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).

ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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Ivanka Petkova[1]

ATTEMPTS OF THE EUROPEAN UNION TO CONTAIN THE FINANCIAL CRISIS

This paper centers on how after banks in mature economies worldwide failed to manage risk and allocating capital properly, both single national and joint efforts of the EU (with special focus on the Eurozone) were channeled to control the deepening financial crisis since September 2008.
The paper is analyzing the reasons for the financial crisis, simultaneously reviewing the discussions on the profound changes in the global financial system in recent years focusing on the excess capacities created in the system and their consequences (the more rapid growth in financial assets compared to the growth in global GDP, the new institutional structure, complexity in financial instruments, increased counterparty risks etc.). The evolvement of the crisis is presented.
The challenges to the implementation of the USA bail-out program as a response to the crisis are examined. Investigating the common and individual efforts in the EU to control the crisis the decisions of the emergency summit of euro zones nations, the national rescue plans of euro-zone and non-euro-zone countries are studied. The EU stimulus package is evaluated, creating a greater flexibility of Eurozone countries with the Stability and Growth Pact, showing the big differences in the fiscal stances of individual countries, their impact on the contributions to the plan, and the heterogeneity of measures to be applied. Special attention has been put on the recapitalization schemes, the issue on state aid and their long-term impact within the EU. The outcomes of the meeting of G20 are also considered. On the basis of the study main concluding remarks have been drawn.
JEL: E58, F02, G15, G28

Introduction

The 2007-2008 global financial crisis has thrown up several issues for discussion. As the credit crunch has evolved into one of the most economic downturns in history it turned also to a challenge to policy action both of individual countries and the European Union (EU).

At the beginning of October 2008 the European Commission (EC) recognized the gravity of the economic situation in the United States and affirmed his confidence, that the financial system of the European Union can cope and has the ability to respond (Press Releases, SPEECH/08/479, 2008).

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The first "truly European response" to the US financial crisis proposed by the EC, consisted of plans to strengthen the stability of the financial system across the Union. It envisaged amending the EU regulation on capital requirements for banks (Capital Requirements Directives 2006/48/EC and 2006/49/EC) (Press Release, IP/08/14333, 2008), refining the rules (including accounting rules) on evaluating complex assets; improving the deposit guarantee schemes; increasing the transparency of executive pay; and stressing the EU commitment to increase economic growth and employment rates (Press Releases, SPEECH/08/479, 2008).

This paper deals with the policy reactions towards the crisis, focusing mainly on the European Union's measures (both joint and those of individual member countries) to contain its negative economic implications.

1. Main causes of the crisis

The 2007-2008 global financial crisis reflects dramatic changes in the financial system in recent years and have stimulated an extensive literature on the main reasons and determinants for the brewing of the financial crisis.

Analyzing the causes and putting aside the current forms the crisis is taking, it becomes evident that there is a deeper reason bringing the global financial system into the current crisis. Some authors (Hummler, K. 2008b) suggest that the reason is the long lasting backing of the financial system by implicit state guarantees aimed at avoiding big institutions to fail. According to some assessments (Hummler, K. 2008b), as a result of such subventions overcapacities in the range of 30 to 50% were created or preserved in the financial sector. During the last months these overcapacities have started to be thrown away from the market through new shocks. It became clear that the problem does not stem from the US mortgage market only, but it is a global problem centered in the Western industrialized countries. Currently, this global problem is revealed in the unprecedented lost of trust among banking institutions (Hummler, K. 2008b).

Several problems were manifested as a result of maintaining of excess capacities in the financial sector.

First, the total value of the world's financial assets grew faster in 2006 at 17% to reach $167 trillion from $142 trillion in 2005. In 2006 the growth in global financial assets was "equity driven". The value of the world's equities went up by $9 trillion representing a 20% growth at constant exchange rates, accounting for nearly half the total increase in financial assets. The growth in financial assets outpaced the growth in global GDP. In 2006 world financial depth (ratio of financial assets to global GDP) increased by 350%. (McKinsey Fourth Annual Report, (2008) Even earlier, (end of 2003) foreign bank assets accounted for 130 percent of world GDP (Schertler, A., C. M. Buch and K. Carstensen, 2006). In 2006 cross-border capital flows grew to USD 8.2 trillion with the euro zone accounting half the growth. In the past decade USA, Euro zone and UK accounted for 80% of growth in global capital flows (McKinsey Fourth Annual Report, 2008). There are at least two considerations as regards such remarkable changes. The first one concerns the behavior of private recipients. Private recipients of capital inflows do not internalize the idea that: a) every capital inflow entails future outflows which could have impacts on the financial system as a whole and b) such outflows lead to a general macroeconomic tightening of liquidity in states of nature when international borrowing constraints are binding (such as during financial crisis). Second, the financial linkages created by these flows are a potential channel through which domestic shocks are transmitted between countries.

Second, the changes centered also in the institutional framework and kinds of activities of the financial system. In the past, financial distress was always a classical banking issue. Only a few decades ago, financial systems were primarily based banking institutions. The key reason for financial distress of such systems was a temporal mismatch between assets (long-term and illiquid) and liabilities (short-term and liquid at par). Thus, crises were frequently driven by (often sudden) losses in confidence in the system. The spreading out of bank runs was the main concern, and new lending tended to stop. These crises would typically take place after a phase of fast and somewhat loose growth in loan books (Fraga, A., 2008) Nowadays, in addition to banks, in the financial systems there are pension funds, endowments, hedge funds, private equity funds and other entities all playing important roles in the movement of capital flows. The big fear was of this new world getting hit by a shock and responding badly as positions are liquidated in disorderly fashion (Fraga, A., 2008).

Third, excess capacities in the global financial markets increased competition, boosted innovation and increased complexity in financial instruments. The intensive use of derivatives, securitization and other risk-transfer mechanisms, increased the complexity of the financial system. In the USA, credit derivatives contracts grew rapidly at a 100% compounded annual growth rate over 2003 to 2007 (OCC's Quarterly Report, 2008). Dealers increasingly used them to structure securities to help meet investor demand for higher yields. Credit default swaps represented the dominant product at 99% of all credit derivatives. It is to be mentioned that derivatives activity in the U.S. banking system is highly concentrated, dominated by a small group of large financial institutions. Five large commercial banks represented 97% of the total industry notional amount and 89% of industry net credit exposure estimations (OCC's Quarterly Report, 2008). Last few years nearly half of the growth in the commercial paper market was due to the expansion of mortgage related asset-backed commercial paper (ABCP) issuance. The issuance of ABCP at short maturities was used by conduits and structured investment vehicles (SIVs) to fund the purchases of collateralized debt obligations (CDOs) and other securitized assets. Within 10 years, the CDOs had become a major force in the derivatives market, in which the value of a derivative is "derived" from the value of other assets. Unlike some fairly straightforward derivatives such as options, calls and credit default swaps, CDOs are more complicated instruments. In a CDO, an investment bank collects a series of assets like high-yield junk bonds, mortgage-backed securities, credit-default swaps and other high-risk, high-yield products from the fixed-income market. The investment bank then creates a corporate structure (special purpose vehicle, SPV) to issue the CDOs and distribute the cash flows from those assets to investors in the CDO. As the ABCPs need to be rolled over periodically, it put pressure on banks' liquidity after mid 2007. It became evident, that the ABCP market has proved an unreliable source of liquidity to banks. Investors began avoiding the purchase of short-term paper in the capital markets and the ABCP issuance was sharply reduced. In September 2007, all types of asset-backed securities and CDOs suffered a sharp drop in the issuance (Stock Market Investors, Wealth Begins with Better Knowledge, 2008). Investors began to realize that these assets were much riskier than what they originally thought.

Fourth, counterparty risks have been covered by derivatives. The instrument of credit default swaps (CDSs) was extensively applied in order to cover counterparty risks. These instruments grew very fast since 2006:

Estimations on the OTC market in CDSs
(contracts outstanding worldwide)

December 2005	December 2006	June 2007	end of 2007	September 2008
\$13.9 trillion	\$28.9 trillion	\$42.6 trillion	\$45 trillion	\$58 trillion

Source: BIS, The New York Times, 17 Feb 2008, US SEC.

The insurance for covering default risk using credit default swaps (CDS) became very costly which further made asset backed securities issues more difficult to sell. With the help of these instruments risks were no doubt better distributed, with assets and liabilities better matched and risk factors being decomposed and allocated to those more capable of bearing them. However, at the same time, the ability to detect trouble places has diminished. Most importantly, the main problem with securitization stemming from the fact that it does not provide protection against systematic risk, was neglected. The crisis has shown that banks can not rely on commercial paper for ever to fund structured investment vehicles (SIVs). Banks are not going to accept vehicles with a 20% line of liquidity now. Investors need 100% funding, but no bank is going to offer during the crisis.

As a result of innovation and raising complexity of financial products it became more difficult for regulators and supervisors to make a critical distinction between financial products. This distinction is to be not whether the products promise different types of returns, but how the “delivery failure” impacts upon the survival of the institution (Davis, K., 2000).

Fifth, in an environment of a high demand on assets (because of access liquidity on the market in recent years) many new products were very hard to price (CDOs, CMOs, SPVs and other such instruments and entities). There is a lot of historical experience on how asset prices, in particular residential property prices, can provide a crucial link through which adverse macroeconomic developments can cause financial instability. Episodes of asset price booms are seen by many as raising the risk of a future sharp “correction” of prices, which could have immediate repercussions on the stability of financial institutions. Indeed, many observers have argued that property-price collapses have historically played an important role in episodes of financial instability at the level of individual financial institutions

(Assenmacher-Wesche, K., S. Gerlach, 2008). It became evident, that traditional asset pricing theory fails to take into account the impact of principal-agent problems in even very liquid markets, having been developed in the 1950s and the 1960s when the US equity market was owned largely by individuals.

Sixths, this market feature was accompanied by a less (and less effective) supervision than in the past and almost no room for coordinated action of supervisory authorities. Many of the institutions and markets now under stress are not subject to prudential oversight. It became apparent, that worldwide CDSs market was "completely lacking in transparency and completely unregulated" (Cox, Ch., 2008). Unregulated financial institutions fall into collective misjudgment of risks. They were simply not forced to manage risk exposure on mortgage-backed securities and related financial instruments well and, as a result, have struggled with losses and write-downs. More importantly, it is recommended the equity ratio regulation within the framework of Basel II, which permits banks nominal reductions in required equity for liquid balance sheets positions to be revised (Hummer, K., 2008a). Fare before the crisis emerged academic circles pointed out, that statistical models for forecasting risks (on which Basel II is based) have been proven to give inconsistent and biased forecasts, notably underestimating the joint downside risk of different assets. The Basel Committee has chosen poor quality measures of risk when better risk measures are available (Danielsson, J. a. o., 2001).

2. Evolvement of the crisis

Since mid 2007 central bankers drew the attention of market participants to the crucial role of large asset price in creating conditions for financial crisis. The market turned to a new-style financial flight from risk-taking, and trigger sales of assets started to emphasize price movements. As expected, often market liquidity that participants need to manage portfolio risk dried up, and the correlations among asset prices that went into calculations of risk management strategies shifted in unexpected ways that increased vulnerability (Kohn, D. L., 2007). Central bank's room for maneuver was also severely restricted.

Remarkable signs of the global financial crisis began with financial market events dating from July, 2007. The actual crisis evolved with failures of large financial institutions in the United States in March 2008. The credit crisis that began in the United States with the sub-prime mortgage crisis has affected Europe and the Asia/Pacific region.

The crisis quickly evolved into a global crisis. The global financial crisis of 2007-2008 became more and more evident expanding into a global economic crisis of 2008, as all major sectors of the global economy are affected. In recent time, some researchers are speaking about a disruption of the system of international payments pointing out that the system of Letters of Credit as well as international shipping, which constitute the lifeline of the international trading system, are potentially in jeopardy (Chossudovsky, M., 2008)

Before the crisis it was typical for financial institution (or individual investors) to borrow in order to invest more, using the effects of leveraging. As it came out, by using credits in order to invest the respective institution could potentially earn more from its investment, but it could also lose more than all it has. Therefore leverage magnified the potential returns from investment, but also created a risk of bankruptcy. More and more institutions failed to honor all their promised payments to others, which spilled over financial troubles from one financial institution to another. The average degree of leverage increased prior to the financial crisis. The crisis has led to a liquidity problem and the de-leveraging of financial institutions especially in the United States and Europe, which further accelerated the liquidity crisis. The credit crisis has made funding a problem.

In the EU the financial crisis resulted in a number of European bank failures and declines in various stock indexes, and large reductions in the market value of equities. Many banks in the EU countries had to be rescued. Great Britain announced a plan of nationalization of mortgage lender Bradford & Bingley Plc. Banking. Simultaneously, the Dutch-Belgian banking and insurance group Fortis was prevented from bankruptcy as the governments of Belgium, the Netherlands and Luxembourg agreed to invest a total of11.2 billion euros in return for a minority stake in the group. End of September, 2008 the British Prime Minister Gordon Brown announced that his government will do "whatever it takes "to protect people's savings in the face of the ongoing global financial crisis." On 1st October Belgium, France and Luxembourg rushed to provide nearly 6.4 billion euros to save Franco-Belgian bank Dexia, the latest victim of the global credit crunch in Europe.

Investors reacted with apprehension to uncoordinated efforts by regulators in the EU and continued bank failures. Credit tightening has begun to affect businesses and consumers, slowing the growth rate of economies worldwide and tipping some of them into outright recession. The crisis contagion occurred in October 2008, when a systemic and simultaneous breakdown of money and bank markets leads to generalized risk aversion and the shedding of all assets that fail to carry public guarantees (Reisen, H., 2008).

3. The USA response to the crisis

The crisis became notably evident in September 2008 with the failure, merger or government protection of several large United States-based financial institutions. The US financial sector has seen huge turmoil in September, 2008, with Lehman Brothers folding and Merrill Lynch being bought by Bank of America. Morgan Stanley and Goldman Sachs (for decades independent investment banking firms) requested to change their status that will see them regulated by the Fed. The move, which means they will expand into the commercial banking sector, arguably marked an end of an era on Wall Street.

Thus the crisis posed new challenges to central bankers and policy makers taking them well beyond the national framework they used to address previous crisis. The kind the crisis was evolving complicated efforts to respond to. Nowadays, financial systems are no longer predominantly bank-based. In the past the response to banking crises almost always included as its key component a cut in interest rates by the central bank, and could also include direct lending by the central bank (acting as a lender of last resort) as well as emergency mergers and acquisitions (to support weak lenders) and concerted lending (to support weak borrowers). Underlying these actions stood a deep concern to keep the payment system functioning.

Bail-outs are not new and there are plenty of examples of successful and unsuccessful bail-outs, both inside and outside the financial sector. At the end of September, 2008 a bank bailout has been proposed under the so-called Troubled Asset Relief Program (TARP) of the US Treasury. Capital infusions or other relief were rather included under the $700 billion bailout plan. The plan aimed to restore confidence by moving the most troubled assets off the balance sheets of banks into the TARP. By removing uncertainty about impending mortgage-related losses the program was expected to pave the way for banks to keep lending and get new infusions of private capital (Paulson, H.(2008). As the plan foresaw reimbursement by financial companies to the government, this effectively means that this plan does not envisage recapitalisation of the banking sector.

One of the big challenges to the program was how to find prices for the assets it wants to buy. It has to pay a high enough price that banks come forward to sell them. But overpaying imposes high costs on the taxpayer. In addition, the assets are complex, which makes a fair price hard to determine. According to the Treasury, the program will pursue "reverse auctions" in which sellers provide offer prices for the securities.

Some bond experts are optimistic that the Treasury's plan will not only ease financial stress but also make a profit for taxpayers (Trumbull, M., 2008). Other observers stress that the "bailout" contributes to a further process of destabilization of the financial architecture. It transfers large amounts of public money, at taxpayers expense, into the hands of private financiers. It leads to a spiraling public debt and an unprecedented centralization of banking power (Chossudovsky, M., 2008)

The Group of Seven (G7) welcomed the US move and reaffirmed its strong commitment to "protect the integrity of the international financial system".

4. The common and individual efforts in the EU

The reluctance of banks to lend out their money was at the center of the current financial crisis, which started to plunge European economies into recession. In the first part of October, 2008, money markets have ground to a halt because banks have been refusing to lend each other money. The European Central Bank, the Fed, the Bank of Japan and other central banks made cash injections into the system.

Liquidity problems and capital injections became key to containing the crisis. The rescue measures started outside of the Euro-system. The four largest UK banks (HBOS, Royal Bank of Scotland, Lloyds TSB and Barclays) asked for a combined

$60.5bn support. The unprecedented move made the UK government the biggest shareholder in two banks, HBOS and Royal Bank of Scotland. An UK €630 billion plan was created to part-nationalize the country's banking sector by buying preference shares in banks, to invest in short-term loans and to guarantee loans between banks. After announcing the plan the UK Prime Minister Gordon Brown wrote to EU leaders encouraging the creation of a "Europe-wide funding plan" to tackle the worsening financial crisis. He added that a "concerted international approach" was needed. Simultaneously, the German Hypo Real Estate, Europe's largest mortgage bank, received a last minute credit facility.

Actually, the UK government, together with other national governments, has rushed to bail-out banks without first getting the confirmation from EU regulators. Only on 8 October, 2008 alone, five EU member states, Britain, France, Italy, Spain and Austria announced measures or the intention to give state support to national banking sectors.

4.1. Emergency summit of euro zones nations (12 October 2008)

A summit meeting of the leaders of the 15 member countries of the Eurozone was held (on 12 October 2008) in Paris. The meeting has been attended by the Presidents of the European Commission and the European Central Bank. The Paris meeting was arranged by French President Nicolas Sarkozy after a financial summit by the Group of Seven leading industrial nations in Washington that promised to do whatever was needed to unfreeze credit markets. Britain's Prime Minister Brown also attended the meeting, but was not involved in formal decision-making (because his country is not member of the Euro-zone).

At the summit the following has been agreed: a) no major financial institution to be allowed to collapse; b) a pledge to guarantee new bank debt issuance on a temporary basis, until the end of 2009; c) loans between banks in the inter-bank market to be State guaranteed; d) to inject capital to unfreeze money markets and restore confidence in the financial system. The European Central Bank took the responsibility to create an unsecured lending facility to buy commercial paper from banks, similar to the move by the US Federal Reserve at the beginning of October 2008 providing, in effect, guaranteed funding for banks.

At the core of the decision package on the summit were the consensus governments to be allowed to support banks by buying preferred shares, and the commitment to recapitalize any "systemically" critical banks in distress. Leaders of the Euro-zone countries pledged to help or directly subscribe to debt-raising by banks for periods of up to five years. Actually, the participants in the meeting agreed to follow the main points of a plan launched by British Prime Minister Gordon Brown a week before the meeting to buy up big stakes in troubled banks, and to guarantee inter-bank lending.

The aim was to take the pressure off the blocked inter-bank money market and also off bank balance sheets in trouble and to restore confidence in the financial system. This agreement showed the unpreparedness of the Eurozone for financial crisis.

Desperate, European governments have pledged about two trillion euros to prop up troubled banks and underwrite loans between financial players. The lesson from the events and the process to come to a joint response in the EU was that banking crisis of that magnitude require quick political agreements, as those of the US. This political agreement was postponed because the misjudgment of the crisis. The Eurozone countries estimated the crisis to be only an US financial crisis. After the US investment bank Lehman Brothers went bankrupt high officials of Germany judged the resulting global financial turbulence to have limited impact on Germany. The losses to be suffered by the German financial sector were described as "bearableHigh German officials pointed out that although the United States was experiencing its worst financial crisis in decades, it would not likely trigger a domino effect in Europe-especially not in Germany." (Kucharz, Ch., 2008). French officials also expected the crisis would have limited impact on the French financial sector. This excessive optimism prevented European countries from taking early action against potential financial turmoil at home.

On 23 December 2008 the European Union approved bank rescue measures for many of the EU member countries, clearing the way for cash injections and loan guarantees expected to help lenders through the financial crisis.

4.2. National rescue plans of euro-zone and non-euro-zone countries

After the summit individual countries (Germany, France, Britain, Italy) prepared plans for recapitalization of their principal banks. The EU Directorate on Competition Policies approved bank rescue measures for Germany, Britain, Spain and Italy. The sanction came after the EC revised its rules for approving state bailouts of banks after a pressure from member states for holding up vital rescues. The EC had to be assured that competition would not be distorted as a result of the bailouts.

The German government unveiled a €500 billion rescue plan to shore up the banking system. It included a €400 billion financial market stabilization fund to guarantee loans and €80 billion to recapitalize the banking sector through the government taking stakes in banks. An additional sum of €20 billion was also foreseen as a provision to cover losses. As a result of the rescue package, the German government abandoned its plan to balance the federal budget by 2011. France and other euro zone countries announced similar bailout plans to halt the crisis. The EC expected the German_government to present its proposed bank rescue plans, which should pave the way for EU approval of a massive injection of state capital into Commerzbank. Germany was in conflict with the EC for going too slow in considering whether or not to approve the aid to Commerzbank. In Germany, the EU approved a guarantee package for the NordLB regional bank to cover its midterm refinancing needs.

In early December 2008 the European Commission approved a French plan to rescue its embattled banks. The French government has offered up to 40 billion euros to banks, with 10.5 billion euros already set aside for the country's six biggest banks. France had to tighten the terms under which banks must pay back aid. Details of the agreement with France showed a compromise over the terms of the support. The EC required the repayment rate to be fixed for the first five years and variable after that. The remuneration, which will average about 8 percent, will reflect the degree of solvency of each beneficiary bank. Eight percent was in line with the rate sought by France. In return, France offered improved incentives for the early repayment of state capital and extra safeguards to ensure that bank lending went to the real economy.

Italy decided to shore up the country's financial system in October, 2008. Italy passed a decree supporting the country's banks through a part-nationalization, although no explicit amount of funds has been mentioned. Cash will be offered to banks in exchange for non-voting preference shares in the institutions. The move however, did not amount to a rescue fund, and, as in France, banks would be offered the money on a case-by-case basis. The Italian government also guaranteed deposits up to €103,000. End of December, the Italian authorities won permission from the EC for an aid package for their banks. EC officials underlined that the scheme was in line with EU guidance on state aid to overcome the financial crisis. This means the program is limited in time and scope while, interest paid to the state is priced according to market. There are also incentives for the banks to redeem the state participation over time. The measures allow Italy to subscribe subordinated debt instruments, which will be counted as bank core tier 1 capital, (a standard of capital held against risky assets). The scheme's budget will be up to €20 billion and only fundamentally sound banks are eligible. Capital endowment for the banks is to be within 2% of their weighted assets and in principle within a level of 8% of tier 1 capital. The banks taking advantage of the program will also have caps on dividends, management pay and an ethical code. The Bank of Italy will monitor how the banks' new funds will be put to use to sustain lending to the real economy. Italy will have to report to the Commission every sixth month on how the scheme functions.

The Austrian measures offer financial support in the amount of €100 billion, of which €75 billion is provided in the form of guarantees to support the interbank market, €15 billion is available for direct recapitalization measures of individual banks and €10 billion is reserved to secure the abolishment of the prior limitation of guaranteed bank deposits of natural persons as well as raising the amount of guaranteed deposits of SMEs. The Austrian Federal Minister of Finance is empowered to provide guarantees to a special purpose vehicle which will be set up and work as a "clearing institute". This clearing institute will, in its own name and for its own account, borrow financial funds via the interbank market from credit institutions and insurance companies and lend financial funds via the interbank market to other credit institutions and insurance companies against payment in line with the market. The company can be owned only by credit institutions, insurance companies or various industrial associations of corporations that act as legal representatives of such companies.

Spain's economy has stumbled badly in 2008, due largely to a collapse in its key construction industry and tighter credit policies at banks. In October, the Spanish government said it would guarantee up to euro100 billion in bank bond issuance in

2008. The E C approved the scheme considering it to be nondiscriminatory and limited in time.

In November, the Latvian government was forced to nationalize Parex Bank – the country's second-largest financial institution in terms of assets – after the bank ran out of cash. The government bought a 51 percent stake in Parex and then injected some 200 million lats (euro280 million, $390 million) into the bank to keep it afloat. Latvia prepared a state plan to stabilize its banking markets.

For Great Britain the EC approved the latest modifications to a British scheme, which had already obtained EU backing.

Denmark (a non-euro-zone country) announced a bank support plan aimed at allaying the credit crunch after some banks were finding it almost impossible to obtain new financing because of the turmoil on international markets. Denmark, however was not considering any move to nationalize financial institutions.

It is clear, that (except for Denmark) de-leveraging (to take equity in order to substitute debt) is in the heard of the plans of individual countries. On this way plans are threatening not the reason for the emerging of the problem, but the outcome of the problem, which lies in the breaking of the credit creation value chain. (Rona, P., 2008). In addition, using public equity to de-leverage financial institutions creates new problems centered on the role of the state and state aid within the EU.

4.3. EU stimulus package and the meeting of G20

It was important to find an adequate way to avoid distortion within the single market that could give rise to unilateral action leading to a spiral of protectionism. In mid October, 2008 the EC adopted guidance to specify how it will apply EC Treaty state aid rules to state support schemes and individual assistance for financial institutions in the current crisis. The EC has adopted more than 20 decisions in order to contribute to quickly restore confidence in the market (Kroes, N., 2008). The EC approved three basic schemes to help restore confidence in credit markets: guarantee schemes (to be applied in Denmark, Finland, Portugal, Ireland, the Netherlands, Sweden, France and Italy); asset purchase schemes (for Estonia) and holistic schemes with all of the above (for Germany, United Kingdom and Greece).

Special attention has been put on how to design recapitalization schemes. First, the core issue concerned the reason for fundamentally sound banks to receive state capital. One of the explanations of the EC was to prevent de-leveraging of such banks in order for them to start lending to the rest of the economy. Second, at the same time distortions of competition had to be avoided, and national approaches had to be coordinated. Third, in addition, the EC had to assure, that the recapitalization provided by the state will not become a permanent feature of the financial institutions within the EU. The recapitalization had on one side to provide effective means of strengthening confidence in the markets and, on the other hand to bring banks to financing the real economy in a period of crisis.

In practice it became soon evident, that incurring into pressure from EU governments, the EC compromised the strict EU aid rules. The Directorate General for Competition had to make the bailout rules more flexible. A major point of contention was the rate at which fundamentally healthy banks would pay for any state aid. The EC required banks to pay a risk premium for the state aid based on their health rather than a fixed rate for all. So, state capital injections should be priced at central bank base rates plus a premium reflecting the level of risk of each case.

In November, 2008 the countries of the 15-member euro zone officially entered a recession, recording a 0.2% decline in GDP for the second quarter in a row. For this reason on EU heads of state and government agreed on the necessity to "look beyond the financial crisis" and take measures to address the worsening economic situation. The EC was mandated to submit proposals in that direction (ahead of the EU summit on 11-12 December). The plan proposed a fiscal stimulus of around 1.5% of EU GDP or €200 billion, higher than the €130 billion that had been floated earlier. The idea was most of the funds to be drawn from national budgets, with EU countries asked to contribute €170 billion or 1.2% of the EU's GDP. The rest – around €30 billion or 0.3% of GDP – would come from the EU's own budget and the European Investment Bank (EIB).

The plan was aimed at boosting consumer confidence and stimulating spending. It included at least five billion euros to help the car industry develop green technologies and a total of euro 2.2 bn to improve the energy efficiency of homes and factories. Aid prepared to small and medium sized businesses over the next two years increased from 10 to 30 billion euros. Easier access to 1.8bn euros worth of EU funding for job training would be ensured. The bigger part of the package would be implemented in 2009, while some measures would continue into 2010.

EU countries were invited to draw from a "toolbox" that includes measures already adopted by some governments. Some countries have already announced fiscal stimulus plans, including Germany and the UK that will be taken into account in the EU plan.

Measures listed in the EU's 'toolbox' include:

- Increased support for the unemployed and the poorest households, which have been hit hardest by the economic slowdown;

- Funding large infrastructure projects such as energy networks and broadband internet;

- Temporary VAT cuts across the whole economy, similar to the one adopted in the UK, and;

- Lowering taxes on labour, in particular VAT on 'labour-intensive' sectors such as hairdressers and restaurants, a proposal which has been on the table for some time. (EurActiv, 27 November 2008).

In assessing the package three points call attention. First, one of the main characteristics of the package was to allow countries greater flexibility with the Stability and Growth Pact, which limits public deficits to 3% of GDP. Periods longer than usual to bring the deficit back under the 3% ceiling were considered. The EC warned about disproportionate use of the flexibility, which would result in "a downward spiral of debt" that would only jeopardize growth in the future. The EC made clear that it "will always prepare a report" if the 3% of GDP deficit threshold is breached "unless the excess is not exceptional, temporary and close to the threshold". However, al these warnings can be considered a reassurance rather on the side of the EC than on the countries to follow strictly the eased rules.

Second, while all countries were asked to contribute, the EC insisted that "a one-size-fits-all approach could not work given member states' different starting points" in terms of their budget deficits and overall economic situation. For 2009, the EC forecasts that budget deficits will vary from nearly 7% in Ireland to a surplus of 3.6% in Finland. In the EU's biggest member states, the UK is predicted to run a 5.6% deficit, France 3.5%, Italy and Spain just under 3% and Germany 0.2%. Similarly, there are concerns about deflation in some countries, while there is double digit inflation in others (Estonia, Latvia and Lithuania), highlighting the need for differentiated measures.

Third, as a second 'pillar' of the recovery plan the EC stressed that the measures must be "coherent" with the EU's longer term objectives, such as fighting climate change, creating clean growth and more and better jobs in the future. An additional goal was put into the implementation of the package: to can get back on a path of sustainable growth and pay back short-term government borrowing. Thus the package was diluted with other tasks, which if implemented gave countries a bigger room of maneuver for interpretation. The question also arises on which institutions will be involved in monitoring the implementation of the package and who will bear the costs for monitoring.

Fourth, UK and Germany announced initiatives few weeks before the stimulus package was proposed by the EC. The German government underlined that it was operating under the assumption that its existing economic package was enough as it was already putting 50bn euros back into the economy, more than the EC's target of 1.2% of GDP.

Both individual steps and coordinated announcements have been taken before the EU stimulus package was prepared.

Great Britain announced a cut tax on goods and services to 15 percent from 17.5% in a bid to boost the economy. A Franco-German meeting was held just hours before the British government unveiled a stimulus package featuring a cut in taxes on goods and services. Because of different implications of the crisis on their economies

France, Germany and Britain followed different approaches. France was pushing for tax cuts and other targeted measures, concerned that the 20-billion-euro aid plan for US automakers will leave European car manufacturers at a disadvantage. According to Germany' officials spending one's way out of a recession is reckless and will do little to address the main factor behind the troubles of the German economy – the weak demand abroad for its exports.

On 12 December 2008 the German government decided to accept the Brown-Sarkozy plan of 200 billion euros in stimulus. The amount of the package of about 1.5% of GDP, is smaller than the US package. But in view of the fact, that the EU has a larger share of welfare state spending, hence there are more automatic stabilizers available than in the US.

Some EU member countries participated also in a global frame to discuss measures to contain the implications of the financial crisis. Realizing that there is without doubt an economic downturn in many countries and period of slower economic growth for most, perhaps all others, a coordinated response has been looked for to be more effective in limiting the severity and duration of the global recession. On 16 November, 2008 the G20 summit in Washington was held where a presence from developing country leaders was also needed.

The common document (IHT, 2008) expressed the short-term aim of limiting the fallout from the financial crisis. It also stressed on the call for co-operation in economic policy, and for countries to use the government finances to stimulate growth. Other actions agreed upon at the meeting included fiscal incentives to enterprises, and more international cooperation to identify and rapidly respond to signs of national and international crisis. The officials agreed that tax cuts and increased government spending are necessary to avoid a recession. They also pledged increased communication and coordination in the face of the crisis.

Each country will decide what measures to apply. There are risks associated with tax cuts and increase of spending for countries whose government finances are already strained. The longer-term problem is reducing the risks of a re-run of the events that created the current crisis. Changes to financial regulation will be at the heart of that. Because they were considered less urgent, so the summit commissioned the work on it from the G20's finance ministers, with a deadline of the end of March 2009.

Conclusion

First, the crisis has become one of the most radical reshapings of the global banking sector, as governments in industrialized countries started to use public equity to avoid disappearance of independent entities in the sector. The question is whether the strategy holds the banks responsible after turning the governments into owners. The problem goes beyond whether when distressed assets will be sold the profits will flow to taxpayers and the governments would be able to recoup more money later by selling their shares as well. It is the question on preserving the current structure of excess capacities in the financial sectors in industrialized countries.

Because the response to the lack of trust is again state aid. The state activism is connected with more costs than initially expected. Most importantly, state interventions have a crowding out effect, because public funds are starting to compete with and are crowding out the private sector money.

The second question, which rises is about the new EU member countries, where the foreign ownership in bank assets is dominated by foreign banks, most of them from the Euro-zone countries. Since the 1990s the former centrally planned economies made a substantial step towards excluding government participation in the economy. Nowadays they are experiencing a new paradigm (disregarding of the fact how long it will be lasting) of a strong intervention and participation of governments in economic life. They are confronted with the question: are there not sufficient market mechanisms and tools to respond to a crisis or is this an exceptional case, where governments must take the role of the most reliable and strong economic agent? Are the market mechanism threats in countries with advanced economies more serious to have to rely on a strong state to meet a stress? Such questions only seem to have an easy and clear answer. They need a profound analysis.

Third, one of the important questions now is how to terminate the various temporary assistance programs adopted in this crisis and restore the private market incentives. Which are the devices to be embedded in order to reestablish the market environment and responsibility of financial institutions now in trouble. This makes regulators to think about the fact that one of the main factor creating distortions in the financial system is the perception of a government guarantee of products and institutions. What is the scope and authority of prudential supervision designed to control institutional arrangements in these sphere. In addition, as a result of competition and financial innovation many of the distinctions between financial institutions and products are disappearing, thus complicating the possibility of effective supervision.

Fourth, the measures envisaging the entering of public equity into financial institutions raises the question on to what extent assistance could put public authorities further into the process of allocating credit and selecting the winners and the losers in the market place. If these interventions were provided solely by national governments the consequences would be not so considerable and long lasting. In the case of the current financial crisis however, the intervention of the government in the credit allocation function is supported by the EC. Putting aside the different interests and conflicts between the countries in accepting the principles and the frame of the stimulus package at the end of the day the common interest was to accept state aid in order to strengthen confidence in the markets. State aid was encouraged by the EC in order to restore confidence in the market, however new insights are needed on the issue on European state aid law in the context of the financial crisis**.** Trust can no longer be placed in implicit state guarantees (Hummler, K., 2008a).

Fifth, at the same time markets are lacking measures to create a different balance between bank-based and market-based financial intermediation. Thus the task of a common regulation within the EU would be rather to create an atmosphere in which banks could act to overcome this gap. The over-levering has been a major problem during the current financial crisis. It calls for extending some form of leverage standards (a minimum capital-to-asset ratio) to those institutions that suffered from inadequate capital. Such kind of capital standard would also help reinforce the pressure that financial investors and creditors are now putting on firms to raise capital and clean up balance sheets.

Sixth, although the financial integration in the EU is well advanced (Eurosystem, single market for liquid reserves/the money market in euro), there are no workable arrangements for crisis prevention, management and resolution. This crisis is especially revealing the serious shortcomings in the crisis management framework within the Eurozone in particular. A conflict between large, complex cross-border financial intermediaries and supervisory regime, based on home-country control became evident. To concert joint actions the main focus was put on short term issues as financial burden sharing. Most importantly is however, that the reponse to the lack of trust in the financial intermediaries was again government support, state intervention, the use of public money. There is a big question on the exit strategies for how to terminate the numerous temporary assistance programs adopted in this crisis and more importantly – how to restore private market incentives.

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES
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Plamen D. Tchipev[1]

GLOBAL FINANCIAL CRISIS IMPACT ON BULGARIAN STOCK EXCHANGE[2]

Bulgarian stock market experienced sharp and continuous decline in 2008 causing this way a heavy pressure and turmoil among its investors. The decline hit the confidence in the prospects for its development raising a lot of concerns. This paper addresses some questions about the contingency of the Bulgarian stock market on the development of Global Financial Crisis (GFC), the channels and magnitude of negative influence, as well as of the necessary measures to be taken in order to smooth and balance GFC's negative impact
JEL: G01, G18.G34, G38

Introduction

The global financial crisis (GFC) which developed rapidly in 2008 went very soon, beyond the immediate financial institutions which were involved in the particularly improper financial speculations. What started as more or less risky operations of some of American investment banks quickly spread out over the whole economic and business activity throughout the world. The global interconnection and mutual dependency made impossible for any country or sector to stay intact no matter how sound, itself, it was, and how remote and distant were its operations from the pure gambling with the subprime mortgage casino-type speculations.

In 2008, Bulgaria was experiencing, probably, a slight slow-down of its economic growth, but was in no way approaching any recession. The published preliminary data for the last year GDP shows more than 6% real growth, even under the conditions of unprecedented stress in the last quarter of the year. Bulgarian banking sector, having undergone in the disastrous hyperinflation storm in 2006-2007, has been quite cautious in the period preceding the crises, caring out a conservative and sound policy. In spite the running credit expansion in 2006-2008, both to the business and to individuals, the overwhelming majority of the exposure is considered sound and safe. Practically Bulgarian banks, even being overwhelmingly

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[2] This paper draws extensively from an ad hoc Report on the GFC development prepared for the office of the President and government of Bulgaria. I need to acknowledge the contribution of Rumen Sokolov, Chief Expert, BSE-Sofia and Ph D. candidate at Institute of Economics at the Bulgarian Academy of Sciences, who provided valuable data research and some of the suggestted policy measures.

EU subsidiaries, do not have exposure toward unsafe derivatives and financial instruments, which caused the biggest deal of concern for the world financial system.

That policy, combined with already more than 10 years of successful history of Bulgarian Currency Board is considered a major pillar for expecting that the GFC impact over the Bulgarian economy might be not that sharp as it already revealed in some of the other East European economies.

At the same time, Bulgaria has quite controversial and even risky values of some of the key-factor macroeconomic indicators, including a deficit on current account of almost 25% to the GDP. That includes, a strongly negative trade-balance, decreasing FDI, which will lead in very short time to a negative balance of payments, stagnating real-estate market etc.

Taken together, the positive and negative dynamics of the current economic situation make quite welcome a discussion about the influence of GFC over the different branches of Bulgarian economy. While this influence in many of the branches of Bulgarian real sector economy is still considered ambivalent and debatable, its impact over the financial sector and the Bulgarian Stock Exchange (BSE) is quite clear. There is an undoubted downturn during the past months of 2009 which was particularly sharp in October and November.

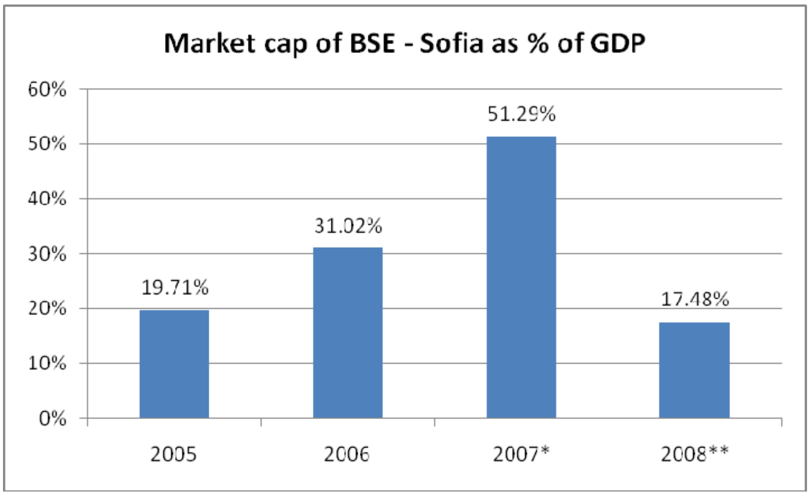
Channels of influence

The crises influence stems trough several different channels. First of all, the crisis ceased the positive development of the trade itself. If we compare the values of SOFIX, the BSE index with longest history – created in October 2000 and because of that, best fit for our analysis, we will see this dramatic turn. For a little longer than a year, from the pick of index in October 2007 till the plunge in mid-November 2008, the index has lost more than 80% of its value reaching the levels of July 2003, after an unprecedented week of everyday drops. Later, after the end of the year, the drop continued again, but in the mid-November were the most dramatic sell offs when the 5% drops happened in many consecutive days and in some days the drop was even above 10% ensuring the crash of index at 319.04 points on November 20th. The drama was particularly shocking since the 2007 rally was long-delayed in Bulgaria and when it was eventually achieved it was abruptly slashed by the unfolding GFC.

The second channel of influence goes through the decrease of market capitalization of the BSE-Sofia, both in absolute and relative (% of GDP) figures. The drop of capitalization from 30.098 ban Bulgarian Leva (BGN) in 2007 to 11.552 ban BGN (November 2008) was more than 60%. Chart 1 is showing the development of the BSE market capitalization against the GDP of the country. As a result of the GFC impact, the decrease of the market capitalization combined with still rising GDP in 2008, caused an almost 3three times fall of that index as compared to its 2007 value. And if one considers that in the countries with emerging capital markets this index keeps traditionally lower values then those in the developed market economies, and this is particularly true for Bulgaria, where the level of corporate financing through the SE is low, then she must admit that even this only aspect of GFC influence has a pronounced negative significance for our economy. That is because it blocks an important source of financing which especially in the environment of stagnated credit market becomes badly needed.

Next aspect of negative influence: after a prolonged and delayed transition, Bulgarian capital market experienced a strong push up by the Accession of the country to the EU. In 2007 the number of deals almost doubled and their volume tripled – up to 9.9 ban BGN. The BSE-Sofia experienced also, a jump in the new listed issues of securities – total nominal reached 970 ban BGN, which presented a 65% growth compared to 2006. In the core of that jump were the issues of public companies equity which went from 195 to 480 ban BGN, revealing the most important event going on the SE – a bust in the investors' trust; attraction of many new investors and capitals and eventually – the increased role and importance of the Stock Exchange for the country. All those positive tendencies were abruptly broken. Thus, Bulgarian stock market could not fully take use from the rise of positive expectations connected to the so long awaited EU accession. Moreover, the slump which emerged caused not just break in the trade itself, but also a fall in the confidence and the capabilities of the SE to raise a capital. According to the data from the BSE, the nominal value of the new issues is just 216.8 ban BGN as of October 2008 of which 29.8 ban are of investment societies with a special purpose as to invest in arable land, real estate etc. The situation deepened further, and practically, all the potential issuers went in a process of waiting and postponing of the planned issues because of the strong negative trends on the market.

Chart 1



* the data for market cap is by 31 Dec
** market cap is as of 20 November 2008 (figures for 2007 and 2008 GDP are preliminary)
Source: calculated from BSE data

Factors of influence

The negative trends raise the issue about the degree of interconnection between Bulgarian and world markets; to what extend one can attribute them to the internal dynamics of Bulgarian stock Exchange, which experienced an unprecedented upswing in the months immediately preceding the crisis. The question is of serious importance since a part of observers tend to blame the same very upsurge for the following crash; pointing out the would-be causes as groundless optimism, unrealistic forecasts, plain greed etc. In that sense, those observers see a natural upturn of the dynamics, which is probably more or less exaggerated as a result of the external influence.

Another group of scholars, pointing out that couple of years ago there was no significant correlation between national and world markets is more prepared to see the events even more dramatically emphasizing that the current Bulgarian market not just repeat, but also amplify the negative waves coming outside within the world financial crisis framework.

This *ad hoc* and also ambivalent reflection of the rabidly developing events on Bulgarian capital market require an attempt for more objective tracing into the facts.

Chart 2 is showing the dynamics of BG SOFIX index juxtaposed to the most familiar world index today – Dow John's Industrial – both taken for a 2-year period, which is covering practically all the most interesting movements of the BG market. The data shows a daily percentage change in the values of both indexes normalized to a common origin in order to make their movements easily comparable. Additionally, the values are taken off on dates when one of the exchanges has been closed for specific holidays or so. That way, the charts are running through identical periods (21.11.06-20.11.08) and could be used to find out to what extent both indexes follow a common pattern. For the sake of the *hot trace paper* presented here, the analysis was just striving to capture the general trend and thus not required to go into a precise regression analysis which might be followed in detail as a next step.

Thus, the more stable and less volatile movements of the US index are assumed as a benchmark to plot against the movements of Bulgarian market and to make conclusions. It is clear enough, that the BG movements were generally following the trend of the world-wide economy though with an emphasized national specific. That specific is due to the overall lower level of development of the Bulgarian market, from one hand, and due to the presence of such a powerful and important event for the nation – as EU accession (01.01.2007), from the other. This way, a long-time suppressed rise of the BG market unfolded powerfully in the late 2006, when the news for Bulgarian acceptance in the EU structures became a process without alternative.

That way, after the mid-January, the BG index reaches a moment maximum values, getting 25% ahead of much flatter movement of the US index. Gradually, the post-accession euphoria passes away and the BG markets experience a relatively calm correction in the next months, within the framework of still advancing world market trend, represented by the Dow. During the second half of April the two indices almost equalize their growths and go in good correlation for more than two months until mid-June 2007. By this point, there is no any evidence which might be regarded as exceptional, absorption, risk underestimation etc.

Chart 2

Source: calculations based on Yahoo Finance and BSE-Sofia data.

Gradually, the distresses cased by the US markets of sub-prime mortgages get speed and the world bourses indices slow down. This is the first instance when one may talk about a break between the trends of the Bulgarian and world market. And the Bulgarian Stock Exchange starts a busting expansion, reaching peak values in October 2007, when the BG SOFIX breaks through and leaves behind the growth of its American counterpart with more than 60 percentage points. Precisely, this is the period considered to be most controversial, and which provides the grounds for assumption, that Bulgarian speculative investment went beyond the limits of the reasonable risk. Although, one needs to consider that the country's economic development, and especially, that one of its capital market, was suppressed for so long period, at a so low level, that none of the reached levels of rapid growth could be interpreted as too high. In fact this growth encompassed a relatively small number of public companies and just when it started to spread wide and to attract more and more new issuers on the market its expansion was put on hold.

In the next period, it occurs a more or less rapid correction, which, by the end of 2007, brings down the speculative peaks of the growth pace and keeps it at about 25-30 percentage points higher levels than those of US Dow John's. This differential is quite understandable provided the existing potential for growth – the real GDP was growing for the last recent years at a pace of above 6%, the positive outlook to the

BG economy expecting 7 ban Euros in the following period from the EU funds, and finally and the positive results of the real sector. Within this framework, the bigger growth of Bulgarian markets seemed justified.

During the next period, SOFIX follows closely the DJI and though the movement is on the negative side, it could not be interpreted as accumulating, and by no means amplifying the external trends of the world markets. Yet in September and the first days of October 2008, when the panic swept all over the world, with the record, from the times of Great Depression, daily slide-downs, causing breaks of the trade in big centers as Moscow and Paris, just then the data for Bulgarian trade worsened substantially. And the Bulgarian index started to produce 2-digit negative results, compared to the level of growth of DJI. In November it marked several times about 34 percentage points lower levels and eventually achieved the already mentioned 80% devaluation against its best score.

Those are the dynamics determining the understanding that the present situation of the Bulgarian Stock Exchange has nothing to do with the internal developments and is result from negative tendencies, attitudes and expectations conveyed from the world economy.

Apart of that, not less detrimental is also the draining out channel of foreign investments. The interest to them is determined by the fact, that unlike the other outflows of financial resources, which eventually may settle in other areas of Bulgarian economy (in banking sector for example), the foreign outflow is terminal. The shrunk liabilities of foreign portfolio investors or decreased size of attracted share capital directly erode the basis for development of the Bulgarian capital market. Limit the business activity and hinder the growth of national economy.

As a result, during the 12 consecutive months before 30 September 2008, the decrease of the foreign portfolio investments is 343.3 millions of euro as opposed to the analogical 12 month period in 2007, which actually showed an increase by 48.1 euro. This is about a 30 million average monthly decrease, leading eventually to a peculiar “peak” in September of 116.5 millions. At the same time the newly attracted share capital from January till September 2008 is more than 500 million euro less as compared to the same period in 2007. Apparently the both groups of figures have a direct influence over the situation on the BSE-Sofia, though this influence is difficult to quantify, since the data in Balance of payments do not differentiate between public and private companies. It is virtually impossible as well to estimate the amount of the remaining foreign investments, since the observed value is just the flow and not the value of the investment itself. Another imperfection comes about the data for the direct investments which show as an aggregate not just the changes in the capital and reserves, but also the investment in the real estate, which do not affect the situation of the capital market directly.

Nevertheless, it is clear that the both groups of investments reveal withdrawals of capital from the Bulgarian stock market. It is also interesting that the process itself has been started yet in 2007, as the withdrawals in that year total at 389 millions of euro.

Summarizing the situation

- The vigorous expansion of Bulgarian stock market, due to country's accession to the EU, positive data from the real sector and the trust in the newly listed companies and issues of the BSE, was followed by pertinent corrections, which could not be determined as disastrous, dramatic or else.

- Moreover, after those corrections Bulgarian market kept for a while the accumulated positive energy and trust, which within encouraging signs from the external economic environment, could easily turn back on the positive side of successive development.

- Yet the recent ubiquitous panic of the late months of 2008 with a mass withdrawal of investors, an outflow of foreign direct investments, and the tightening of credit conditions in the country, combined with the overall bad expectations from the financial sector eventually caused a distinct negative situation.

- The indices reflecting the movement of prices of the Bulgarian securities are going down, not because of worsened results of the companies, but rather because of presence of more sellers than buyers, i.e. because of the changed perspective for trade.

- Just the opposite the results of the public real sector companies remain positive after the third quarter of 2008; as it is shown in the published positive balances and reports. Nevertheless, the value of the companies continues to shrink due to massive sell-offs based on the panic which swept through world markets.

- After October 2008, one has a good reason to conclude, that a process was developed on the Bulgarian capital market, which do not just reflect, but also amplify and multiply the negative external influence of GFC. This process emphasizes, the specifics of the national economy inducing in some investors fears about uncertainty and unpredictability about the economic performance of some real sector companies.

The more the negative events unfold in the developed market economies, the more certain this situation is going to worsen and deepen. Apparently, the lack of positive reaction of the American markets after the announcement of the new survival plan of the government administration and the failure of the EU to adopt such a plan for the most badly hit countries of the Eastern Europe is driving away the hopes for short and not too severe recession of Bulgarian economy.

The more apparent becomes that the world recession is going to last more than a year, the more cloudy becomes the perspectives for Bulgarian survival and the hopes that this economy has a substantial positive potential, gradually but steadily turn into fears that such a vast outflow of investments will erode the very basis for development of the capital market. Even more, the concerns now start to include even the stability of the Currency board, which definitely will be challenged under the condition of negative balance of payments, which is quite possible to develop in the early months of the 2009.

Some suggestions

The suggestions, for alleviation of the sharp negative impact of the global financial crisis, which are offered here, find its ground in the presumption that the current problems of Bulgarian financial markets are rather due to a problem of trust, of confidence in the near feature, than to a lack of available resource. Hence, the main suggestion addresses the efforts for maintaining and enlarging the confidence in the Bulgarian Stock Exchange, emphasizing the stable fundamental development of the successful real sector businesses. All in the same direction are the enlightening activities of the capital market institutions, targeted on the small investors, in order to focus the attention of the latter on the individual performance of the companies, making them less penetrable to the bad market news and more immune of the chaotic and panic responses.

An emphasis needs to be done on the advantages brought by the good corporate governance and the associated high status of the public companies, thus encouraging those businesses which decide to obtain such a status. A short-term measure might be also, creation of clearing house and the so called “double-listing” of some securities, where a company goes simultaneously at two markets – on BSE and somewhere else on bigger world bourses.

Within the context of the good corporate governance, it is quite possible to consider the abandonment of the withhold dividend tax as a measure stimulating the trade in securities. Currently, this tax is not an important source of revenues for the Bulgarian government and its dismissal will create another motive for investors to obtain and hold securities for longer period. Actually, this is also seen, as a measure to encourage the companies to distribute less reluctantly their profits through the dividend policy, under the condition where the market refuses to appreciate their performance adequately.

Later, provided the extremely fast development of the world financial processes, and the huge capital transfers occur within days and hours on a global scale, it is necessary to elaborate the system for monitoring of those processes. That means more precise and detailed measuring of the portfolio investments, separation of the data for the public and private companies, publishing of the data for the share capital as individual items etc. The objective is to make clear and available in any moment, all the information about the size of foreign investments in order to allow more precise forecasts of the policy makers about the effects in case of rapid outflow within abrupt movements of the world market.

Apparently, the serious worsening of the indices for trade in securities from the last months requires even more radical measures for supporting the Stock exchange. Those may include preferable participation in the auctions for EU funding, or introducing new trade instruments on the market flour as raising capital for large infrastructure projects.

Not least, the policy makers need to contemplate again the opportunity for privatization of the remaining shares from the still government owned companies, including the use of different voucher instruments, which are also accepted as means of payment.

Finally, it seems quite necessary originate a debate about the future development of the BSE- Sofia; to attempt to answer truthfully of the question – what are the possibilities for quick recovering of the world and so Bulgarian economy? What are the chances to guarantee a minimum but sustainable level of trading volume of the market, needed not just for the functioning of financial institutions, but also for attaining good corporate governance in near future? And if more of those answers are negative, it seemed quite necessary to discuss the forms for making the Bulgarian stock market a division, a branch or part form a bigger and more developed stock market, most probably a European one. This hard decision could be realized in many different ways through merger, selling or other transformation, keeping more or less independence of its future existence according to the understanding and wishes of Bulgarian economic establishment.

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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Tatiana Houbenova-Delisivkova[1]

THE FISCAL POLICY OF BULGARIA IN THE CONTEXT OF THE EU MEMBERSHIP

The fiscal policy of Bulgaria is revealed with regard to the progress made in the process of compliance with the EU requirements for membership and for the preparation for Bulgaria's entry in the EMU. The paper underlines the main trends of fiscal performance that has been an outcome of the Europeanization. Fiscal policy's contribution to the ongoing restructuring of the Bulgarian economy is discussed in the following main aspects: 1)changing the role of government in providing public goods and services; 2)reforming the public revenues and expenditures structure and policies in order to make efficient the use of public resources; 3) better management of public spending policies and improvement of public accountability of the public finances.
On the basis of comparative analysis the paper outlines the problems and the prospects of the fiscal policy with regard to the Bulgaria's preparedness for the entry in the European Monetary Union. Conclusions are drawn as regards: 1) the main factors and trends of the financial restructuring of the public finances; 2)evaluation of the process of the Europeanization of the public finance management.
JEL: E61, E62, E63, F42, H61

The fiscal policy of Bulgaria has undergone important changes as a result of the preparation for accession to the EU and the ongoing changes since joining the EU in 2007. Due to the discipline achieved in the last decade after introducing the Currency Board regime in 1997 and the compliance with the EU requirements the public finances management has become instrumental for achieving higher economic growth and macroeconomic stability.

The contribution of the public finances policies to the economic growth has been brought to the fore front by a number of developments over the present decade contributing to positive changes in the level and composition of public expenditure and its financing via higher revenues and budget surpluses. Fiscal policy has set growth promoting incentives for the domestic private sector and foreign investments. It has made more efficient use of public resources. The macroeconomic stability has been supported by stable and sustainable public accounts. Due to Bulgaria's accession to the EU the fiscal discipline has been increased considerably.

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The coordination of Bulgaria's fiscal policy with the EU requirements has contributed to: a) the improvement of the effectiveness and the efficiency of the public budget process; b) the implementation of medium term budget programming within the framework of the Convergence programmes's requirements; c) the sustainability of high economic growth.

The fiscal policy has contributed to the ongoing restructuring of the Bulgarian economy in the following main aspects: 1) changing the role of government in providing public goods and services; 2) reforming the tax and social security systems in order to create incentives for the private sector and make efficient the use of public resources; 3) better management of public debt, including the sustainable governance of the external payments.

The institutional framework of the fiscal policy and its compliance with the EU requirements

Bulgaria's preparation for accession has been an important stage in the development of the contemporary institutional framework of the public finances as the environment within which the fiscal policies operate. This institutional framework has been redefined to promote better markets' functioning in compliance with the good practices and experiences of the co-ordinated budget policies of the EU member-states since 2001 when the accession negotiations with the EU started. The changes that have been introduced have been contributing to the adequate transition to a fully fledged functioning of markets by the introduction of rules for the transparency of the budget process, legislation for public procurement requirements, public aid regulation, requirements for public management accountability through the improvement of the public management and control systems in Bulgaria.

An important factor for the fiscal policy development has been the implementation of the set of requirements for the compliance with the EU accession and the convergence criteria of the EMU. Two phases of the progress to compliance with the EU requirements may be distinguished. During each of them the institutional framework for Bulgaria's public finances has undergone profound changes and its rapid implementation has not been an obstacle to economic growth though it has had some adjustment costs and socially unpopular consequences (for instance the reduction of the employed in the public sector in order to raise the efficiency of public expenditure, the difficulties with the reform of the public management and control system as well as the transition to the decentralized extended system of governance of the European funds, etc.).

The fiscal policy has involved measures which aim at stimulating economic growth, investment activity and employment. It has been targeted at improving the effectiveness of the structural adjustment of the economy by re-allocation of public resources towards priority fields and enhancing the quality of public finances. Thus the changes in the institutional framework of the fiscal policy have played and still have to perform a significant role in the overall design of the macroeconomic policy mix. Further improvement of the quality of public finances through enhancement of the strategic planning systems, the adherence to tight budgetary constraints by all economic agents both in the public and private sectors, and the effective control over the appropriate, expedient and provident spending of the available budget resources remain the main principles of the fiscal policy's institutional framework.

In the pre-accession phase the compliance with the EU requirements in the area of public finances has been important with regard to:

1. the closure of Chapter 11 (concerning the exclusion of the direct resort of the government for public debt financing by the Central bank);

2. the requirements of the Chapter 24, 28 and 29 of the negotiations for accession (concerning the regulation of Bulgaria's joining of the EU customs union, the indirect taxes, the EU own resources system, the public financial management and control systems for national budget resources and EU funds, the protection of the euro and the fight against money laundering and irregularities and fraud, the multi-annual budget programming, etc.);

3. improving the transparency of public expenditure by the introduction of centralized system of management of budget resources and establishment of the treasury Single Account system.[2] The systems of SEBRA(system for electronic budget payments) and RINGS (Real time Interbank Gross Settlement) at the Bulgarian National Bank are in full compliance with the EU requirements and member states good practices for coordination of national budget policies.

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[2] The main goal is to concentrate all payments within the first level spending unit (FLLSU), and thus to centralize the funds into the Single Account and streamline the payment procedure. The Ministry of Finance sets spending limits on the first level spending units'accounts in the Bulgarian National Bank (BNB) for carrying out aggregated control of public expenditures. Since 18 June 2000 all budgetary, extra-budgetary and suspense accounts in BGN at the BNB have been centralized in the Treasury Single Account system. A framework agreement was concluded with 21 commercial banks linked for servicing the accounts and payments of the spending units of budgetary appropriations. A new system for electronic budget payments (SEBRA) was developed and introduced to manage and exert a computerized control over payments ordered by the spending units. All the FLSU and their subordinate divisions were included in the system step by step until the end of 2001, 2500 spending units all together. In 2002 the system was further improved.Since 05.08.2002 the central government transfers to the municipalities and the payments have been put through SEBRA, as per paragraph 19 item 12 of the State Budget Law of Republic of Bulgaria for 2002. By the end of 2002 the introduction of RINGS (Real time Interbank Gross Settlement) in the BNB took place and the whole banking system and its connection with the Single Account and the SEBRA system. In 2004 the autonomous budgets, and particularly the National Health Insurance Fund, the Bulgarian National Television, the Bulgarian National Radio, the state universities, the National Social Insurance Institute and the Teacher's Pension Fund were included in SEBRA on a step-by step basis. As of 17.10.2005 in compliance with paragraphs 23, item 4 of the Law on theState Budget for 2005 the Judiciary accounts were included in the SEBRA. SEBRA and RINGS are in full compliance with the EU requirements and member states good practices for coordination of national budget policies.

The second phase of Europeanization of the institutional framework for the public finances has started since 2007 with Bulgaria's EU membership and continues onwards. The Europenization at this phase is aimed at achieving the compliance of the national public finances policies with the fulfillment of the EMU membership criteria and the respective participation of Bulgaria in achieving the goals of the EU policies. The first Convergence Programme of the Republic of Bulgaria (2006-2009)[3] was submitted to the European Commission at the start of the country's full European Union membership from 1st January 2007. The Convergence Programme of the Republic of Bulgaria replaces the Pre-accession Economic Programme implemented in the period of accession of Bulgaria to the EU. In the future, after the accession of Bulgaria to the eurozone, the Convergence Programme will be replaced by a Stability Programme. As the Convergence programme is upgraded annually already three Convergence programmes have been instrumental for the public policy management.

The present Convergence Programme (2008-2011)[4] has been elaborated in compliance with the requirements stemming from the process of multilateral fiscal surveillance within the framework of EU macroeconomic policies coordination. It addresses the sustainability parameters of the fiscal policy of the country according to the recommendations of the Stability and Growth Pact. It contains the analysis for the previous and the current year, as well as forecasts for at least the following three years.[5] It outlines the policies whose implementation would allow a sustainable achievement of the Maastricht criteria for Eurozone membership. The policies defined in the Programme are closely linked to the National Reform Programme and the National Strategic Reference Framework of the Republic of Bulgaria.

The fiscal policy's contribution to the macroeconomic stability

Within the long –term strategy for Bulgaria's entry in the EMU the fiscal policy is of primary importance for the compliance with the criteria of stable public finances. The implementation of the goals of the Convergence Programme of the Republic of Bulgaria (2007-2009) has been revealed in the annual national budget planning within the priorities set in the Three Years' Budget forecast for the period 2008-2011.[6] The priorities and directions of a medium-term budgetary objective for (2007-2010) have been instrumental for setting further implementation of fiscal policy changes on the track of pragmatic oriented structural adjustment of public

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[3] Convergence Programme (2006-2009), December 2006.

[4] Convergence Programme (2008-2011), November 2008.

[5] It covers the following main topics: 1) medium-term budgetary objective, represented by a balanced budget or a budget surplus, in order to avoid the risks of excess budget deficits; 2) min assumptions concerning the future developments of employment, economic growth, inflation, etc.; 3) an assessment of policy measures, by which the objectives set in the Programme are expected to be achieved; 4) a sensitivity analysis of budgetary and debt stances of the country with respect to changes in the assumptions concerning the economic variables; 5) medium-term objectives of monetary policy and their influence on price stability and the stability of the exchange rate.

[6] Convergence Programme of Republic of Bulgaria (2007-2010), November 2006.

finances. The introduction the flat tax of 10% as well as the ongoing reform of the social security system have created tax incentives for investments and stimulate economic growth. On the side of the public expenditure policy the progress achieved in the adequate implementation of programme-oriented public spending policies at the Republican level and further sustainability of local budgets through municipalities' public expenditure have also contributed to higher growth.

Real GDP growth reached 6.2% in 2007 and 7.1% in the first half of 2008 driven by domestic demand mainly. Investments in fixed capital grew in real terms by 21.7% in 2007 and 22.7% in the first six months of 2008, accelerating from 14.7% in 2006. The share of national savings in GDP rose from 13.5% at the end of 2006 to 15.6% at the end of the first half of 2008. However, as a result of the intensified investment activity, national savings covered only 40.4% of the capital expenditures made by the economic agents in the last 12 months, in comparison with 42.6% in 2006.

This dynamics was entirely generated by the private sector as the savings-investment balance of the government has improved marginally during this period. Almost 80% of investments growth in 2007 was concentrated in the following sectors: real estate, renting and business activities, manufacturing, production and distribution of electricity, construction, and trade. These sectors (excluding manufacturing) remained efficient and attracted investments in 2008 as despite the reduced liquidity on a global scale they absorbed half of all investments in the first six months of 2008 contributing for about 90% of their growth.

The expectations for the period 2009-2011 may be for further deterioration of the external environment and slowdown of the growth of the Bulgaria's main trading partners. The strongest negative impact of the world financial crisis on the processes in the real sector of the economy is expected to take place in 2009. The impact of the economic recession and the global financial crisis on the Bulgarian economy may not be further aggravating in a medium term prospect as Bulgaria is still and may remain in the periphery of the crisis. If the recovery of the growth in the world economy and, in particular, in the EU economies will be in 2010-2011, the higher the expectations for Bulgaria's sustainable macroeconomic growth may be.

The main impact through which the world financial crisis is expected to affect the Bulgarian economy is through the reduction of aggregate demand and lower foreign capital inflows. Though the negative impact from the crisis on the Bulgarian economy will be considerably weaker in comparison to the big European economies, the fiscal policy is of utmost importance for preserving economic stability and counteracting existing imbalances.

As anticrisis fiscal measures since the autumn of 2008 have been under consideration, there are efforts to strengthen the fiscal reserves and the provision of adequate and prudential fiscal stimuli. These may become much more necessary to counteract the difficulties to be encountered, for example because of expectations for higher unemployment, dimishing orders for the enterprises that are export-orieinted etc. Nevertheless there is a persistent official public policy's caution of maintaining the budget surplus as extremely important in the crisis times for the monetary stability of the Currency board, though it is much debated by some Bulgarian economists that favour either budget equilibrium or running into budget deficit in order to render greater public spending possibilities and thus to raise demand.[7]

The most important change for 2009 refers to the planned buffer to limit the non-interest expenditures and transfers of the republican budget, which has been raised from 7 to 10%. The restriction refers also to the capital expenditures and the reserve for unexpected and urgent expenditures. The possibility for implementation of an additional investment programme, financed by the reserve for public investment and potential reduction of the budget surplus by up to 1% of GDP, has been removed in the approved by the parliament budget law for 2009. The level of the planned budget surplus was retained at 3% of GDP to cushion any possible underperformance of the fiscal revenues. The non-interest expenditures and the transfers under the republican budget may be reduced further if the underperformance of the consolidated fiscal revenues reaches a level that may lead to a negative budget balance of the consolidated fiscal programme.[8]

Main factors for the sustainability of the fiscal policy are the good macroeconomic indicators of the country, the presence of considerable reserves and buffers in the economy due to the continuos prudential nature of the policy of maintaining fiscal surpluses, the strict control of the responsible institutions over the country's financial system, and the continuing structural reforms in the country.

Due mainly to unfavourable external environment, the economic growth in Bulgaria as foreseen in the Convergence programme is expected to slow down from 6.5% in 2008 to 4.7% in 2009. This moderation is expected to be a result of lower domestic demand mainly as the highest drop is expected in terms of investments growth. Nevertheless, the economic growth will remain high and in view of the expected developments in the EU economies the growth differential with the average EU growth rate will increase slightly, i.e. the real convergence process of the Bulgarian economy will continue.

The sustainability of solid public finances, maintenance of public budget surplus and further improvement of the role of fiscal policy for the economic development is targeted at the achievement of *nominal macroeconomic convergence* with the EMU. On the road of preparation for entry in the Economic and Monetary Union (EMU) the fiscal policy has been designed to support the achievement of convergence of the main macroeconomic indicators to the Maastricht criteria especially the criteria for solid public finances and the convergence level of inflation.

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[7] Angelov, I. Bulgaria needs a managed floating exchange rate regime. – In: Central Banking, Quarterly Journal,Vol XIX, N 1, August 2008; Ganchev, G., Ch. Nikolov. Social strategies for the Budget surplus. – In: www.redhouse-sofia,org/bg/projects/p-debates/surplus in crisis?, 20 November 2008.

[8] Republic of Bulgaria, Government Budget Law for 2009. See also: The Addendum to the Convergence Programme (2008–2011) of the Republic of Bulgaria.

Originally in the Bulgaria's Strategy for the adoption of the euro (approved in 2005) the entry in the EMU was foreseen for year 2010. In the spring of 2007 Bulgaria has applied for joining the ECM II. Yet higher inflation rate and the need to improve the functioning of the markets have delayed the access to the EMU II. The global financial crisis has also brought some uncertainty to the issue as the recession has worsened and thus new entries in the EMU are becoming an issue of higher involvement for providing financial and monetary stability.

The Convergence Programmes of the Republic of Bulgaria and The Three Years' Budget forecast for the period 2008-2010 have been under close surveillance for the first time in the Convergence Report of the European Central Bank as of May 2008.[9] Their implementation serves the needs of the process of coordination and multilateral surveillance of economic policies of EU Member States. The Convergence Programme as policy instrument has introduced to the national budget procedures the discipline of setting the targets of:

1. a medium-term budgetary objective, represented by a balanced budget or a budget surplus, in order to avoid the risks of excess budget deficits;

2. after proper analysis setting national priorities concerning the future developments of employment, economic growth, inflation, etc.;

3. a description of economic policy measures, by which the objectives set in the Programme are expected to be achieved;

4. a sensitivity analysis of budgetary and debt stances of the Bulgarian economy with respect to changes in the assumptions concerning the economic variables;

5. medium-term objectives of monetary policy with regard to the sequence with the fiscal policy and evaluation of their influence on price stability and the stability of the exchange rate.

Under the Currency Board regime there is absence of proper monetary policy of the Bulgarian Central bank (the only instrument available being the minimum requirements for reserves of the banks with the central bank). The fiscal instruments serve an important role in striking the right balance of the budget policy impact on aggregate demand and reducing its pro-inflationary expansion. Debt levels and developments are also strictly observed and the indicators so far are better than the convergence EMU criteria.The government debt level as of the end of 2007 amounted to 5162.8 million EUR or 17.9% of GDP. By the end of the 2008 it is expected to decrease further by about 3 percentage points, as a result both of the reduction of the nominal debt and the expected GDP growth. The end-year projection of the debt level is based on the envisaged reduction of the amount of the newly-issued domestic government securities and on the early repayments of about 300 million EUR of World Bank debt carried out during the year 2009.

[9] ECB, Convergence Report, May 2008, p. 35-36.

The present higher level of inflation differentials in Bulgaria as compared to the macroeconomic criteria for the EMU are still at hand though there has been considerable reduction of the inflation rate in 2008. However, as these differentials are rooted still in structural asymmetries, the cost of adjustment to EMU membership still remains to be borne until fulfilling the convergence criteria for the inflation (See the attached Table: "Overview Table: Economic Indicators of Convergence" for comparison with other EU countries).

The restrictiveness of the fiscal policy thus is serving the anti-inflationary goals though at the same time fiscal surpluses may be considered as a result of higher taxes. Therefore the stance of the fiscal policy has been oriented towards designing the tax structure which may be providing reduction of income taxes and corporate taxes and keeping the proportional sales taxes comparatively high but servicing the needs of creating incentives for the economic actors and bringing revenues for the government budget.

The overall impact of taxes on the economic growth may be considered as contributing incentives for growth. As a result of the carried out tax reforms in compliance with the preparation for accession to the EU Bulgaria has experienced clearly trends of raising the productivity of labour much higher than the wage increase. Thus tax incentives have increased private investment as well as the inflow of foreign direct investments as the efficiency of the economy has been improved.

Compliance to the fiscal rules of macroeconomic convergence still provides the national government with a definite room for manoeuvre in order to prepare to join the EMU.

The proponents of early EMU membership of Bulgaria contemplate the realization of expected expansionary stabilization effects, associated with lower interest rates and direct transition from fixed rate of the Bulgarian lev to the euro adoption. On the side of the business circles even there has been strong demand for transition to the euro as soon as possible as a safe way of governance of the economy in the global crisis. On the other hand, the public authorities and those who opt for a more cautious approach to the adoption of euro, maintain that the achievement of the convergence criteria for the entry in the EMU is necessary in order to reach better structural adjustment. Besides there is a need to comply with the discipline of the EMU and the EU membership obligations of Bulgaria.The process of adjustment is to be perceived also as one of gaining experiences in better sequencing of fiscal and monetary policies with anti-inflationary stance. In this field there is a great need of better understanding the EU and the EMU policies which proves the need and the role of further preparation work to be done for the entry to the Eurozone.

As experiences of EMU member states have shown, this process may last also after the entry to the EMU, and some authors argue that the experience in the EMU has amply demonstrated that nominal convergence may barely make a country fit for the single currency.[10] At times of the global financial crisis the issue of the freedom of manoeuvre of the fiscal policy of the EMU countries becomes crucial as anticrisis governance of public finances is burdened with specific issues in eacn country. According to some authors[11], if the Stability Pact can no longer function as a credible European surveillance, member states should set their own rules on fiscal discipline and invest in institutions and tools.To exit the stalemate of the global crisis all EU countries should be participating in the fiscal stimulus packages, and it should be up to the most indebted and the weakest to commit, in return, to take drastic belt-tightening measures once growth resumes.

The correct fiscal policy at the time of global crisis is neither to put the brakes on nor to freewheel but to spend public money efficiently in order to boost the economy and, at the same time, commit just as seriously to saving and improving reserves. Creating liquidity buffer in order to overcome the credit crunch is one of the possible contribution of the fiscal policy in the anti-crisis governance. Fiscal discipline thus goes entirely hand in hand with the better preparedness for adoption of the euro. The Bulgarian fiscal policy is based on adequate rules of fiscal discipline but their implementation may be further improved. It is necessary to pay higher attention to the administrative capacity of the public institutions and the legislation and the tools which can guarantee that the public interest is protected through efficient governance of public revenues and expenditure. This is the the only basis for the fight against corruption which is one of the issues to be tackled by the public governance of the budget policy implementation.

The specific measures, proposed by the Bulgarian government to contain the adverse effects of the world financial crisis on the Bulgarian economy basically do not change the priorities of prudent fiscal policy.

The Convergence Programme of Bulgaria for the period (2008-2011) sets priorities within the framework of the Stability and Growth pact of the EMU thus providing further support for stability-oriented domestic fiscal policies. Along the lines of specifying medium term fiscal targets the fiscal performance is expected to rely upon further reform of the public sector and of the more efficient provision of public goods and services. The strategic targets are set to meet the challenges of:

1. supporting the “acceleration of the convergence of the real incomes’ level in Bulgaria to the EU average incomes’ level”;

2. meeting the challenges of the unfavourable trends of demografic development in Bulgaria as regards the problems of the aging of the population and the outflow of qualified labour force;

[10] De Grauwe, P. Living with the Euro: A Provisional Balance Sheet. – In: Tsoukalis, L. (ed.) Governance and Legitimacy in EMU (Florence: European University Institute), 2005.
[11] Jean Pisani-Ferry. We need a proper Stability Pact. – In: Le Monde, 12 December 2008 (http://www.bruegel.org).

3. functional and operational reform of the Budget management in order to develop the capacity for absorption of the EU funds by adequate implementation of the EU policies,and the Structural funds;

4. providing adequate conditions for participation in the European structures and EU common policies.

Bulgaria is not only a recipient of the EU policies. It has encountered difficulties during the preparation for accession but the experiences gained are good enough to join the integration process on equal terms with other EU new member states. Yet there is still much work to be done to become a member state contributing to the reform process in the EU, as regards:

- the ongoing reform of the EU budget as regards the own resources system of the EU, the financil control and management systems of public finances and the EU funds;

- the reform of CAP and its proper transposition with regard to the changing external and internal state of the agriculture as a main sector of the Bulgarian economy that can be contributing to raising the efficiency of the investments and labour and be supply responsive only if further reform is carried out;

- the reform of the financial sector regulation as global crisis response of the Eurozone and the EU;

- the pending needs of the highly indebted third world countries, etc.

There is a good reason to believe that the participation of Bulgaria in the process of deepening the integration may come through the sustainability of the good practices and results achieved thus far in the public finances governance. In order to improve the level of conceptualization new policies' approaches and operational implementation and improvement of the effectiveness of the EU policies there is a need of improving the transparency of the public governance and developing further national policy approaches adequately reacting to own national problems. Some aspects of further policy concern include:

1) Implementing the EU policies in the effort to attain EU common priorities and targets by contributing with active national policies (Explicitly made recommendation for the need of "national policies" in the ECB 2008 Convergence Report for Bulgaria) as regards labour market for marginalised social groups and infrastructure and transport development as needs neglected so far);[12]

2) After the failures due to cases of irregularities, fraud and corruptrion in the implementation of the pre-accession funds, Bulgaria has to meet the challenge and to invest efforts in the creation of adequate administrative and financial

[12] ECB, Convergence Report, May 2008, p. 35-36.

control and anticorruption transparency policy in order to prepare for the absorption of the EU funds.

3) Improve the administrative capacity and the economic efficiency in order to achieve better utilization of the EU Structural funds and to carry out successfully the Operational programmes in the respective fields of operation. As seen from the Fiscal Framework (2007-2010) the total revenues account for 44% of the GDP and the total expenditures are forecasted to reach 40% of the GDP. By 27 October 2008 a small progress of achievement of the goals and measures of the operational programmes (OPs) could be reported – the fulfilment of the financial commitment for the period 2007-2008 on signed EU funds contracts, co-financed under the Structural Instruments, represents 29% of the annual programme. The portion of the signed contracts under OP "Transport" is 54% of the annual financial commitment; the share of the signed contracts under OP "Administrative capacity" is 118%; the utilisation of the funds under OP "Technical assistance" stands at 109%. In other areas, such as OPs "Environment", "Regional development" and "Competitiveness", contracting procedures at the total amount of over EUR 400 million are expected to be completed by the end of the year. Therefore, the fulfilment of the annual financial commitment of the operational programmes will result in transfers from the EU Structural Instruments to the Bulgarian economy of more than one billion Euro by the end of the year 2008.

Table 1

The Fiscal Framework of Bulgaria for the Period 2007-2010 (million BGN)

	2007	2008	2009	2010
Total revenues	21377.6	27192.3	30246.8	33365.3
(% of GDP)	39.0	44.1	44.2	44.2
Total expenditures	20357.6	24711.0	27408.8	30217.4
(% of GDP)	37.1	40.0	40.0	40.0
Contribution to the EU Budget	634.4	659.9	813.3	918.3
(% of GDP)	1.2	1.1	1.2	1.2
Total expenditures plus the contribution to the EU Budget	20992.0	25370.9	28221.1	3135.7
(% of GDP)	38.3	41.1	41.2	41.3
Balance	385.6	1 821.4	2 024.7	2 229.6
(% of GDP)	0.7	3.0	3.0	3.0

The Changing Structure of the Budget Revenues and Expenditures upon Bulgaria's Joining the EU may be revealed both on the revenue and the expenditure side of the Republican Budget. In all mentioned bellow items of the Budget structure important changes are under way with regard to their Europeanization.

<u>The Republican Budget Revenues</u>

- Revenues from personal income (flat 10% tax since 2007)
- Social security contribution (the formula 12)

- Revenues from corporate income tax (10% tax since 2007);
- Income from indirect taxes (VAT, customs revenues, excise duties become involved with the EU own resources system);
- Other revenue items.

<u>The Republican Budget Expenditures</u>

- Government Public Consumption;
- Government Public Investment;
- Government transfers;
- Government interest payments;
- Government other expenses (administration wages, etc.)

The changes in the Bulgaria's Budget revenues policies and tax harmonization with the EU Law have started since the pre-accession adjustment in the following aspects and they are still under way:

1) phased increase of the excise duties – continuing in year 2009;
2) introducing changes in the VAT collection by law amendments after 2007; for 2009 Government plans for improving the VAT return procedures in favour of the companies is looked upon as an anticrisis measure of the Government expected to be helping the liquidity problems of the businesses;
3) Implementation of the EU Common Tariffs in compliance with the EU Common Trade Policy: the Bulgarian business is extremely quick to react to any earlier announced tariffs' increase by the European Commission (for instance, as sugar tariffs were expected to increase since the 1st November in the 3 months preceding this date the import growth of sugar is considerable, which is indicative of the high degree of adjustment of the business to the EU rules).

As regards *Budget expenditures'* policies the following changes have been introduced and applied as Europeanization is under way:

1. 3% fiscal surplus approved as a permanent threshold of fiscal sustainability under the Currency Board since 2007;
2. Limitation of the redistribution function of the Republican Budget up to 40% of the GDP (main sectors beneficiaries of the state Budget are set to be incliding: the human capital investment; raising the productivity of labour; the agricultural sector; infrastructure and environment development);

3. Acknowledgement of the European public goods by: rationalising and modernisation of the administration, modernisation of defence and security system as NATO membership of Bulgaria stipulates as well as providing for internal affairs and national security, healthcare, social policies and state aid in compliance with the EU law;

4. Besides the changes in the structure of the separate types of budget expenditures, the budget reform is to comply with the recommendations of the European institutions as regards the reduction of current budget expenses at the account of increasing the capital expenditures.

Example: In 2008 ECB Convergence Report there is a specifically underlined recommendation that budget expenditures have to bring to strong national policies in sectors lagging behind EU average level.

The trends in the budget revenues in 2008 are indicative for the effectiveness of the fiscal policy.

Tax revenues have increased due only to the rising revenues of the custom duties (increased by 50%) and excise duties (by 21.7% increased revenues) combined by reduced revenues from VAT due to less transactions (VAT rate of 20%) but as well as due to a moderate rise of about 6.5% of the revenues from the corporate and the personal income tax. The Government intention for 2008 and year 2009 budget has been sustainable and prudential with regard to the risks of falling revenues in the future if global crisis persists: there are no grounds for any reduction or differentiation of the VAT and the excise duties are to keep on rising.

As regards Non tax revenues they increased considerably by mid-2008 due to some repayment of Irak's debt but it might not be possible to rely upon such source in the future.

There is also a new source of revenues in 2009 – the raising of the tax value that is to be taxed on property transactions.

The Budget expenditures in 2008 have also been changing though some trends are to be more cautiously observed as the impact of the global crisis may weaken the revenues from VAT and excise duties and thus the fiscal policy should be more prudential. There has been some unfavourable trend by mid2008: the greatest increase is registered by the Government subsidies – 86%.

- Current expenses are 7.6% above the level of the first half of 2007.

- The growth of public investment is only 13.6%, and the size for the 7 months of 2008 amounted only to 27.1% of the foreseen by the Law for the 2008 Budget. The reason for this is related to the failure to co-finance EU funded projects as well as the EU funds were suspended on a number of capital investment programmes like ISPA.

- Interest payments are reduced by 8.5%, because of reduced repayment of external debt. The size of the contribution to the EU budget is equal to 36.4 million BGN.

- The surplus of the cash saldo of the consolidated budget by the end of July achieved 4.22 billion BGN. Thus being by 74.4% bigger than in 2007. The revenues raised by 24.4% reaching 16.4 billion BGN, expenditures increased by 12.7% reaching the sum of 11.8 billion BGN.

- The primary and the internal saldo reach the sum of respectively 4.7 и 4.6 billion BGN.

The initial impact of the EU membership is not disturbing the revenues' adequacy to expenditures of the Government as the following changes have occurred:

First, there is an increased amount of revenues of excise duties.

Second, custom duties are reduced as a budget revenue because they as are being due to the Own resources of the EU budget.

Third, reduced VAT income and revenues for the Budget as Bulgaria's joining the Internal market changes the charging of the transactions (the reduction is between 10 and 30%).

As a whole a sustainable impact on the Republican Budget of Bulgaria has been evident due to the following changes as a result of the EU compliance:

- European excise duties are higher and revenues are higher – there has occurred a redistribution at the cost of taxing specific goods;

- EU impact on the spending of public money – overall regulation, public accountability and control is improved;

- Specific European public goods are acknowledged – thus the priorities for public money spending are definitely a brakethrough in the post transition period.

The Bulgaria's standpoint to the EU budget reform

Bulgaria's fiscal policy is fully compatible with the co-ordination of the policies of all member states. Some of the main achievements and issues have been already discussed above. Bulgaria is for retaining the nationally specific corporate taxation and may not be in favour of the introduction of EU common corporate tax base in medium term. There is still no public unified opinion on the need of newly to-be-introduced European tax in line with profederalistic approach to the EU budget reform. The compliance with the EMU criteria is considered as prerequisite for further achievements of the EU membership agenda for Bulgaria.

The forecasts for Bulgaria's contribution to the EU Budget (2007-2013) underline the fact that the budget expenditure as co-financing to the EU funds may remain considerably low in case the absorption of EU funds is not improved considerably. An increase in the Government consumption may boost domestic demand and raises GDP by almost 1.01% as a primary effect.The fiscal expansion stimulates production and investment (though still awaited is higher capital investment not only subsidies). The anticrisis re-orientation of fiscal policy must observe the risks of the higher inflation in order to reduce it to the convergence criteria.

As regards further Europeanization of Bulgaria's fiscal policy some new priorities of the EU Budget 2009 must be taken into consideration in the national programming. It is possible to complement the goals the Bulgarian national fiscal policy with new ideas and targets. The EU Budget in 2009 has been setting the priorities of the investing more in economic progress by:

Creating Jobs, innovations, growth:

- 60 billion EUR total for Competitiveness and cohesion.
- Investment in environment by the EU budget is on the rise:
  - total funds for environmental targets exceeds 10% of the budget, 14 billion EUR;
  - green investment in different areas boosted by 17.3% (aside from Cohesion/ rural development).

Greening the EU Budget expenses is to include the following aspects:

- enterprise: eco-innovation (+18% increase);
- energy and transport: environmentally friendly transport (+5% increase);
- environment: LIFE+, biodiversity, climate change (+8%increase);
- programmes against deforestation; sustainable energy solutions and energy efficiency.

Some specific areas that are relevant and of specific interest for Bulgaria include the following areas of public interest:

- investment in research and development;
- development and stability for rural communities;
- management of natural resources;

- citizenship, freedom, civil society;
- creating institutions and capacity for the implementation of the EU funds;
- EU funds for infrastructure and sustainable energy solutions.

Conclusion

The fiscal policy in the future is still to be reconsidered and improved as public efficiency and accountability is still to be improved. The fiscal policy has contributed to the economic growth of Bulgaria as well as to the progress of the nominal macroeconomic convergence with the EU. Nevertheless the need of further improvement of the public finances' contribution to achieving the goals of the Stability and Growth Pact and the Lisbon strategy of the EU make it necessary to improve further the specific choice of the diverse fiscal instruments and objectives in order to support better investment, innovation and growth with regard to the *real macroeconomic convergence* with the EMU.

Bulgaria's fiscal policy has to develop further instruments for the implementation of the Lisbon strategy and for macroeconomic convergence with the EMU. We may consider the present state of economic turmoil and of unsettled ideas about the broad lines of world financial crisis governance and the EU anticrisis policies as a challenge to be encountered by the fiscal policy of each member state as well as at the EU level. As the English Nobelist James Meade wrote in 1974: "The present state of economic turmoil and of unsettled ideas about the broad lines of economic policy makes it suitable, as it was in the years of the post-war reconstruction, to reconsider the basic philosophy of our economic society.[13]"

[13] Meade, J. The mixed economy: the intelligent Radical's guide to economic policy. Cambridge University Press, 1974.

ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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Tamás Szemlér[1]

OLD AND NEW EU POLICIES IN THE BUDGET OF THE EU27 AND BEYOND. A SUMMARY OF SURVEY RESULTS FROM 2008[2]

The enlargement of the EU in 2004 and 2007 has led to a significant increase in population and territory, but also a huge increase in differences regarding economic structure and development levels. Despite the traditions of the EU in dealing with such differences, the scope of the latest enlargements is a challenge for existing EU policies. In addition, potential additional tensions stemming from further enlargements would be added to the present unsolved debates on the EU budget.

After presenting the current situation and the main challenges regarding the expenditure side of the EU budget, it summarises the results of a recent survey on the perception of experts and decision-makers from different member states regarding EU budget expenditure. This is followed by a summary of the main findings of the same survey regarding preferences for the future; the paper is completed by the conclusions.

JEL: F36, H87

Introduction

With its enlargements in 2004 and 2007, the number of the member states of the European Union (EU) increased from 15 to 27. The consequences of this change are manifold, and very different: they include a significant increase in population and territory, but also a huge increase in differences regarding economic structure and development levels.

The EU has a long tradition of dealing with such differences; still, the scope of the latest enlargements is a challenge for existing EU policies. Moreover, taking into account that enlargement is not considered to be finished, this challenge is expected to be even more urging in the next few years. Last, but not least, potential additional

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[2] This paper summarises the EU expenditure related results of the following research report: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson.

tensions stemming from further enlargements would be added to the present debates on the EU budget, that are far from being satisfactorily solved.

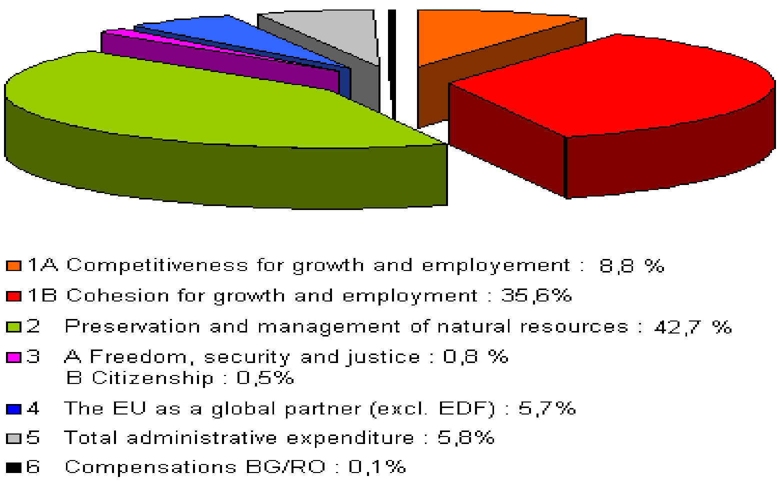
In section 1 of this paper, we present the main features of the expenditure side of the EU budget in the period 2007-2013, with particular weight on the issues that were key topics during the last accession talks and are also expected to be the most sensitive ones in the case of further enlargements. In section 2, we proceed with a short summary of the results of a recent survey on the perception of experts and decision-makers from different member states regarding EU budget expenditure; section 3 presents the main findings of the same survey regarding preferences for the future. Conclusions presented in section 4 complete the paper.

1. EU budget expenditure today: the cake at stake

The period 2007–2013 brought some new elements into the distribution of EU budget expenditure. The main expenditure headings have been changed: the changes meant not only new names for most headings (with the exception of administrative expenditure), but also a partial restructuring of a part of the expenditure items. The structure of EU budget expenditure for 2007–2013 is presented by Figure 1.

Figure 1

The cake at stake - the distribution of EU budget expenditure, 2007-2013



Source: http://ec.europa.eu/budget/prior_future/fin_framework_en.htm

The most important changes relate to headings 1A, 1B and 2. Altogether, these headings represent more than 87% of total expenditure in the period. Within this, the explicit appearance of competitiveness is a new phenomenon demonstrating the EU's intention to devote more attention to this issue. Cohesion expenditure remained important; in fact, with the enlargement of the EU, it is more important than ever (even if it is not fully reflected in its share).

Headings 1A and 1B together represent a higher amount (and thus a higher share) than heading 2 – this can be seen as a turning point in the history of the EU budget: this is the first time when agriculture is not the biggest item of the expenditure side. It can also be symbolic that agriculture is no more the first one of the expenditure headings in the numbering; in addition to it, the fact that the name of heading 2 is not agriculture (although its content is overwhelmingly the Common Agricultural Policy) strengthens even more this symbolic change.

As for expenditure headings 3 and 4, they represent partially new priorities, but they also include many of the traditional expenditure (under the former "Internal policies" and External actions" headings). Their share is quite low, therefore they do not belong to the really debated hot issues. The latter statement is true for headings 5 and 6, as well.

As it can be seen, expenditure and, as a result surprisingly, the most intensive debates are concentrated to the issues of competitiveness, cohesion and agricultural policy. In the debates and perceptions integration traditions, country interests and the changing situation play an important role. The expenditure structure for 2007–2013 is the result of a compromise, but it cannot be regarded as an eternal result: discussions about changing the EU budget are running continuously. In 2008–2009, these debates are channelled into the EU budget review, a process aiming at arriving to proposals for a more up-to-date and more efficient EU budget.

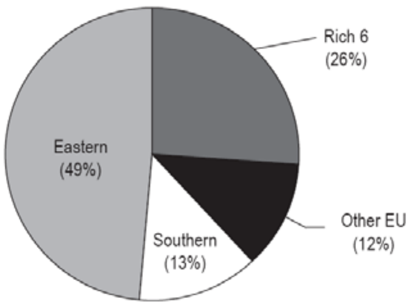
In December 2006, the Institute for World Economics of the Hungarian Academy of Sciences (IWE) was commissioned by the Swedish Institute for European Policy Studies (SIEPS) to map the positions of the EU member states with regard to the EU budget review 2008/2009. The research report employed a twin-track approach: First, a questionnaire survey was carried out (questionnaires were sent to policy-makers and researchers throughout the EU); second, a number of budget researchers were asked to analyse the likely positions of eight member states. The following sections present the main results of the survey and summarise the main findings of the report[3] regarding the expenditure side of the EU budget.

The result of the above mentioned survey is a sample that consists of 167 questionnaires, received from 23 member states. These member states have been divided into four categories, according to their „EU budget history". The composition and the share of each category is presented by Figure 2. As for the country papers, they were prepared for the following eight member states: Germany, France, Sweden, the UK, Spain, Poland, Hungary and Bulgaria.

[3] The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson.

Figure 2

Country groups – shares in sample



* *Eastern*: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Slovakia and Slovenia; *Other EU*: Belgium, Cyprus, Finland, Ireland and Italy; *Rich 6*: Austria, France, Germany, the Netherlands, Sweden and the UK; *Southern*: Greece, Portugal and Spain.

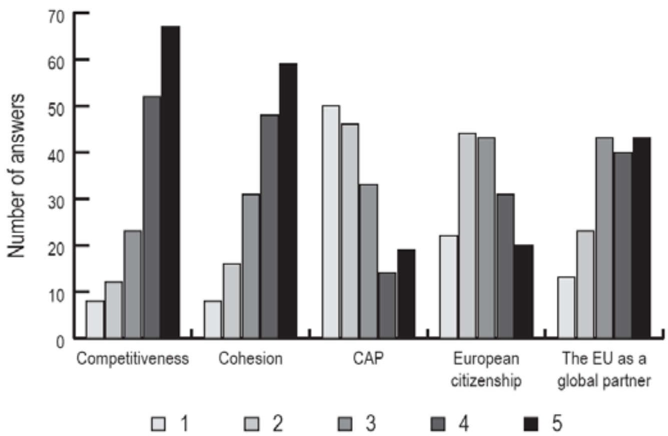
Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, p. 45.

2. Survey results: perceptions about current EU budget expenditure

Regarding the current (2007-2013) expenditure structure, we asked the respondents' opinion from two angles: the importance and the actual share of the main expenditure headings, in order to get – indirectly - information on opinions on the possible restructuring needs of the current expenditure structure.

Figure 3

Opinions on the importance of current expenditure items



Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, p. 36.

Table 1
Evaluation of the importance of the expenditure items of the EU budget (%)*

Competitiveness	1	2	3	4	5
Eastern	3.85	7.69	10.26	30.77	**47.44**
Other EU	5.26	10.53	10.53	26.32	**47.37**
Rich 6	7.14	4.76	14.29	35.71	**38.10**
Southern	-	9.09	31.82	**36.36**	22.73
Cohesion					
Eastern	5.13	3.85	11.54	30.77	**48.72**
Other EU	5.26	5.26	21.05	**42.11**	26.32
Rich 6	7.14	16.67	**30.95**	26.19	19.05
Southern	-	18.18	22.73	22.73	**36.36**
CAP					
Eastern	24.36	**28.21**	20.51	11.54	15.38
Other EU	15.79	**26.32**	**26.32**	15.79	15.79
Rich 6	**47.62**	26.19	14.29	2.38	9.52
Southern	**36.36**	**36.36**	22.73	4.55	-
European citizenship					
Eastern	9.09	19.48	**33.77**	27.27	10.39
Other EU	26.32	**42.11**	26.32	5.26	-
Rich 6	9.76	**26.83**	24.39	17.07	21.95
Southern	22.73	**45.45**	9.09	9.09	13.64
EU as a global partner					
Eastern	7.69	11.54	**30.77**	28.21	21.79
Other EU	-	**42.11**	21.05	15.79	21.05
Rich 6	7.14	4.76	28.57	26.19	**33.33**
Southern	18.18	18.18	13.64	18.18	**31.82**

* *Eastern*: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Slovakia and Slovenia; *Other EU*: Belgium, Cyprus, Finland, Ireland and Italy; *Rich 6*: Austria, France, Germany, the Netherlands, Sweden and the UK; *Southern*: Greece, Portugal and Spain.

Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, p. 51.

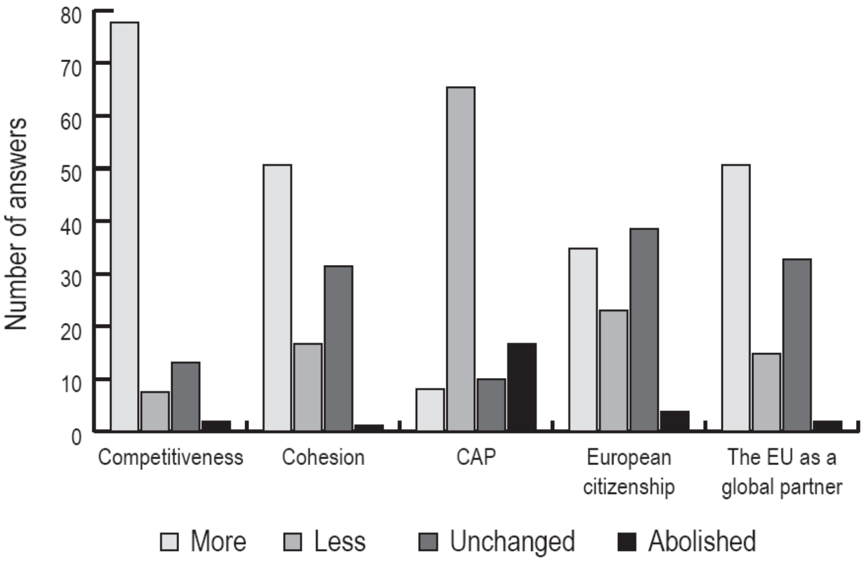
Figure 3 presents the survey results regarding the importance of the present expenditure headings in the EU budget. Respondents were asked to evaluate the importance of each heading on a scale from one to five, five being the best mark. As the results show, competitiveness and cohesion were ranked as being very important by the vast majority of the respondents. On the other hand, the Common Agricultural Policy (CAP) was regarded as unimportant or not very important by a clear majority of the respondents – many of them from countries which benefit considerably from the CAP (see Table 1 for details on answers according to country groups). This may be perceived as a “wind of change” (this „wind of change” seems to be confirmed by the results of the country papers – see later). The other two –

much smaller, and thus much less interesting from the point of view of the traditional EU budget bargaining – items were judged to be of medium importance.

On the basis of the above results, there is no surprise in the answers to our next question, where we asked respondents to evaluate the actual share of the expenditure items int he EU budget, to judge whether resources were sufficient or whether there were areas where they should be increased or decreased. The results are presented by Figure 4, and are very much in line with our previous findings.

Figure 4

Opinions on the shares of current expenditures



Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, p. 37.

More than 3/4 of the respondents considered that the share of the item “Competitiveness for growth and employment” should be increased; half of them thought that the share of “Cohesion for growth and employment” and “The EU as a global partner” should be greater, too. At the same time, almost 2/3 of the respondents a preference for decreasing CAP expenditure; according to 17% of all respondents, the CAP should be abolished altogether.

3. Survey results: preferences and prospects for a future budget

Regarding the future shape of EU budget expenditure, we asked them to specify any new expenditure items they wished to see in the EU budget (if any). Table 2 presents the results of this question.

Almost 40% of all respondents considered that new expenditure items would be necessary in the EU budget. Table 2 presents the ideas of these respondents, together with the number of cases of mentioning for each idea. Quite much in line with present Europe-wide mainstream thinking, a common energy policy, climate change and environmental protection, R&D, development, education were among the issues on the top of the list; meanwhile. While it is not surprising at all, the presence of European defence among the most mentioned proposals is more interesting.

Table 2

New expenditure items suggested by respondents

New items suggested	Number of answers
Common energy policy	13
Defence	12
Climate change/environmental protection	10
Research & development/education	10
Immigration/social group integration/social policy	5
Labour market development/net job creation	3
More funds to solidarity, equality and gender issues	3
Foreign aid (make EDF part of the EU budget)	2
Culture	2
Infrastructure	1
Baltic Sea Strategy	1
Union integration projects	1
Common EU embassies	1
Conditional financial aid to North African countries*	1
The EU faces new challenges**	1

* Condition: low level of illegal immigration to EU; aim: to motivate North African governments to better patrol their external borders, so as to alleviate pressures on EU social security systems and to make workers remain in their home countries.

** Rising energy prices; demographic change; sustainable development; alleviating globalisation effects; and development of knowledge-based economy. The EU needs to reflect, first, on what the EU's political priorities are – i.e. which challenges the EU should try to find answers to – and, second, on how current EU policies could be adjusted to comply with these political priorities.

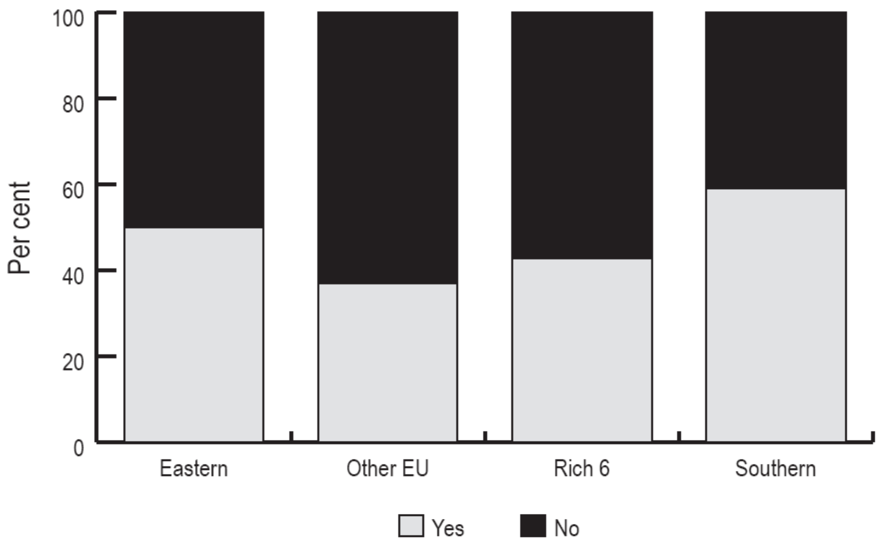
Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, p. 38.

In the survey, a specific question was devoted to the issue of enlargement and the (supposed) additional budgetary burden related to it.. The reason for it was that previous enlargements have always caused additional tensions around the EU budget negotiations, and it can be expected to remain so. The objective of the question was also to specify fears and expectations in this respect – we asked the respondents to describe the most important factors (if any) that would endanger the proper and efficient functioning of the EU budget in the case of further enlargements.

The answers to this question show (see Figure 5) that opinions are very much divided. There is some difference between the country groups, but altogether more than half of the respondents think that the present EU budget will not be able to deal with tensions stemming from further enlargements. They provided various reasons (see Table 3); most of them emphasised the problem of Turkey's accession, while several respondents considered the present structure of the CAP as a hindering factor.

Figure 5

"Do you think the present structure of the EU budget will be able to deal with the needs of further enlargements?"*



* *Eastern*: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Slovakia and Slovenia; *Other EU*: Belgium, Cyprus, Finland, Ireland and Italy; *Rich 6*: Austria, France, Germany, the Netherlands, Sweden and the UK; *Southern*: Greece, Portugal and Spain.

Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, p. 54.

The results of the country papers (included in the report) reinforced the impression got from the questionnaire survey. Country positions mapped by the country papers regarding the expenditure side of the EU budget are presented in Table 4.

Although Table 4 shows that there is an increasing understanding of the necessity to reform major EU policies – including the CAP and the Cohesion Policy – as well as a principal agreement on the importance a number of new items. However, the last line of Table 4 reminds us that budget size is probable to remain a key issue, and that net position considerations will also continue to be important.

Table 3
Potential problems stemming from further enlargement – main issues raised by the respondents

Remarks related to Turkey

- Too large a share to ineffectively centralized CAP. In case Turkey becomes a member the agricultural policy will not be sustainable
- Accession of Turkey is the biggest problem, may become an incalculable risk. Probably impossible to accommodate Turkey within the present structure. The EU budget could in no way accommodate the accession of Turkey in 10-15 years. It will need to be thoroughly overhauled for this purpose - especially the CAP which should be abolished by the time Turkey joins the EU. CAP and Cohesion expenditure would under current conditions go largely to Turkey and the Balkans; therefore current Member States would see dramatic reductions in these receipts. Turkey would not fit in under the current structure, the Western Balkan states maybe;
- Possible accession of Turkey to the EU would cause substantial burden for the EU budget (especially in the area of Cohesion policy and Common Agriculture Policy of the EU). In that case EU should restrict the share of EU budgetary expenditures spent on Common Agriculture Policy and Cohesion Policy should be concentrated on the development of the regions lagging behind in the poorer Member States with GDP per capita below the EU average. In the case of future EU enlargements without Turkey the present structure of the EU budget would be considered sufficient.

Remarks related to the financial burden of enlargement

- Further enlargements (mainly involving much less developed countries) will mean new types of challenges;
- Current and potential candidate countries need higher financial support because they have much more complicated problems as compared to the previous enlargements;
- New Member States are even more underdeveloped and will thus require high levels of financial assistance. There is not enough money for enlargement;
- The EU budget at its present structure is not able to deal with the needs of further enlargements of the EU, especially in cases where enlargement refers to countries with huge populations and low standards of living;
- More funds are needed in order to better integrate Balkan states.

Remarks related to increasing differences

- Inequality in the EU is too big;
- More expenditures for cohesion is required;
- The current system does not adequately deal with regional differences in the Union, such as the greater importance of a particular policy for an individual region.

Other remarks

- Excessive bargaining power of core countries;
- Less attention should be given to *juste retour*;
- Too much money for agriculture and the Structural Funds. Too little money for research, education and innovation;
- A general correction mechanism should be introduced. Also greatest increases in the Budget 2008 are related to internal policies for the Member States;
- No more enlargement, at least in ten years;
- May need to move to EU tax but not on business and only if corresponding reduction in other taxes.

Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, p. 130–131.

Table 4

Summary of country positions on top issues related to EU budget expenditure

Issues	Germany	France	UK	Sweden	Spain	Poland	Hungary	Bulgaria
CAP	Reform; national co-financing of direct payments	Maintain; increasing openness for reform	Abolish/ reform	Abolish/ reform	Reform/ abolish	Maintain; increasing openness for reform if equal competition conditions for all EU producers ensured; no re-nationalisation	Increasing openness for reform	Openness for reform
Cohesion Policy	Concentrate on the neediest regions; more emphasis on Lisbon targets	Concentrate on Objective 1 regions in the EU-27; bring objectives into balance; broaden funds' competence	Significant reduction of current EU funding	Concentrate on neediest Member States; coherence ensured to avoid counteraction between policy areas	Increased concentration necessary for higher efficiency	Maintain; no renationalisation; concentrate on Objective 1 areas	The country's share to be kept high – at least for the next Financial Framework	Important; to be kept at present level and to be made more efficient
New or increasing expenditure items proposed	Lisbon objectives	Lisbon objectives; Education and youth; Security and justice	R&D, CFSP	Lisbon objectives; Justice and Home Affairs; safeguarding peace, democracy and human rights. However, any new expenditure item only as a result of CAP and Cohesion Policy reform (reduction)	Industrial policy, social and employment policy, defence, EU diplomatic corps	European Neighbourhood Policy; Globalisation, energy, sustainable development	A defensive position: preserve existing policies, but openness to many ideas, e.g. energy policy; R&D policy; innovation; education; social policy; employment policy; health policy; and migration policy	International cross-border projects in physical infrastructure
Budget size	Max 1% of EU GNI	Max 1% of EU GNI	Max 1% of EU GNI	Max 1% of EU GNI	Around 1% of EU GNI	At least 1% of EU GNI	At least 1% of EU GNI	At least 1% of EU GNI

Source: The EU Budget Review: Mapping the Positions of Member States, SIEPS Research Report 2008:2, edited by Tamás Szemlér and Jonas Eriksson, pp. 130–131.

4. Conclusions

The most important conclusions of the report regarding EU budget expenditure – on the basis of the questionnaire survey and the country papers – can be summarised in the following:

- While the need for fundamental change is clear, old sources of budgetary conflicts remain important. Therefore, old debates will probably continue, at the latest during the discussions on the Financial Framework beginning in 2014.

- The budgetary net position is still central in the line of thought of most member states. A change in the long run is not inconceivable but a major deviation from the present course seems unlikely in the near future. Of course, the ongoing budget review is an eminent occasion for change in spirit, but its results will not be binding in any sense for the Agenda 2014.

- Considerable shifts on the expenditure side have quite good chances now. The main issues in this respect are the future reform of the CAP, and of the Cohesion Policy and the reinforcement of the competitiveness objective. There are a number of converging ideas regarding new expenditure items but a closer look reveals that most actors probably base their thoughts on the status quo.

- It is important to note that there is no general division line between old and new member states. Beyond their specific short or mid-term interests in their economic catching-up process, new member states seem to understand the importance of being part of a strong EU. They are also well aware of the fact that in the case of further enlargements, the CAP and the Cohesion Policy in their present forms would mean a greater financial burden for them, and would first of all benefit the future new members. Therefore (the actual) new member states seem to be open for reforms in the long run.

- More generally, most groups of member states are not homogeneous and thus no general coalitions may be expected. This was already a well-known fact among the old EU15 and this applies to the new EU12, as well. One exception might be the group of net contributor countries (the group of the “Rich 6”), although France and the UK may have special interests potentially dividing this group as well.

ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES
ГОДИНА XVIII, 2009, 1

Nadya Yorgova[1]

ENTERING THE EUROZONE: COMMITMENTS AND CHALLENGES TO BULGARIA IN TERMS OF FINANCIAL CRISIS

Establishing the currency board arrangement (CBA) in Bulgaria played a key role in overcoming the results of the last and pointed as one of the worst financial and economic crisis. This decision still remains a serious factor for Bulgaria in the terms of European Union membership. Related to the act of accessing EU the obligations Bulgaria undertook, are partially provided by the fiscal stabilization, successfully achieved thanks to the currency board arrangements introduced in the state. Price stability, however, further remains an impediment towards economic policy. It is tightly connected with the next main challenge: to overcome the inner obstacles for fulfilling the Convergence Criterion for a proper entering the Euro zone under the conditions of spreading world-wide financial crisis. This article aims to summarize the recent background which led to the nowadays economic development and related to it future advantages and challenges.
JEL: E42

1. Background

In the months and years to come, Bulgaria will face many challenges concerning the latest development of world-wide negative tendencies in the financial sector and similar to those which the rest of the world will. Only the impact on the Bulgarian economy is expected to be different and it could be relatively less affected than the more developed financial markets. For a better view of latest economic challenges, it could be useful to review the recent historical development.

The Bulgarian banking system as a whole operated on one horizontal level until 1989 when its economy faced the challenge to be transformed from a planned one to a market-oriented. Along with the processes of reorganization and privatization in the real sector, banking system went trough a general transformation also. It gained the right and obligation to relocate the free capital from the economic subjects holding savings surpluses to those with liquidity deficits.

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Bulgarian National Bank (BNB) obtained the functions of a typical central bank. Most of its territorial divisions were transformed into commercial banks in a join-stock manner. The boom in these transformation processes came in 1990 when The National Bank gave licenses for banking activity to 61 commercial banks. In these conditions of a new developing market-oriented banking system, the legal framework was of a crucial importance for the proper functioning of the economic system as a whole. For example, as of 1991 Bulgarian National Bank performed as independent authority, but through the State Budget Act it was given a legal option for a governmental pressure in order tied loans to be issued and in this way the independency of the National Bank seemed to be just formal. This happened to be one of the options for the system to gain bad loans.

On the other hand, in the period 1990-1996, most of the small and medium-sized commercial banks were consolidated. The biggest part of the sector remained public until the end of 1997. In commercial banks' portfolios liabilities were accrued because of financing public debt and public enterprises not yet privatized and in pecuniary difficulties.

In the sphere of the private part of commercial banks a boom was recorded in the period 1991-1993 because of the liberal license conditions. Firstly, a legal chance was given for starting a private commercial bank with loaned capital from the public ones. According to the law in force, there were no obstacles for a bank to issue loans to its owners and related to them persons. And in case of liquidity difficulties, the bank itself could have been refinanced by the National bank. This, on the other hand was a channel for relocation of capitals and another precondition for the later crisis development. Of course, most of those legal flaws were instigated by the general transformational processes and the lack of experience related to acting in liberal market environment.

Another segment of the banking system was the foreign commercial banks' branches in Bulgaria. Although their share was varying but not exceeding 18 percentages in the period before 1997 and their contribution to the negative situation development was of no consequence.

All the above reviewed conditions and processes in the banking system led to serious difficulties related to the sector and increasing negative balances in the most banks' portfolios. Most of the banks faced liquidity problems and by the beginning of 1996 they became unable to assure their depositors with money on demand after the governmental decision referring to the National Bank that had to stop pouring refinancing flows in them. In the spring of 1996, 14 commercial banks, holding around a quarter of all the assets on the banking market, lost their licenses. The trust in the financial institutions in the state rapidly decreased. Besides, these negative tendencies became obvious yet in the beginning of 1996 and developed till the end of the same year when the economy faced serious instability ahead with privatization obstacles and hyper inflation affecting the financial stability which transferred to the real sector as well.

The evolvement of crisis led to the necessity of quick and reasonable measures to be taken. The government admitted its incapacity to deal with thus developed situation by inner means. The financial stability could only be retrieved by implementing the rules of a Currency board arrangement. Along with the economic, there were certain political preconditions and will for gathering around decision of following the International Monetary Fund (IMF) recommendations.

As a result of the negative tendencies and processes a caretaker government was the one to take the new policy course of financial and fiscal discipline. It was 10th of June 1997 when the 38th Parliament passed the new Law for the Bulgarian National Bank, establishing the Currency Board arrangements in the state in a more flexible framework than the typical (orthodox) model of Currency board as general.

2. Before and after establishing Currency Board

For a clearer vision of the results of Currency Board arrangements in Bulgaria a table is given below containing basic macroeconomic indexes for a seven-year period before and after the year of establishing its rules. As it can be seen, the inflation had reached enormous rates (average values for the period), which respectively affected the economy as a whole and all the other relative macroeconomic indexes. For the both compared periods before and after adopting the rules of Currency board the positive influence is more than obvious. The most visible difference could be sought in the inflation rates, which decreased from three-figured to single-figured numbers. In the early 1997 the national currency lost positions against the United States Dollar, and for a little more than a year (end of 1995-beginning of 1997) Bulgarian Lev was undervalued against US Dollar more than 25 times. This on the other hand contributed to the sensitive decrease of import and export flows in and out of the state. Such dramatic future fluctuations had been prevented by fixing the national currency of Bulgaria to a reserve one. The growth of investments in the state on the other hand increased from negative basis to almost three times higher and positive amount. The budget deficit was decreased from more than 6 percentage points of GDP to almost balanced (zero) revenues. Along with that, the GDP growth increased from minus 4.6 percentage points to the plus 4.55 percentage points. Another significant index is the growth of broad money, which decrease was of about 80 percentages for the compared periods.

Indicators	Period 1990-1997	Period 1998-2005
Inflation (%)	210.1	7.27
GDP growth (%)	-4.6	4.55
Investments growth (%)	-8.8	20.1
Budget Deficit (% of GDP)	-6.3	-0.1
Average growth of Broad Money M3 (%)	103.7	20.0

Sources: National Statistic Institute, Bulgarian National Bank, Ministry of Finances of Bulgaria, own calculations

The table above and comparing the data before and after establishing the rules of Currency board in Bulgaria clearly shows this was the right line to be followed. The achieved stabilization played a key role during the years to follow and on Bulgaria's way to accessing the European Union.

3. Bulgaria in the European Union and the Eurozone perspectives

From 1st of July 1997 on, the Bulgarian Lev was first fixed to the German mark, later substituted with the Euro currency in exchange rate of 1.95583 for one Bulgarian Lev. This measure came to show the pro-European course Bulgaria had undertook and which has been followed until today. This step was very important for the stability of the exchange rate since Bulgaria is a small open economy.

As a result of many years of preparation for the accession, at the beginning of 2007 Bulgaria became a full-fledged member of the European Union. The Bulgarian Lev remained fixed to the Euro and this clearly showed once again the course of passive following the monetary policy of the Union, since in the conditions of Currency Board arrangements Bulgaria does not apply an autonomous monetary policy.

Along with the accession to the EU, Bulgaria undertook the obligation to adopt European Union's common currency. For this purpose it is necessary the Convergence (as known as Maastricht) criteria to be fulfilled. They can be divided in few major groups observed in more details in the next few paragraphs.

The most stable criteria fulfilled by now concerns sound **government finance.** The statistics clearly show the position followed by the government in the field. As it can be seen in National Statistical Institute official data, since the accession of Bulgaria in the European Union, the percentage of **government and government guaranteed debt** to GDP is far below the values of reference defined by the Convergence Criterion, namely 60 at most. The revenue of Bulgarian government debt to GDP in 2007 is 19.8 percentages and 15.9 percentages for the third quarter in 2008 according to the statistics.

The other item related to the sound government finances according to the Stability and Growth Pact concerns the **annual government deficit to GDP**, which should not exceed 3 percentages. In the recent years Bulgaria follows stable tendency of reaching surpluses. Namely – 3 percentages in 2006, 0.1 percent in 2007 and the targeted for 2008 3 percentages and very likely to be reached and even exceeded. Both these indexes are measuring the stability and buffers Bulgaria has and the policy of stable and transparent financial policy followed after The Currency Board's arrangements. This stability could play a key role for the months and years to come under the financial crisis influence. And, of course, these tendencies could contribute to a quicker and smoother entrance and convergence in ERM II and respectively the Euro zone.

Concerning the **exchange rate** as a precondition of a proper entering the Euro zone, according to the Treaty for accessing EU, Bulgaria had signed, the state should have been in the Exchange Rate Mechanism (ERM) II for at least two consecutive years without devaluating its national currency against any other member-state's currency. This can be taken as a test for the national currency's stability. This, on the other hand is necessary for the national currency in case it should be a part of a stable supranational one. In the Bulgarian case, however, this stability has already been proved by the followed principles of Currency board for more than ten years, which do not allow any fluctuations in the exchange rate.

In the sphere of **Long-Term interesting rates,** as second main condition for entering the Euro zone, stable revenues of this index are recorded. According to the Maastricht Criterion it should not reach more than 2 percentage points higher than this in the three lowest inflation member states for the year, preceding evaluation.

According to the Bulgarian National Bank's data, for November and December 2008 this indicator is respectively 6.0 and 7.76 percentages, following an increasing tendency. According to Eurostat's data the three lowest inflation states in European Union for the same period are Luxemburg, Portugal and Germany. The average of their revenues is 4.08 and 3.74 percentage points and adding to them two more percentages the calculated result is 6.08 and 5.74 percentages. If this trend remains, another gap will be opened and Bulgaria will have to catch up the convergence level necessary.

The third requirement is one of the most debated one since its fluctuations are publicly very tangible, namely **inflation rate** measured with Harmonized Index of Consumer prices. The lowest rates of Harmonized Index of Consumer Prices in EU are reached in Luxemburg, Portugal and Germany. The average value, measured as reference is 0.86 percentage points for November and December 2008 which shows dramatic decrease from 3.2 percentages in August 2008. Bulgaria's data for the same months, according to the National Statistical Institute is also sensitively decreasing in the last months of the year but still much higher respectively 8.8 and 7.2 percentages for the same periods.

This criterion remains not yet fully reached and is pointed as most problematical. In the dynamics of developing financial crisis, this index is fluctuating sensitively. In the next months, the forecasts are related to its decrease. Still the issue of replacing higher inflation rates with lower GDP growth remains. According to the IMF forecasts this indicator will decrease from 6.3 percentages in 2008 to 4.2 percentage points in 2009. This relatively low growth would be followed by a decrease in the trade balance deficit and current account of the state. On the other hand, the recent tendencies of lowered credit activity on bank's part comparing to the last year will regularly lead to a shrinking in the domestic demand (especially in the demand of luxury goods and investments). All other things being equal, the above mentioned shrinking would decrease the inflation rates in a long term.

These effects, on the other hand, will impact the labor market as in particular sectors the unemployment will undoubtedly increase. In this scenario, rates of inflation would probably decrease, along with higher levels of unemployment and lower rates of GDP growth. However, the tendencies, mentioned will not be seen only in Bulgaria. In the case of comparing values with the three lowest inflation rate states in EU it remains an open issue how should the development of financial difficulties affect the European union as a whole and where should these effects be seen most obviously.

4. Advantages and challenges related to the Eurozone accession

The expected advantages for accession of Bulgaria to the Euro zone could be put in the hypothetical framework. At first place to be mentioned is the stability and awareness of the public in relation of the main course of the policy followed. In that defined framework the households and business could plan activities strategically. Especially what concerns the dynamic force in the face of business and entrepreneurs whose loans in their larger extend are in Euro currency.

The transaction cost in the trading activities could be saved if the sole currency replaces the national. But, on the other hand, this could lead to speculative rounding off the prices as a whole and thus to an increasing in the inflation rates. Taking both these effects, the total result could be doubtful and depends on which effect would prevail. On the other hand, the negative trend of higher prices and inflation based on the currency changeover may be eased if following the example of Slovenia as one of the states lately introduced the Euro currency in 2007, followed by Cyprus, Malta in 2008 and reaching the number of 16 as of 1 January 2009 by Slovak joining the Euro zone. Measures such as dual price display in the ERM II period for few months (in the case of Slovenia – more than four months or 16 days as in the so-called "big-bang" scenario Slovakia will perform) could be used for more transparency and minimizing the speculative rounding off. This measure gave Slovenia a result of only 0.3 percentages euro inflation for the year following the currency changeover.

The last years' trend of GDP growth based on extend flow of foreign direct investments mostly involved in the construction market was provoked by the fact that Bulgaria was a trustworthy destination of good perspectives for economic development. Along with this the low currency risk and stability of Currency board turned Bulgaria into a promising field for investing free capital. On the other hand, in the circumstances of decreasing of foreign direct investments and more carefully choosing of their destinations, this low currency risk could play a key role for softening the negative effects. According to data provided by Bulgarian trade banks' dealers, the estimation of the currency risk is 12-14 percentages.

The more comfortably comparable prices of goods and services in Bulgaria as part of European Union market are serious advantage for the business and households. Along with saving transaction costs this factor could improve the business climate significantly. Moreover, the latest sociological researches show that states such as Denmark where a new referendum is under consideration because the financial crisis clearly showed Denmark pays high economic and political price for staying out of euro zone and for this reason should join it. Similar position is shared also by Sweden and even Iceland after losing national currency positions. In this relation, it becomes more obvious that the Euro zone is a stability factor in times of world wide financial instability.

Positive influence could be mentioned also on a governmental level. Transferring the national monetary policy on a supranational level gives an opportunity for more flexible fiscal policy. Of course in the spirit of Currency board arrangements, the monetary tools are reduced to minimum, but though not missing as a whole. And the fiscal policy of discipline and straight budget buffers is one of the advantages that could play a key role in preventing much of the negative influences other states would examine in the context of crisis development.

The most serious arguments against adopting sole currency are BNB and the government losing incomes from seigniorage. Latest public discussions were provoked by the issue of one-sided euroisation and replacing the national currency with the common Euro. The given arguments for and against this step in times of financial instability should be carefully considered since it has the character of breaking the Treaty for accessing the European Union and the resulting from this consequences for the state. In this regard, tense relations later could be of a crucial significance for the state. However, these political decisions have to be taken carefully with as wider as possible observation in a long term. In the circumstances of indefiniteness, originated from the latest financial crisis' development, many of the risks have to be minimized.

5. Readiness for joining the Eurozone

The official position, the Bulgarian government and the monetary institution in charge – The Bulgarian National Bank, have taken is to adopt the Euro currency and enter the Euro zone in the shortest term after accessing European Union. This was targeted by joining the ERM II as quick as possible after the date of accession and preserving the currency board arrangements with the current exchange rate. This position was clearly underlined by the Bulgarian institutions even before the 1 January 2007. The ambitions of the Government in adopting the Euro currency were to stay in ERM II for the minimum period required and to replace the national currency by 2009 or latest 2010. Even the goal of two year period in ERM II seems hard to be achieved both in view of the current situation of the possibility to fulfill the inflation criterion by Bulgaria, and the financial and macroeconomic crisis in the Euro zone.

The Maastricht Criteria, related to the inflation rates in Bulgaria as mentioned in the paragraph above remains the criterion most distant from the convergent revenues. This is one of the main reasons, pointed by the President of European Central Bank (ECB), Jean-Claude Trichet, underlining that the price stability is one of the main direct benefits, achieved by establishing the Euro Currency ten years ago. Connecting this official ECB position with the necessity for Bulgaria it must be pointed out that lowering inflation rates by disciplined fiscal policy and long-term structural measures were accomplished by Bulgaria far before its EU accession. But currently, it comes clear that the Convergence Criterion will be more strictly applied for the new Euro zone members, in order for the achievements in the area to be preserved stable. Thus it would be even harder for the Central and Eastern European countries to join the Euro area. As a proof of this statement the Lithuanian and

Estonian positions to remain out the Euro zone because of inflation rates could be taken also under consideration. .

The regular Convergence Report on Euro readiness, adopted by the European Commission in May 2008 (in which Bulgaria was examined for first time) high rates of inflation, measured with HICP were pointed as a serious gap to be filled. These high inflation tendencies, on the other hand are partially result of the sought convergence in the emerging economies of the new member-states like Bulgaria after 2007. The wages and incomes are rising, which naturally provokes higher rates of demand and of course inflation. In this regard, the issue on how adequate Maastricht Criterion is becomes quite disputable. The regular Convergence report clearly shows the positions of ECB and EC both on economic indexes and legal convergence of the states with derogation which in 2008 points that Bulgarian law also does not comply with all the requirements for Central bank independence and legal integration into the Eurosystem

This position of ECB and EC, within a world spreading financial crisis, could be expected to be even more conservative and cautious accompanied by not accepting more members of the Euro zone for a certain period of time. And the institutional ambitions and inflation challenges in front of Bulgaria still remain. The more likely and realistic horizon for introducing the Euro currency for Bulgaria for now remains the year after 2011-2012 if Bulgaria manage to overcome the financial crisis showing stability.

6. Instead of conclusion

In short term, the following months and probably year Bulgarian economy will have to face the effects of global financial crisis. The fiscal stability in terms of financial instability will play a key role in the economic development of the state. According to the forecasts of respectable institutions such as Bulgarian National Bank and the Agency for Economic Analysis and Forecasting the macroeconomic indexes in the following periods will be sensitively worsened because of the financial crisis' impact. Proof of this is the implemented forecasts in the National 2009 Budget Act where publicly discussed and serious buffer amount was stipulated in both optimistic and pessimistic scenarios on the crisis' future development.

Two years after Bulgaria became a full-fledged member of European Union, the debates of accessing the ERM II still remains. In the optimistic scenario of 2007, Bulgaria could have been part of the Euro zone by the beginning of next year and under the circumstances of global financial crises to be able to ease part of the external shocks expected. But, two years later, even a green light for entering ERM II is not disputable in ECB or ECOFIN. This regularly brings up new discussions about one-sided introduction of Euro currency. The above assessing of pluses and minuses following such one-sided decision to be taken shows that from the present point of view the negative political and economic consequences would sensitively exceed the positive ones. And the more reasonable option remains working on the inner obstacles Bulgaria is still facing on its way to converging with the rest EU member states.

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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GLOBAL ASPECTS AND A POSSIBLE CONTENT OF A COMMON EUROPEAN ENERGY POLICY

Many people say that the European Union needs to create a common energy policy. However, only a few of them gives details about its content. In this paper, we examine the global, long term aspects of the European energy situation. We base our proposals for the content of the common energy policy of the EU on the conclusions drawn from this analysis. According to our findings a common energy policy should incorporate foreign policy (including climate change diplomacy), educational policy, R&D policy and setting strict rules for building related energy consumption.
JEL: Q48

Introduction

Many politicians say that the European Union needs a common energy policy. However, only a few of them is aware of its necessary contents and its global linkages and background. Having experienced some natural gas supply troubles and disputes between the Russian gas monopoly, Gazprom and Ukraine or Belarus, one most recently, at the beginning of 2009 between Russia and Ukraine, they argue that Europe needs to reduce its energy (most importantly natural gas) dependency from Russia through building gas pipelines to be filled with non-Russian gas or pipelines bypassing recent transit countries like Ukraine or Belarus. Another argument for creating a common energy policy is the need for a strong bargaining position of the EU against big energy suppliers, mostly Russia.

In this paper we try to give a picture about the necessary linkages, possibilities and background which should inevitably be taken into account when considering the creation of a common energy policy for the European Union.

As energy sector is a very stable and slowly changing sector, with a need of huge investments and long return on investment we are examining changes and possibilities emerging on the long term, mostly in the next 20-50 years.

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Firstly, we examine the global demand and supply situation for the most important fossil fuels, crude oil and natural gas. Secondly, we deal with its implications for Europe. Next, we give some suggestions for the possible content of a European energy policy. Fourthly, we deal with the global linkages of the climate change efforts made by the European Union. The final section concludes.

Long term demand and supply of the main energy resources

To be able to judge the conditions for the European energy policy, first of all we need to know the global and the European demand and supply prospects. We need to know this as these are the circumstances under which the European energy sector has to operate, these data show whether Europe will need more crude oil or natural gas in 20-50 years time and whether there will be resources available at that time. This analysis may indicate how fierce the competition for these resources will be and to what extent we may be forced to switch to the use of other energy sources like renewable ones. We don't need an exact projection of supply and demand, and this is not the goal of the current paper, we only need to know to which direction global demand and supply is going to move and whether it is expected to result in an increase of the European energy dependence.

Demand

Global demand for energy has increased for several centuries. There might have been some slight valleys in the demand curve, especially during global economic repressions, but on the average demand for crude oil and natural gas has been steadily increasing. In the last 2-3 decades one tendency has strengthened, namely the catch-up of developing countries in terms of energy consumption. Developing countries, especially China and India, keep increasing their share in the global energy demand. In Figure I below there are two important changes deserving attention. First, the increase in the total global demand amounts to 73% between 1973 and 2006. Second, the share of OECD countries dropped from 60.6% in 1973 to 47.3% in 2006. Asia, China, Latin America, Africa and the Middle East together almost doubled their share (from 22.8% to 41.5%), which is an increase of energy consumption of 215% during 33 years (on average 3.5% yearly). A huge increase, especially in comparison to the relevant data for OECD countries: an increase of 35% over 33 years (on average 0.9% yearly).

Obviously, past tendencies don't determine future developments. To project future developments let us have a look on the factors determining energy demand:

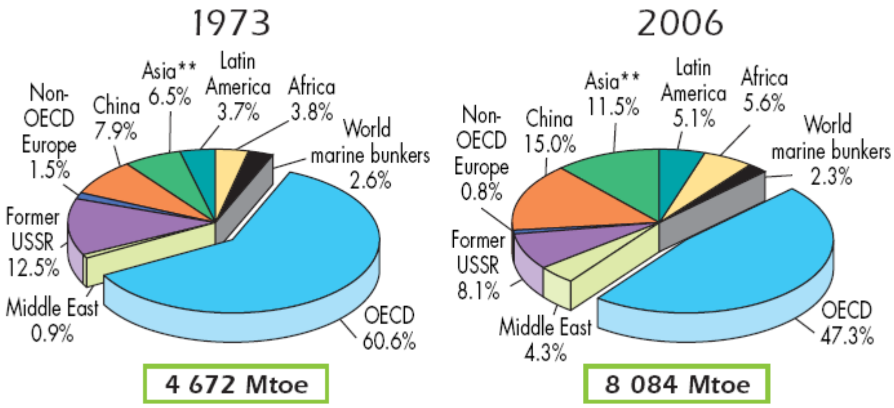
- World population: high growth rates especially in developing countries like China, India, Middle Eastern, African and Latin American countries. Developed world: rather stagnating or slightly shrinking population.

- Growth of per capita income: moderate rates for developed countries, higher rates for China, India, Russia and some other developing countries.

- Transport sector: characterized by the number of automobiles per 1000 people (transport sector accounts for 60.5% of the total oil consumption[2]), see fig. 2.

Figure 1

1973 and 2006 regional shares of total final energy consumption

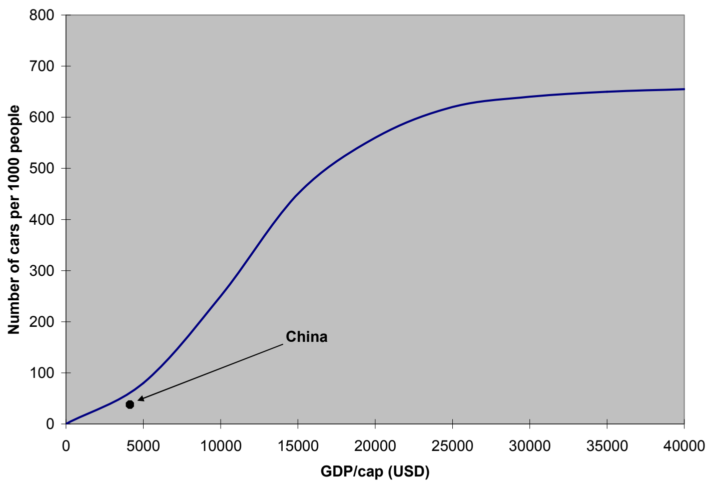


** Asia excludes China

Source: graph taken from IEA: Key World Energy Statistics 2008, p. 30.

Figure 2

Number of automobiles per 1000 people



Source: presentation of László Varró, Strategic director of the Hungarian oil and gas company MOL Zrt., given on 2nd December 2008 in Budapest. This figure is only an approximate copy of the figure projected by László Varró, exact data of the original figure aren't available for the author of this paper.

[2] Source: IEA: Key World Energy Statistics 2008, p. 33

This figure refers to the crude oil consumed only in the transport sector. According to this we can expect a strong increase in the number of automobiles sold in the developing world, including China and India, therefore we can expect a strong growth in crude oil consumption in these countries.

- Industry: several industrial sectors are exposed to a global competition therefore adoption of energy saving technologies is crucial for these sectors. The increase of industrial energy consumption is expected to stay moderate.

- Households (space heating in buildings): through the increase of the world population and the ongoing individualization tendencies (fewer and fewer big families living together in one household and building) further increase is expected.

Figure 3

Energy consumption in the industry sector, in Mtoe

	World			OECD			Non-OECD		
	1973	2006	Change (1973 = 100)	1973	2006	Change (1973 = 100)	1973	2006	Change (1973 = 100)
Industry sector	1545	2180	141.10	955	866	90.68	590	1314	222.71

Source: IEA: Key World Energy Statistics 2008, p. 36-39, own calculations

Implications from the demand side

Most probably, all these tendencies continue to increase global energy consumption on the long run.

Population and per capita income developments (high growth rates in the developing world) and transport sector developments aren't expected to change their directions which implies that developing countries are expected to keep increasing their shares in the global energy consumption.

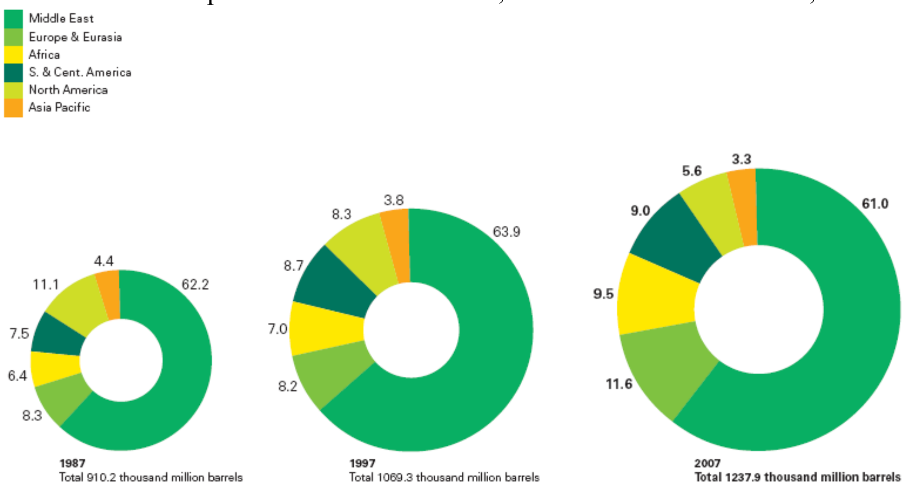
Supply

When considering the long term supply side conditions for Europe we need to know where we may expect to get the most important energy sources from in the future, namely crude oil, natural gas and coal. To know this, we need to have a look at the proved reserves of these resources.

Regarding crude oil reserves, the European Union is expected to rely on crude oil mostly from countries outside its borders, most probably from the Middle East and/or South and Central America. Current extraction data justify this assumption as North Sea oil fields supply less and less each year.

Figure 4

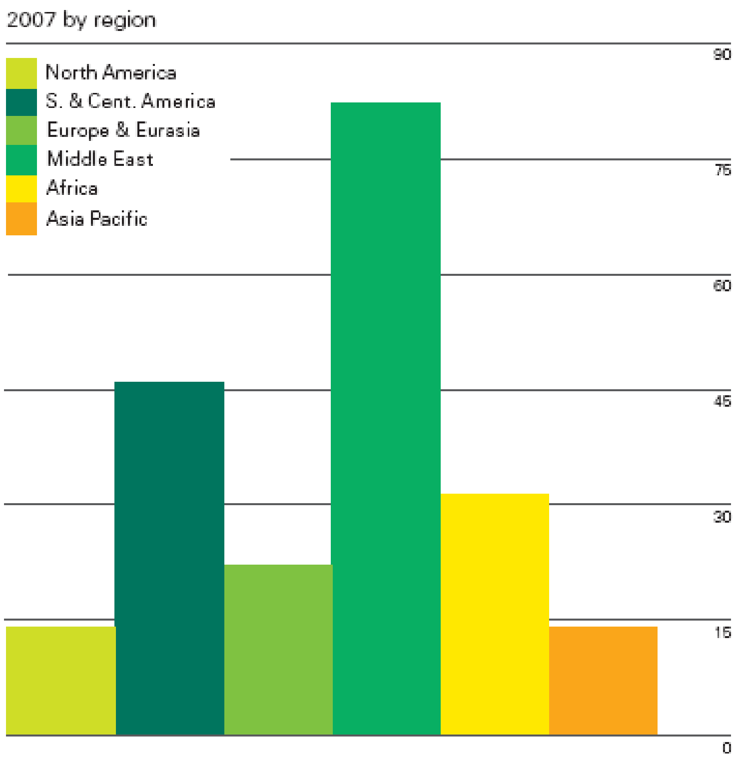
Distribution of proved oil reserves in 1987, 1997 and at the end of 2007, %



Source: BP Statistical Review of World Energy, June 2008, p. 7

Figure 5

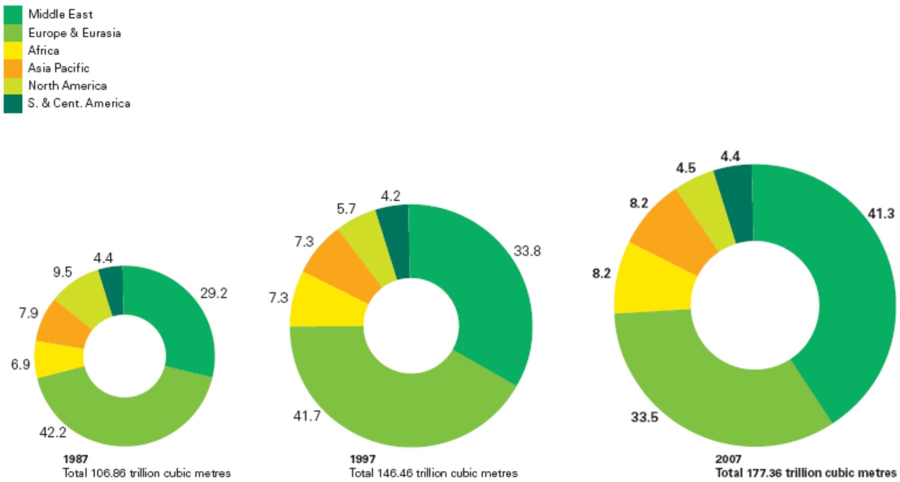
Reserves-to-production ratios by region in 2007, crude oil, years



Source: BP Statistical Review of World Energy, June 2008, p. 10

Figure 6

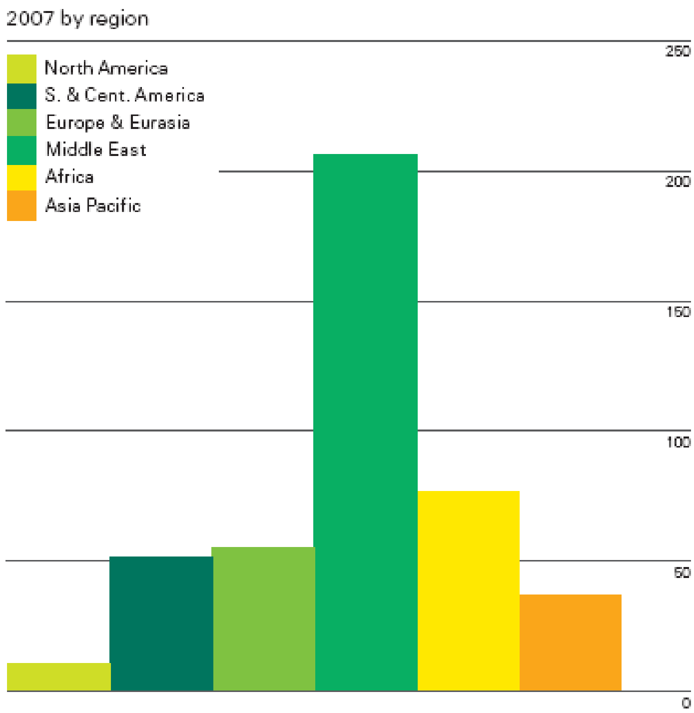
Distribution of proved natural gas reserves in 1987, 1997 and at the end of 2007, %



Source: BP Statistical Review of World Energy, June 2008, p. 23

Figure 7

Reserves-to-production ratios by region in 2007, natural gas, years



Source: BP Statistical Review of World Energy, June 2008, p. 26

Regarding natural gas, the European Union will be forced to fulfill its natural gas needs to an increasing extent from abroad as its gas fields' yields are expected to decline in the upcoming years. As "European and Eurasian" sources mean mostly Russian sources, the EU itself can't avoid doing business with its most important natural gas supplier, Russia. Moreover, as natural gas is preferably transported via pipelines, to only a smaller extent via ships as LNG, and EU production is declining while EU demand is steadily increasing, pipelines are crucial for satisfying the EU needs for natural gas. According to the figures above, these pipelines must transport natural gas either from Russia/former Soviet Union countries or from the Middle East. However, if the conditions/tendencies mentioned before happen to change, new pipelines may happen to be unnecessary.

Figure 8

Distribution of proved coal reserves in 1987, 1997 and at the end of 2007, %

Proved reserves at end 2007 Million tonnes		Anthracite and bituminous	Sub-bituminous and lignite	Total	Share of total, %	Reserves / production ratio (years)
US		112261	130460	**242721**	28.6	234
Total North America		**116592**	**133918**	**250510**	**29.6**	**224**
Total South & Central America		**7229**	**9047**	**16276**	**1.9**	**188**
Kazakhstan		28170	3130	**31300**	3.7	332
Russian Federation		49088	107922	**157010**	18.5	500
Ukraine		15351	18522	**33873**	4.0	444
Total Europe & Eurasia		**102042**	**170204**	**272246**	**32.1**	**224**
South Africa		48000	–	**48000**	5.7	178
Middle East		1386	–	**1386**	0.2	*
Total Middle East & Africa		**50817**	**174**	**50991**	**6.0**	**186**
Australia		37100	39500	**76600**	9.0	194
China		62200	52300	**114500**	13.5	45
India		52240	4258	**56498**	6.7	118
Total Asia Pacific		**154216**	**103249**	**257465**	**30.4**	**70**
TOTAL WORLD		**430896**	**416592**	**847488**	**100.0**	**133**
of which:	European Union	8427	21143	**29570**	3.5	50
	OECD	162490	194420	**356910**	42.1	168
	Former Soviet Union	93609	132386	**225995**	26.7	463
	Other EMEs	174797	89786	**264583**	31.2	70

Source: BP Statistical Review of World Energy, June 2008, p. 32; EMEs = emerging economies.

As this table makes it clear, proved coal reserves are far more equally distributed on Earth than either crude oil or natural gas. In spite of this fact, the EU is not even with this energy source very well supplied. If production is kept unchanged, reserves will last 50 more years.

Implications for the European energy situation

During the next decades competition for energy sources is going to strengthen. It is explained by not only the new global players, such as China and India, but by a decline of the available traditional energy resources, as well. Extraction of fossil fuels will become more expansive, it will require more developed technologies for getting these resources out of the ground. Increased demand is going to face a declining or at much higher costs extractable supply which is going to lead to higher energy prices, and to the spread of higher inflation rates induced by higher production/transportation costs. For monetary authorities this kind of inflation, namely cost side inflation is difficult to handle with, interest rate increases keep back demand and investments, therefore economic growth unnecessarily.

Clash of different countries for the same energy resources is going to increase tension between different regions/countries of the world. An early form of appearance of this is already currently observable in Africa and South and Central America. China cultivates fruitful relationships with countries which suffer from the embargo of the Western countries (e.g. Sudan) or aren't considered as members of the friendly states such as Venezuela, Cuba or Iran. In exchange for loans and other financial aids Western countries often require efforts from the African countries, such as building hospitals, cutting back government expenditure, spending more on the health and educational system, efforts to strengthen democratic values and protect human rights etc. China, however, turns a blind eye to the oppression by dictators or human right infringements and supplies these countries with cheap loans or other financial help in exchange of only natural resources[3]. With this activity China undermines the development policy of the European Union and the USA which may lead to conflicts between the Far-Eastern giant and the Western world. This may lead to a need of rethinking of Western development policies towards the third world.

Another region important for energy supplies is the Middle East. As the figures about the distribution of proved oil and natural gas reserves make it clear, on the long run we must rely on Middle Eastern countries as energy suppliers. Currently, few would say that diversifying our energy supplies to Iran or Iraq would increase the supply security of energy resources for Europe. Instability in Iraq, war between Israel and Hamas in the Gasa Strip started on 27th December 2008 and the supposed nuclear program of Iran make the whole area instable and insecure as suppliers. Going to the North, to Middle Asia we face an unresolved legal status of the Caspian Sea, a forward pushing Russia buying up all the oil and natural gas resources possible in the former Soviet Union countries. Further, we see an unsolved conflict between Russia and Georgia.

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[3] See: Hugyecz, A. Kína: nyersanyag- és energiapiacok, Együttműködési és konfliktusmezők hazánk számára. [China: commodity and energy markets, Potential cooperation and conflict fields for Hungary] Budapest, Institute for World Economics, Hungarian Academy of Sciences – Prime Minister's Office, 2008.

In this respect, the possible common energy policy of the EU is far more foreign policy. First, we should solve the problems of the Middle East and come to an understanding with Russia, which, by the way, has always, even during the cold war, been a stable and reliable supplier of energy resources to Europe. The gas disputes and gas delivery difficulties in 2006, 2007 and most recently at the beginning of 2009 aren't manifestations of an unreliable Russian supplier, but rather consequences of the reluctance (and perhaps ability) of Ukraine to pay market prices for the Russian gas.

Anyway, if things continue to happen the same way, on the long run there won't be other alternatives for Europe than to buy natural gas and crude oil from Russia, the Middle Asian and Middle Eastern region.

As the European demand for these resources increases and other possible suppliers can't fulfill the EU needs, the EU's energy dependence on countries mentioned above is going to increase.

Possible ways to go for the European common energy policy

Demand

Europe can't increase the stock of its fossil energy sources. It therefore has to deal with energy consumption.

First of all, the EU has to force its member states to realize investments which are realizable at negative costs[4]. These include energy efficient technologies for households, using compact fluorescence bulbs, installing efficient furnaces and massive insulation for house walls. The EU has to set very strict rules and standards for energy efficiency of houses as technologies eliminating natural gas based heating systems are already available at reasonable costs. Such systems are geothermal heat pump systems or passive houses.[5]

In some countries of Europe, especially in Germany, Sweden and Austria, geothermal heat pumps are very popular. Currently, almost all new houses in Sweden are equipped with heat pump systems, therefore no natural gas is necessary for space and water heating. In some other countries, however, due to the lack of demand and supply prices for heat pumps are prohibitive. People simply don't know how heat pumps work, others (many) simply don't believe that one can produce 4-5.5 kWh heat energy by consuming only 1 kWh electricity.

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[4] For such investments see for example: Novikova, Ürge-Vorsatz. Carbon Dioxide Mitigation Potential in the Hungarian Residential Sector. Budapest, October 2007, p. 3; McKinsey Global Institute. The Carbon Productivity Challenge: Curbing Climate Change and Sustaining Economic Growth. June 2008, p. 15.

[5] Passive houses are houses which due to the massive insulation of the walls, floors and the roof and thanks to special windows don't need a traditional heating system. Such houses are heated by the people living and electric devices operating in it.

As local governments consider setting so strict rules/standards as politically unfeasible, this must be the task of the European Union. EU subsidies must be available in countries where heat pumps don't appear on the market. A big market has to be established with many customers and more and more suppliers through which prices can drop to real market price levels.

Building standards have to be modified and have to become very strict. Buildings (including houses, commercial, public use and industrial ones), if once built, are going to use energy for at least the next 50 years. It's very cost efficient to include energy efficient solutions during the planning and building stage of a building. You can easily and at reasonable costs build houses using 60-70% less energy for space heating than houses with nationwide (see not only Hungary and other Central and Eastern European countries but Germany for instance, as well) average energy needs[6].

People living in the European Union have to contribute to a stop of increase of building related direct natural gas use (building related natural gas consumption is responsible for a big share of natural gas consumption in several European countries). People have to be explained that other technologies do exist, moreover, as most probably explanation won't have the necessary effect, they have to be forced to build houses with no direct natural gas consumption (heat pumps need electricity whose production to a certain extent is based on natural gas in several EU countries, that's why we say "direct natural gas consumption").

By the way, it's necessary to mention that natural gas consumption is in 17 EU member states more carbon dioxide intensive than electricity consumption. It also means that in 17 EU member states it would decrease the overall carbon dioxide emissions if we switched from natural gas consumption to electricity consumption. Moreover, it has to be mentioned that imposing carbon price on electricity producing power plants (see recently approved EU Climate Change Package) is going to increase electricity prices and therefore it is a disincentive for switching from natural gas use to electricity use in the EU, although such a switch would lead to a decline in the overall carbon dioxide emissions in 17 member states of the EU.[7]

Another area for creating strict standards is the consumption of electric devices used in households, mostly refrigerators. Strict standards for standby modes of such devices are necessary, as well.

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[6] The Hungarian residential sector needs on average 292.5 kWh/m2/year energy for space heating (Source: ÉMI Kht. [Institute for Building Related Quality Control and Innovation]). It can be reduced remarkably and at negative costs by insulating the walls massively. Through installing special windows you can reduce this value even further. Relevant standard for passive houses (with no heating required) is 15 kWh/m2/year (not achievable in case of houses already existing).

[7] See: Ellison, D. L., A. Hugyecz. Why (is there) No Carbon Price on Natural Gas?. Paper prepared for the Workshop on "Energy: A Cross-Cutting Influence on EU Widening and Deepening", CEPS, Brussels, November 12th 2008.

Banning traditional bulbs is the most cost efficient way of increasing energy efficiency in places where you need lightning.

The EU has to set strict standards for the fuel consumption of automobiles, as well. Automobile taxes should be based on carbon dioxide emission per km, these taxes should be high enough to mean a real incentive for buying less polluting cars and using public transport. On the long term, we will have no alternatives but for using electricity driven cars – not only because of depletion of current fuel sources but rather because of a need to mitigate climate change effects. Electric engines are far more efficient than internal combustion engines. The European research and development strategies must focus on the improvement of batteries, on the development of very efficient cars.

R&D investments will result in a developing environmental technology sector which will result in more jobs, increased export of goods and services originating from Europe and a global leading role of the environmental technology sector of the EU (insulation materials, renewable energy systems, energy and material saving technologies etc.)

Educational policy plays a crucial role in the behavior of the next generations regarding energy and material saving. The way of thinking has to be changed, environmental consciousness has to be improved. Reducing energy consumption resulting in a drop of standard of living is a wrong way to go. Only a few, environmentally very conscious people can be convinced that way.

Supply

Another way to reduce the energy dependence of the EU member states is a use of renewable technologies, such as hydro, wind, solar heat energy, solar photovoltaic (PV), geothermal energy and perhaps biomass. The most abundant sources are wind and solar energy (heat and PV). Solar heat energy is mostly used for warm water heating in households, for space heating it's used to a smaller extent.

Electricity generating systems, like wind energy or solar PV are popular and promising technologies. The biggest constraint against their spread is the integration of such power plants into the electricity systems. Electricity system operators often face difficulties in keeping electricity supply and demand balanced. Once great number of wind parks are in operation, whose electricity production keeps changing steadily and to a big extent, other very flexible, easily manageable power plants must be available in order to keep electricity supply and demand balanced. A storage of electricity in batteries is due to the great necessary storage facilities unfeasible but there is a suitable and commonly used technology, namely pumped storage power plants. They are capable of giving a very dynamic response to an excessive demand or supply in the electricity grid caused by either demand side fluctuations or by supply side changes due to wind speed fluctuations for example. Such pumped storage power plants can enable the integration of remarkable electricity producing capacities using renewable sources. Until recently, there has not been used any similar, so flexible, easily manageable, tried and tested technology with so small environmental effects. Such pumped storage power stations have operated in several countries (e.g. France) with great success for several years.

It could be a task of the EU common energy policy to promote the building of such pumped storage systems therefore to overcome the integration problem of renewable technologies.

Cross-border connection of electricity grids of different EU member states is another urgent task. Small countries have to cooperate in balancing electricity demand and supply but they can manage it only if electricity grids are connected to each other. Smaller countries in Central and Eastern Europe like Austria, Bulgaria, the Czech Republic, Hungary, Romania, Slovakia and Slovenia have to create a really integrated electricity system. Such EU-wide grid developments should be promoted by the common energy policy, as well.

EU initiated building of natural gas storage facilities and the cross-border connection of gas pipelines would increase energy supply security of the individual member states.

As figures about proved energy reserves (oil, gas and coal) imply, the European Union can only rely on coal, as a locally available energy source for a longer time period. As climate change puts constraints on building traditional coal-fired power plants, we will be able to build them only if we develop carbon capture and storage (CCS) facilities for each coal-fired power plant. Such facilities aren't in operation yet, there are 13 demonstration projects being built in several countries of Europe. If this technology turns out to be a success, it can result in some relief regarding energy dependence.

Most importantly, the EU's common energy policy has to promote the creation of an electricity producing system which, first, enables the integration of the abundant renewable sources, second, results in an environmental friendly electricity production.

We are convinced that one can avoid building new nuclear power stations through installing electricity saving lightning systems and the production of electricity from renewable sources.

New nuclear technologies (e.g. fusion energy) are currently not available in industrial scale and won't be used in power stations until 2020. If it turns out to be environmental friendly and flexible, it can solve the electricity production difficulties for many decades. This is another argument for a need of promoting extensive R&D investments in the energy sector.

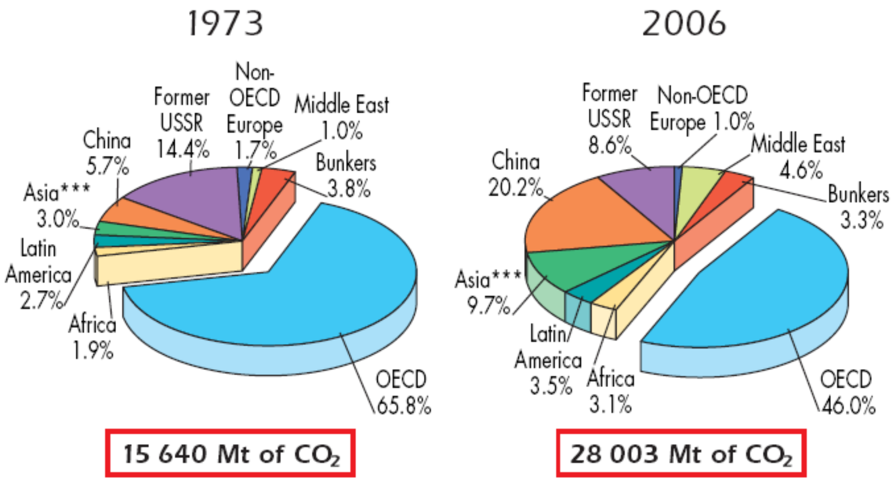
The global need for clean energy

The European Union makes remarkable efforts to (force its member states to) reduce its greenhouse gas (GHG) emissions and its energy consumption. The Climate

Change Package, approved in December 2008, is aimed at reducing the EU's GHG emission by 30% if other big GHG emitter countries commit themselves to a remarkable reduction of their GHG emission. As the EU-27 countries account for only a quite small share of global GHG emission, other countries with big GHG emissions should be convinced of sharing such efforts. Most urgently, the USA, China, India, Russia and Japan have to become members of a global climate change mitigation regime as in 2006 this 5 countries alone accounted for 55% of the total global CO2 emissions.[8]

Figure 9

1973 and 2006 regional shares of CO2 emissions**



** Calculated using the IEA's energy balances and the Revised 1996 IPCC guidelines. CO2 emissions are from fuel combustions only.
*** Asia excludes China.
Source: IEA: Key World Energy Statistics 2008, p. 45.

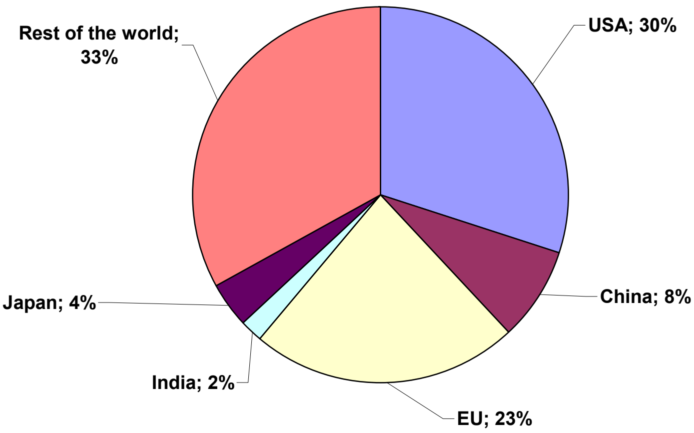
Developing countries are reluctant to commit themselves to a remarkable reduction of GHG emissions as they are convinced that this is not them who are responsible for the climate change but the developed world. If you add up the energy related CO2 emissions between 1900 and 2005 you'll see that their opinion is well-founded. China, for instance, accounts for only 8% of the total emissions.

Unfortunately, even if this argument is strong, big emerging economies can't avoid sharing climate change mitigation efforts as they are affected by climate related catastrophes and health diseases, as well. They might be right in their argumentation but it doesn't help to mitigate climate change effects.

[8] Source: IEA: Key World Energy Statistics 2008, p. 48-57, own calculations.

Figure 10

Cumulative, energy related CO2 emissions between 1900 and 2005



Source: International Energy Agency: World Energy Outlook 2007, China and India Insights, Paris, 2007, p. 191.

The recently approved Energy and Climate Change Package of the European Union is a good demonstration of commitment to stop climate change. However, the EU's commitment alone won't be enough to reach this ambitious goal and the EU, through its climate diplomacy, has to be able to convince other big polluter countries to cut back GHG emissions. That's pure foreign policy and, at the same time, a great opportunity for the European environmental sector to sell its products and services globally.

Just some examples: the energy efficiency of the whole Chinese building stock has to be increased very much. An energy efficient reconstruction of only 4-5% of the existing buildings in China requires an investment of 150-200 billion euros. Moreover, 15-20 million people migrate from countryside areas to urban areas. Until 2020 this tendency results in a growth of the Chinese urban population by 165-220 million. These migrants need new houses, schools, hospitals, power plants, manufacturing plants, storage facilities etc. which could be a good market for European companies. Further, until 2020 China aims at fulfilling 16% of its electricity needs by renewable energy and aims at spending 187 billion euros for the investments necessary for achieving this goal.[9]

As seen before, climate change is not only a constraint but at the same time a great opportunity to increase FDI and exports of products, services and technologies originating from EU countries.

[9] See: The German Chamber Network: Marketing für deutsche Standards, Produkte, Technologien mit Schwerpunkt Shanghai und Yangzi-Region, in Building, Energy & Environment, Shanghai, May 2007, p. 1-2.

All in all, climate change diplomacy has to be part of the future European common energy policy.

Conclusion

As we have seen, the European Union will have to rely on its current energy suppliers, moreover, its energy dependence will increase further if current energy demand and supply tendencies don't change.

Several factors contribute to the development of a stronger competition for fossil energy resources. New players on the energy market (on the demand side) are developing countries, like China and India.

If the EU wants to diversify its energy suppliers, on the long run it won't have any other alternatives but to import crude oil and natural gas from the Middle East, from Russia and Middle Asia. The Middle Eastern and Middle Asian region is a politically instable region. We can only ensure energy supplies and increase energy security in Europe if this region is a stable one, filled with friendly states and governments.

The common European energy policy has to incorporate a strong foreign policy towards the Middle East and the former Soviet Union countries. Wars, political instability of the region have to be eliminated.

Another foreign policy task is that the EU has to convince big polluter countries to share efforts for reducing greenhouse gas emissions and mitigating climate change. Not only developing but developed countries have to be part of a new climate change regime.

Within the borders of the EU it has to reduce its energy consumption. It has to make use of investments realizable at negative costs. The energy efficiency of buildings (including houses, industrial, commercial and public use ones) has to be increased by a huge extent and, where possible, natural gas based heating systems have to be replaced by heat pumps. The promotion of such technologies (through correct price incentives) and a creation of big markets for these technologies result in declining costs. Many of the currently available technologies are already available at reasonable costs. These have to be published to as many people as possible. The next generation has to learn in schools how one can be economical with energy without a drop in the standard of living.

R&D investments and a leading role in environmental technologies are going to be a great opportunity to create jobs and increase the European export.

Easily manageable electricity producing power plants have to be built and electricity grids of different EU member states have to be connected to enable the integration of renewable energy technologies into the electricity system. Creating effective financial incentives for it must be part of the common European energy policy.

All in all, the common energy policy has to be a complex policy, including effective foreign policy, climate change diplomacy, R&D policy, educational policy, setting strict rules and policies to improve energy efficiency in the (above all) non-competing sectors of the economy.

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ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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FOREIGN DIRECT INVESTMENTS IN BULGARIA: DO THEY HAVE AN EFFECT ON THE ECONOMIC DEVELOPMENT OF THE COUNTRY?

The article is trying to analyze the benefits of attracting foreign direct investments (FDI) and the supposed effect on the economic development in Bulgaria. The increase of FDI per capita is important for the penetration and absorption of FDI in the economy, as well as for the creation of new jobs. FDI's accumulation demonstrates the relative increase of the absorptive capacity of the Bulgarian economy. The regressive analysis shows that there is a strong connection between the attracted FDI and the increase of GDP. Despite that FDI are increasing in processing industry and financial intermediation, the last years they are directed to the real estate, building and acquiring industrial, logistic and trade projects or to companies with intermediation or leasing activity. Thought the macroeconomic indicators in Bulgaria are relatively stable, the deficit in the current payment balance is deepening and the attraction of FDI is considered as a source for financial assistance. At present, and regardless of the strong relation between FDI and GDP, it is not possible to affirm that the increase of FDI in Bulgaria is contributing to the development of export-oriented economy. The global financial crisis also is creating an unfavorable economic environment, influencing negatively on the inflows of FDI in Bulgaria and on the economic development.
JEL: F21, F32

1. Introduction

The enlargement of the foreign investments activities of the Multinational enterprises (MNE) has been regarded as one of the characteristics of the world economy and an impetus for economic growth and development. As one of the main form of foreign economic relations**,** FDI has taken place in the context of the promotion of outward looking economic strategies. Hence the developing countries have been undertaking policy shifts from import substitution industrialization models towards more export-oriented economic policies (Narula, 2004). This makes FDI especially attractive for many developing and countries in transition to market

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economy and without doubt for Bulgaria too, as the country experienced a long way of difficult restructuring of the economy during the last two decades.

FDI represents one of the defining features of reshaping the international business environment and there are a lot of studies, examining the changing structure of international production and growth of FDI activities. FDI pave the way for the design of new strategies and policy with the purpose to attain some main goals of the economic growth and development: increase the investment and modernize the economic structure and fulfill the shortage of financing of the economy. Therefore, FDIs entrance helps the host countries because they can obtain a launching pad from where they can make further improvements in the industrial and economic sectors.

This trend has manifested itself in the last years. Any form of FDIs, which is providing capital knowledge and technological resources into the economy has been able to play an important role vis-a-vis the economic development of the recipient countries. These countries have changed their economic stances and have allowed the foreign investors to come in with the expectations to restructure their economies, bringing in new technologies and expertise.

Also, the experience of the last years shows that firms of economic developed countries, on their part, are interested a lot to invest in other countries, through moving some industries outside. This inflow of foreign capital can be channelized into various sectors of the economy. It is normally done on the basis of the awaited profit from this investment of the foreign firm, but in the same time represents a financial assistance for development of the host economy.

The well known Dunning's classification, explaining why the MNE are investing abroad, has underlined the importance of the foreign firm's presence on the real sector of the host country. The foreign firms, localized on other markets, realize ownership advantage, what is probably unlike for the local ones. The benefits of the ownership advantages are in the form of knowledge in the area of new technologies, which is a premise for introducing new production and goods, creating new opportunities for improving the management of the company and a successful marketing.

An important effect of FDI is also the spread of indirect effects (spillovers) over the host economies, mainly concerning the influence of foreign branches on the behavior of the local firms. The branch specialization is a main factor for attracting FDI. The foreign firms, specialized in production of certain goods, have decided to invest abroad, because of the presence of similar industries in the host country and qualified labor force. The influence of FDI is horizontal when they are spread in depth at inter-production level, and vertical when they are spread in two different productions. The horizontal distribution is connected with acquiring certain specific knowledge about certain branch, despite the intentions of the foreign investor. This type of FDI gives some advantages to the local producers, concerning qualification of the labor force, production of substitutes of foreign products, etc. The vertical FDI present general and not specific knowledge about the development of the branch and are useful for the firms' suppliers, as well as for the buyers.

The connection between the foreign and local company is especially significant for the transfer of technologies and for the increase of the labor production. The new technological development of the host country pave the way for approving the intra-industry linkages and increase the knowledge in some definite economic sector, which can have a positive impact on other industries in the host country and overall economic development.

FDI is able to improve the infrastructure of the host country. It is well known that the private sector firms are not always interested in undertaking activities that help in improving the infrastructure of the country, due to the fact that the gains from the infrastructural activities are made only in the long term. There are no short term benefits as such.

The standard of living of the general public of the host country could be improved, as a result of FDI, also some social activities may be ameliorated too. FDI can assist in helping countries with shortage of capital to build their own research and development bases that can bring in new technologies. This is a very crucial contribution as most of the countries are not able to perform these functions on their own. These impacts are important especially in the context of the manufacturing and processing industries and in services of the particular country, that are able to enhance their productivity and ultimately realize a notable economic development.

What is important is that FDI help the creation of new profits on the basis of new comparative advantages in some definite production and give opportunities for development of export-oriented branches. The latter change their policy from productions based on substitutes of foreign (imported) goods to export-oriented productions. The outcome of the mergers and acquisitions is a permanent transfer of manufacturing know-how and management expertise from the foreign company that boost the efficiency and output of local affiliates. These participations have a long term horizon and exercise a significant influence on local management.

The spread of MNC into different sectors of the economy is determined also by the aggressive liberalization of the FDI regimes and of the privatization programs of the host countries. Encouraging "green investments" is also part of the government policy to develop certain production sectors.

At macroeconomic level, FDIs are also contributing to the financing of the deficit of the current account of the balance of payments. It is important to overcome the shortage of finance for the economy, to provide for the macroeconomic stability, to ensure additional funding for the increase of investments, economic growth and employment. Also, FDI, as a source of financing of the deficit of the current account of the balance of payments, do not generate additional debts for the country.

Despite the positive direct and indirect economic and financial effects of FDI, studies of the linkages between FDI and development have produced contradictory results. Some have shown that FDI spurs economic growth in the host country; others do not discern these benefits. Actually for years it has been unclear whether developing countries benefit from their resources to attract FDI. Recent researches tend to point to evidence that spillovers' benefits do exist, but their effect is not widespread. The obtained diverse results are due to differences in the host country, varying in relation with qualification of the labor force, private sector, competition, legal practices and host country policies toward trade and investments. A vast majority of the existing empirical studies indicate that FDI does not always make a positive contribution to either economic growth and factor productivity. This is often because host countries are not able to capture the bulk of benefits associated with FDI without a certain threshold level of absorptive capabilities.

The article tries to define if FDI growth leads to perceived benefits in terms of the injection of capital, technology and knowledge, financial flows. Bulgaria succeed to attract increasing inflows of FDI although do they really turn out to be a connecting-rod for further economic growth and development?

2. Inflows of FDIs and main determinants attracting FDI in Bulgaria

At the country level, growth in FDI can be measured in total value of inward investment and in net flows. The FDIs inflows measure the amount of foreign investments entering a country during a one year period. The FDI stock is the total amount of productive capacity owned by foreigners in the host country. It grows over time and includes all retained earnings of foreign-owned firms held in cash and investments

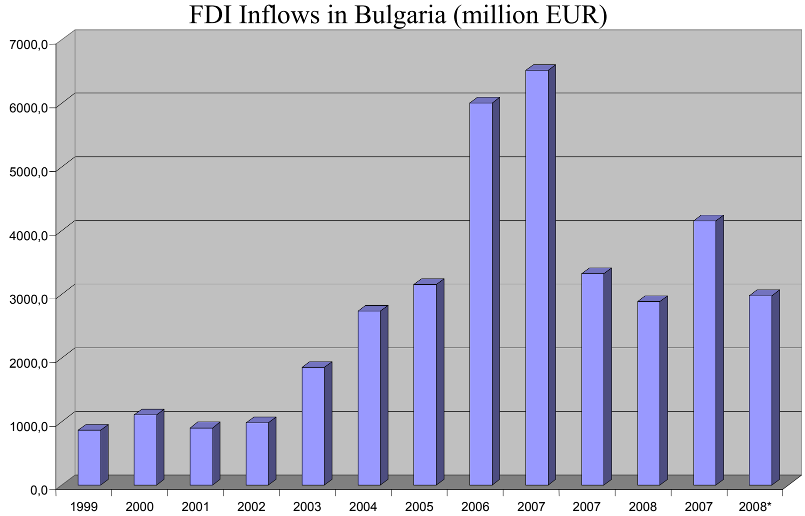
The total FDI inflows in Bulgaria in the period of 1996-2008 amount to 33.71 billion EUR. From 1996-2000 the FDI flows have increased relatively slowly, but since 2000 they started to rise annually. By type of investments the most important part of foreign investments are coming from equity capital, which amount for the period 1996-2008 to 19.81 billion EUR. The type of foreign investments - other capital is amounting to 10.17 billion EUR. The item "Other Capital shows the inter-firm loans, given by foreign owners of local companies, which also show the intensive development of the foreign firms. The figure demonstrates the evolution and the accumulation of FDI inflows with the relatively slowing of the foreign investments near by the end of 2008 (fig. 1).

The "green investments" are an important item since it shows the number of attracted projects in Bulgaria, compared with other countries in South Eastern Europe. In the period 2001-2005 Romania owns 40% of the market share of FDI with 285 projects, Bulgaria – 25% with 174 projects, after that are Turkey with 20%, Serbia with 9%, Greece with 4%.[2] The Bulgarian Investment Agency (BIA) examines more than 30 "green investments" projects, which apply for certification by the new law stimulating the "FDI of quality". The new law aims to improve the competitiveness of the economy through stimulating investments in certain branches of the real sector where the State considers that they are of primary importance for the economy.

[2] Ernst@Young South East Europe Attractiveness, 2006, Survey 2007.

Figure 1

FDI Inflows in Bulgaria (million EUR)



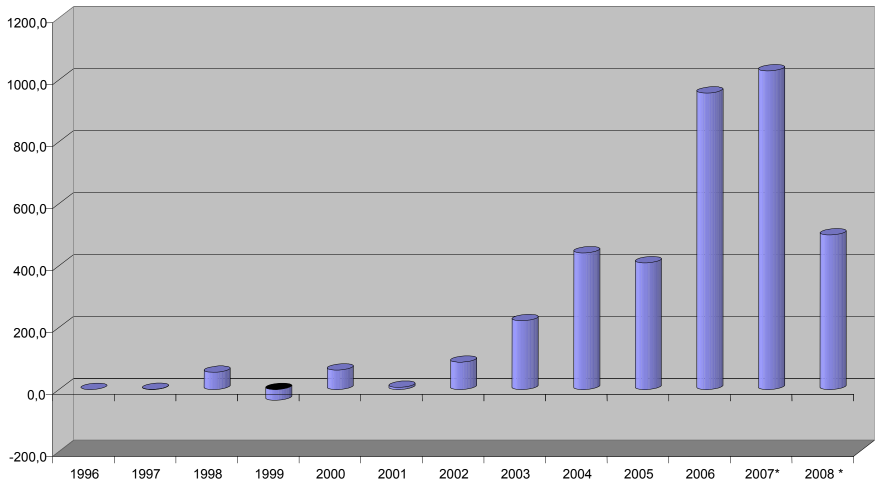
Source: Payment balance of BNB; data from firms with foreign participation, Privatization Agency, NSI, Central Depositary, banks, etc.

Since the statistics in the item "FDI" includes incomes of any character, like foreigners purchasing homes and partial transfers of Bulgarians abroad, only the "reinvested profit" is outlined as the most representative component of FDI. The reinvested earnings are the most important part of FDI. They show the real impact on the economy and its absorption capacity, demonstrating the real effect of FDI on the economy. The reinvested accumulated profit of the foreign companies has appeared in 1997 and increase since 2000. .The reinvested earnings are amounting to 3.74 billion EUR for the period 1996-2008, which illustrates a positive effect for the development of the economy. The reinvested profits of the foreign investors registered a drop in 2007, i.e. when they should increase, due to the adoption of the flat rate of 10% in Bulgaria. Exactly this item should react positively to the decrease of the profit tax, and really stimulates the foreign investments, but there is no substantial increase the low tax stimulates the purely speculative investment with the immediate transfer of the money abroad, and not the long-term investments (see fig. 2).

Figure 3 show that the main part of the accumulated FDI (1998-2007) by economic sectors went to real estate (21%), finance intermediation (19%), manufacturing (19%). In the first three quarters of 2008 these sectors retained their key role, with the shares of real estate operations and business services, financial intermediation and manufacturing accounting for 25.8%, 24.5% and 14.5% respectively. Trends in the foreign investment flows by economic sector show a slowing in FDI to real estate and business services on an annual basis.

Figure 2

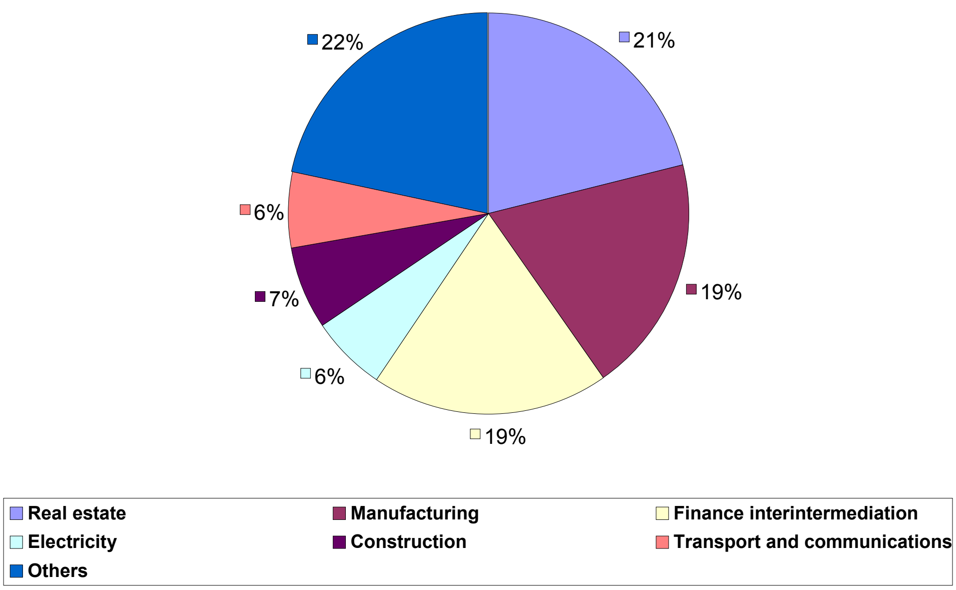
Reinvested Earnings of FDI in Bulgaria (million EUR)



Source: http://www.bnb.bg/statistics

Figure 3

FDI Stock by Sectors, 1998-2007 (%)



Even that the share of FDI in the processing industry increases, we cannot neglect the small ratio of foreign investments in significant branches for the development of the real sector of the economy, like high-technological manufacturing, electronics, education, R&D and others. In branches like manufacturing, electronics and computers, transport and agriculture are invested respectively 1.67, 0.89, 1.18, 0.24% of the total attracted FDI in Bulgarian economy.

FDI have in fact a small contribution to the development of the real sector of the Bulgarian economy, because the ratio of FDI to the internal investments in the real sector is about 27% in the period 1998-2006. This shows again that the Bulgarian economy has not been attractive for the vertical FDI and generally for development of higher technological branches.

We can underline that Bulgaria's industrial sector is in its developing stages and the country is primarily a producer of raw materials, concentrated on low-tech, labor-intensive industries. The sector is also relatively fragmented. However, a steady stream of foreign investment has helped propel sector growth of about 8% per year since 2003. While still relatively small, Bulgaria's mining industry, producing mainly copper, iron, lead, zinc, manganese and coal, has also witnessed substantial growth as privatization efforts have taken effect, with production increasing by 8.5% in 2007 in manufacturing.

A shortage of qualified labor and outdated technology are challenges, which are leading to increased competition from countries such as Macedonia, Romania and Serbia. Other issues to be addressed include Bulgaria's outdated transport infrastructure and technology, and spiraling energy prices. The pharmaceuticals industry is showing good growth, with foreign and local companies bringing new products onto the home market, as well as expanding their presence abroad.

The EU member countries are the main trade partners of Bulgaria, thus the main investors come from these countries too. The Netherlands, Austria, Belgium, Greece, United Kingdom are of the main investors in Bulgaria.

Table 1

Some main foreign investors in Bulgaria for the period 1996-2008 (billion EUR)

COUNTRY	FDI STOCK 1996-2008
Austria	5.427
Belgium	1.577
Cyprus	1.752
France	0.614
Greece	3.070
Germany	2.186
Netherlands	3.949
UK	2.741

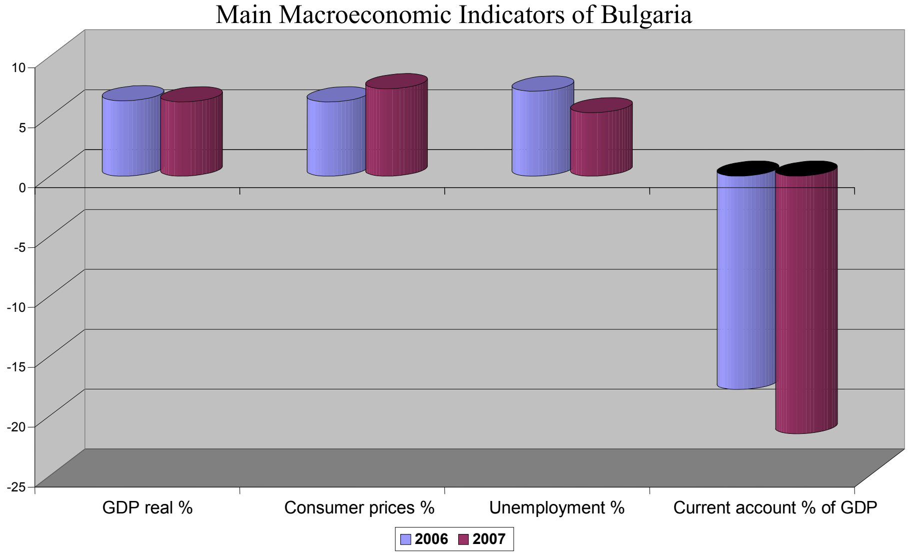
Source: BNB Statistics on FDI.

The determinants that encourage the companies to invest abroad are important for their presence on a certain market. The increase of the FDI inflows in Bulgaria is due to the combined impact of many factors, like privatization, regulating the legal orders, taxation policy, etc., which are part of the traditional determinants (spillovers) of the behavior of the foreign investors, as well as of the economic and financial stabilization of the state. The memberships of Bulgaria in EU were the most important event that changes the foreign investors' behavior towards investing in Bulgaria and increase their presence in the country. Since 1st January 2007 Bulgaria adopts the legal base of EU (acquis communautaire) and reduces the risk premiums of the foreign investors, while the accession to the customs unions decreases the transaction costs.

One of the main arguments is that the macroeconomic indicators in Bulgaria are relatively stable, like continuing trend of positive economic growth continues, decreasing unemployment, increasing inflation higher than EU average, as well as deepening deficit in the current account balance.

Figure 4

Main Macroeconomic Indicators of Bulgaria



One of the main incentives, for the foreign investors in Bulgaria is the low price of the labor force, because the decision for foreign investment is made only when it coincides with the interests of the company and its strategic interests and not because of the impact of other factors.

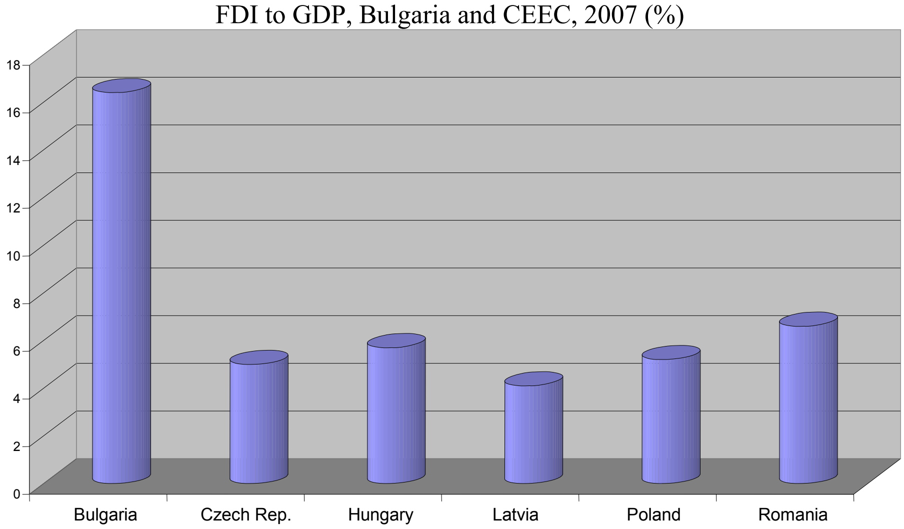
3. Impact of FDI on economic development and the behavior of foreign companies in Bulgaria

Economic development is an all-encompassing conception. It centers on economic and social progress and also entails many different aspects that are not easily quantified, such as economic, social political and others. All this matters contribute to create an economically favorable environment and better way of living. All this variety of elements forming economic development correlates positively with economic growth. As a general rule, countries with higher rate of economic growth have more rapid development and attract much more FDI. FDI has been acknowledged as most crucial factor in enhancing economic development and the standard of living for emerging economies. Studies have found a positive correlation between FDI inflows and economic growth, provided that the receiving countries have reached a minimum level of educational, technological and/or infrastructure development (Hansen & Rand, 2006). South Korea, Singapore, and Taiwan are examples of nations outside the OECD countries that have greatly benefited from FDI and the integration into the global economy. In recent years, China and India have made remarkable progress in attracting FDI and realizing technological and economic success.

FDI related to GDP ratio is an important indicator showing how FDI is influencing the growth of the host economy. The relationship between the two variables FDI and GDP for the period 2000-2007 show that the foreign investments have influenced really the production with a lag of time and have a sizable impact on the size of the economic growth. The share of foreign stock as a percentage of GDP has been high in Hungary, the Czech Republic, Slovenia and Slovakia, In Poland, the share of foreign stock as a percentage of GDP was much lower.The figure is demonstrating that among the Central and East European Economies (CEEE), Bulgaria has the highest percentage of FDI to GDP. It also shows that in the last years in the county entered higher FDI which gave some impetus to the economic growth and increased the GDP. With the relatively slowing of the FDI inflows since 2007 the correlation between FDI and GDP is decreasing. For the period 2007-2008 the correlation FDI to GDP drops from 16.3 to 10.8%. The data show that the countries that have attracted FDI generated high economic growth. *Bulgaria demonstrated a better absorption capability in comparison with other countries of the Southeastern Europe region, with the exception of Romania*

Figure 5

FDI to GDP, Bulgaria and CEEC, 2007 (%)



Source: Bank Austria Creditenstalt.

The regressive analysis also confirms the upper affirmation that there is a strong connection between the attracted FDI and the increase of the GDP. The mentioned eclectic way of reporting FDI, i.e. the high share of real property also contributes to the increase of GDP. However, it will be doubtful to maintain this trend of FDI inflows with the ongoing global financial crisis and recession and the question is rising what will be the main sources for economic growth and development in Bulgaria. It can be underlined that the estimation of this indicator is limited because are not taken into consideration the population and the sectors where FDI have been invested. But, the high percentage of foreign stock in GDP indicates that FDI played a vital role in CEEE and represented one of the most important phenomena showing the CEEEs' insertion in the globalized world economy.

Table 2

Coefficients of Correlation of FDI and GDP

Countries	Information for the model			Model adequacy		Coefficients		
	R	R^2	Std. Error	F	Sig.F	B	T	Sig.T
Bulgaria	0.944	0.892	2.459E9	82.314	0.000	3.184E6	9.073	0.000
Croatia	0.697	0.486	6.541E9	9.449	0.012	7.241E6	3.074	0.012
Romania	0.972	0.944	7.131E9	169.446	0.000	8.207E6	13.017	0.000
Albania	0.918	0.843	9.915E8	53.566	0.000	2.077E7	7.319	0.000
Bosnia and Herzegovina	0.914	0.835	1.263E9	50.645	0.000	1.212E7	7.116	0.000
Serbia	0.755	0.570	6.737E9	13.272	0.005	6.096E6	3.643	0.005

An indicator showing what is the real size of growth of FDI is FDI per capita because it is recognized that investors are selecting countries that are growing and/or are expected to be growing. For example, FDI was coming to the Czech Republic and Hungary even when these economies were not growing, because investors believed in a long time strong growth potential of these countries. Those CEEE experienced fast growth (Hungary and Poland) and tended to attract more FDI. FDI per capita is showing also the rising foreign investors' interest. In Bulgaria the FDI stock per capita is almost two fold less than this of the Czech Republic for example. The data show that FDI stock per capita is higher in Bulgaria, Romania, and Croatia in comparison with the other countries of Southeastern Europe (Albania, Bosnia & Herzegovina, Serbia). The obtained results of this indicator are limited because it has not been taken into consideration some important indicators like population estimates, demographic changes, and regional distribution of FDI.

The foreign companies with their activity contribute to a change of the social-economic climate in different regions, but they cannot attract capital-intensive projects, which require new technologies. The limited in size FDI cannot service specific goals of the economic development and that is why there is a need of attracting FDI in those branches, where there are comparative advantages and perspectives for development.

Table 3

FDI per capita in the Central European and Southeastern European countries

Countries	FDI stock (million USD) 1989-2007	FDI stock per capita (USD) 1989-2007
Czech Republic	63122	6128
Hungary	49480	4915
Poland	97734	2572
Slovakia	23357	4325
Bulgaria	**29444**	**3824**
Croatia	17467	3932
Romania	43050	1984
Albania	2669	834
Bosnia and Herzegovina	4311	1135
FYR Macedonia	2207	1103
Serbia	11995	1599

Source: IMF, Central Banks and EBRD estimates.

According a study examining the profile of 200 firms with foreign capital in Bulgaria, those with less than 50 employees prevail. They are efficiency seekers because they try to improve their production abilities and the quality of their production or service and thus increasing their comparative advantages compared with the main contractors. Most of the foreign investors contribute to the activity of the company with investments in equipment, new technologies, access to new markets, education.

The FDI directed to production of clothes with materials from the client help creating law-skill jobs, as well as decrease the poverty in certain regions. However, without further state policy, conformed to the directions of EU policy concerning the development of the FDI quality, a significant long-term growth cannot be realized.

In some of the case the low wages are determining for attracting investments in production activities with low value added, for example assembling parts. In the period 1998-2006 the low wages attracted in Bulgaria FDI of 269.9 million USD in the tailoring industry (textile), where the investors supply the entire production except the labor force.[3]

After dropping off of the quotas and the accession of Bulgaria into EU, the foreign investors cannot rely on the competitive advantages of the low wages in the mentioned sector, but will have to invest in activities, which require higher value added. The question was whether the foreign firms will be inclined to increase their production costs and to modernize their production in the country or will prefer to export it in third countries with lower wages and thus maintaining their competitive low labor costs, remains open. Probably the relatively small Greek and Turkish firms, which gain competitive advantages based on the unregulated labor and cheap labor force, will close their productions. The improvement of the macroeconomic

[3] Such view is expressed also in World Investment Report. FDI from Developing and Transition Economies: Implications for Development, 2006, Geneva, http://www.unctad.org

and investment environment will push away these firms to neighboring countries like Serbia, Albania and Macedonia.[4]

The increase of the competitiveness and efficiency of the production in the host country also depend on the attracted FDI. First, 65% of the foreign firms take into consideration that the competitive advantages are due to the higher quality of their product or provided service. Secondly, 40% of the foreign investors register indicators, like lower prices, better servicing and speed of supplies, as factors influencing positively on the competitive advantages of their firms. The ability quickly to adapt to the requirements of a certain market is also significant for 1/4 of the investors.

About 1/3 of them (or 36%) considers that their technological level is higher compared with the one of the competitive firms. About half of them (47%) think that their production is comparable with the one of the best producers in the relevant branch. About half of the companies with foreign capital have completely renewed their equipment, while 30% of the firms – partly. Very small percentage of the managers of the foreign companies in Bulgaria state that they have no intention to invest additionally in new equipment.

The foreign investors contribute to the activity of the firm mainly with investments in new equipment – 51% of them, in new technologies, access to new markets, and qualification and education of the labor force. Approximately 88% of the firms consider the mother company a source of providing capitals, know-how and access to new network of consumers.

Another aspect concerning the impact of FDI on the competitiveness and effectiveness of the production is the attracting of quality investments, directed to high-technological branches. Still we cannot state that the increase of FDI in Bulgaria is able to contribute to the development of export-oriented economy, as it is seen in Czech Republic, Hungary and Estonia. The import and export structure in Bulgaria for 2007 shows that the export gradually outruns the import. The positive trend probably is related with a production increase, additional investments, or even contraction of the real sector due to the well-defined outlines of the recession.

Except for few larger companies in Bulgaria, smaller foreign companies are present in the country. While in the beginning they are attracted by the opportunity to participate in the privatization buying at a profit real assets and/or localization in a geographic region allowing access to other markets (i.e. they are market seekers), now they are more efficiency seekers.

The increase of the effectiveness of the production is related with the attraction of FDI in structure-determining branches based on a certain strategy for development

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[4] In the beginning of 2007 the largest tailoring factory, owned by a Greek firm, exported its production in Serbia, since it will not be possible anymore the profit norm to increase on the account of the violated rights of the workers.

of high-technological branches, connected with the information and communication technologies (ITC).[5]

4. FDI as a source for financing the current account

One of the main impacts of FDIs is their capabilities to contribute as a source of financing at macroeconomic level, influencing positively on the balance of payments' current account stance. Figure 6 shows that, in the last years, the FDI increase allows covering the current account, in some years by more than 100%. After 2007 this indicator decreases almost in half, but the increasing foreign currency reserves are an additional instrument for the stabilization of the current account. This statement confirms also by the coefficient of correlation between the FDI inflow and the deficit in the current account in the period 1991-2006, which is -0.69562. The deficit in the current account is due mainly to the negative trade balance during the last years. The FDI inflows can be considered like a buffer for the increasing deficit of the current account. Data from the payment balance in August 2008 show that for the whole period January – August 2008 the balance of payments is positive in the amount of 2.4 billion EUR – almost 50% more than the previous year. In the item current account of the balance of payments, the deficit on the current account in August 2008 is 228 million EUR (compared to 265 million EUR to August 2007). For the whole period January – August the deficit has increased from 11.4% of GDP to 14% of GDP. The increase of the deficit by current account is due to the increase of the deficit of the trade balance and slight exceeding of the import over the export.

For now there is no decrease in the foreign currency reserves and fiscal surplus, which suggests certain macroeconomic stability and opportunities for overcoming problems with financing deficit of the current account, despite the known decrease of FDI.[6] The budget parameters are conformed to the identified main risks for the fiscal policy concerning mostly the high deficit on the current account of the balance of payments, maintaining the domestic demand and economic growth. Maintaining a positive budget position and a significant fiscal reserve insures a buffer and an opportunity for a reaction in case of unfavorable economic development. The foreign currency and fiscal reserves, as well as relying on considerably well

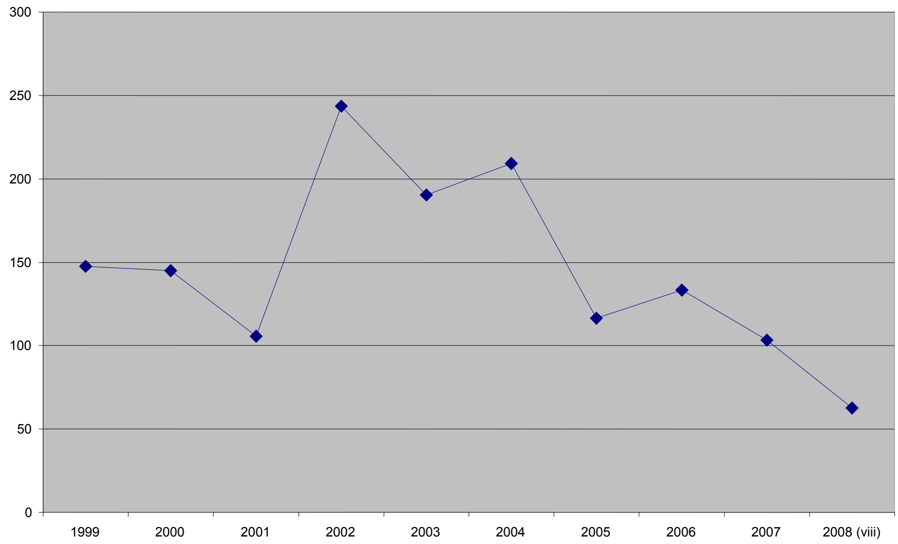
[5] To the moment, Bulgaria occupies 73rd place among 104 countries, classified by the World Economic Forum Global Information Technology Report (2005) by indicators concerning the access to internet and other ITC technologies. Estonia, South Africa and Israel have gone up in the ranking, while Bulgaria and Romania show the lowest percentage concerning use of information services compared with the European countries.

[6] The economic and fiscal policy is directed towards maintaining the achieved macroeconomic sustainability, stimulating the competitiveness of the economy and the quality of the social systems for improving the life standard. The main tools are maintaining the consolidated costs (without the contribution in the common EU budget) up to 40% of GDP and the positive balance of the consolidated fiscal program at least 3% of GDP (counting the influence of the economic cycle) and conformed with the middle-term goals for maintaining positive budget position in the program period, determined in the Convergence program (2007-2010).

capitalized and liquid bank system give certain confidence for maintaining the stability of the Bulgarian economy and compensating the drop of the FDI inflows.

Figure 6

FDI in Bulgaria to Current Account Deficit (%)



Source: http://www.stat.bg/index.html, own calculations.

Despite the set budget parameters, the achievement of these goals remains questionable because of the unpredictability of the collapse of the financial markets, of the effects of the recession in Europe and in Bulgaria of the possible depth of the crisis. This pessimistic version can lead to outflow of financial resource, decrease of liquidity, combined with strong limiting of FDI, which will make the set parameters lacking a real base and hit the overall economic development. The decrease of FDI, however, concerns the withdrawing of significant for the economy investors, which can limit the development of the economy, of the export-oriented branches, of the labor market. The decrease of the FDI inflow can cause difficulties in the financing of the deficit of the current account.

The global financial crisis has without doubt a negative impact on the slowing of the economic development in Bulgaria. The international financial crisis since the middle of 2007 has raised the question whether FDI are stable enough, compared with other capital forms, which are rather influenced on the state of the financial market. The collapse of the market of mortgage credits and the instability of the bank system in USA and the Euro Zone has an impact on the process of merging the enterprises and acquiring joint-stock capital, as main activity of MNC, and limit the intentions and opportunities of the foreign investors to expand their activity in the countries of CEEC and namely in Bulgaria.

The economic recession in EU affect Bulgaria too; still more than 2/3 of the foreign trade is with EU member countries like Germany, Italy, UK, France and Spain. The delay of the economy of these countries will reduce the demand of Bulgarian exported goods. NSI data show that in August 2008 the export of Bulgaria has had the lowest values since February 2008.

The immediate effect of the global crisis is for now relatively weak concerning FDI in Bulgaria. Generally FDI are less sensitive to the current situation on the financial markets, since they are determined rather by long-term strategic priorities. The FDI drop is a fact in 2008. It is obvious that fewer foreigners buy real estate. In the industry there is also a decrease of the transactions due to the recession in Europe. The real estate sector can cause a shock in the economy (from 01.08.2007 to 01.08.2008 drop by 22.4%). The most mobile FDI element – credits, has already stricken the economy. For the first 8 months of 2008, compared with the same period in 2007, the drop is 68.7%, or 83.9% of the total FDI drop for the period.

The FDI decrease undoubtedly will influence on those branches of the economy of Bulgaria, where they are concentrated. The FDI structure shows that they are not evenly distributed in the economy and do not determine investments in branches, requiring higher added value. The crisis affects already the manufacturing sector in Bulgaria. Workers' dismissals and/or their forced leave also started. This concerns companies with foreign participation as well. We can assume that due to decrease of the demand from the European partners, the enterprises discharge the labor force in advance, so they can adapt faster to the challenges of the economic recession. The relative drop of the purchasing ability of the Western Europeans will probably shrink the purchase of properties in Bulgaria; this will lead to a shrink of the construction due to the raise of the costs of the credits. In the processing industry the investments are 804 million EUR. However, Bulgaria has no targeted industrial policy yet, which is probably a reason why the quality FDI will most likely not direct to Bulgaria. The strategic plans of Bulgaria concerning attracting quality FDI in R&D will probably delay.

Some of the FDI in Bulgaria are based on a long-term investment interest and strategy. It can be assumed that this will make them comparatively stable and that they will not be hit by the recession. Apart this, the foreign investments are shrinking due to the insecurity concerning the opportunities for financing and the expectations of economic recession. The import of investment goods, which depends on FDI inflows and on the development of the bank credit, is decreasing to some extent, which will not have a positive effect on the Bulgarian economy. The opportunities for attracting foreign investments in the infrastructure will delay, which will influence negatively on the restructuring and functioning of the economic development of the country.

5. Conclusions

- Besides the large MNC in the area of gas and gas products, chemistry, pharmacy, investments in properties, in Bulgaria there are small in size and capitals foreign companies, and that is why we can assume that they will limit their activity due to lack of enough liquidity and credit lines from their banks. We can expect a decrease of the demand of labor force on the labor market.

- In the future the pressure on the trade balance can be not so significant also due to the relative drop of the prices of the energy sources. The transfer of some of the enterprises with foreign participation from Central Europe to South Eastern Europe, Bulgaria in particular, due to the cheaper labor force is unlikely. However, the transferring of parts of this manufacturing can happen in Romania, which has more significant production base. Romania turns to be an economic center of the Black Sea region.

- Unlike the portfolio investments, which can be converted relatively easier into ready money and be exported from the country, FDI allow production expansion through the reinvested profit and the inter-firm financing, which allows increase of the export opportunities.

- FDI-led growth is not a process that occurs automatically in Bulgaria but is related with the country's absorption capacity. The critical problem for Bulgaria is the unsatisfactory qualification and productivity of the labor force, the low level of living standard, the corruption and the non-performing legal system and other economic, political and social impediments. That is why it is obligatory to invest FDI in R&D, education, high-technology.

- Certain factors outside the situation of the global financial markets can have an impact on the FDI inflows and economic development like the shortage of qualified labor force, corruption, inefficiency of the legal system, the delay in the reforms of key sectors, etc.

- The inflow of private foreign investments will continue to decrease and the means from the European funds would allow the revival of the investments in infrastructure, regional development, agriculture and other sectors. This compensates the weakening influence of the FDI in the sectors, which drove the economic growth in the last years.

- The reduction of FDI can turn into an unfavorable effect on the opportunities for financing the deficit of the current payment balance, if there is also a drop of the foreign currency reserves of the country. Keeping the surplus in the budget also serves as a buffer against unforeseeable declines in the economic situation.

- The possible delay of the economy growth and development can be softened through investments in products and services with high added value, which require high professional qualification. The right way is the public investments in infrastructure, building energy projects, as well as unfreezing the facilities from the operative programs of the European Union.

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ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES

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ON SOME CHARACTERISTICS OF FOREIGN DIRECT INVESTMENT IN CHINA

In this paper we analyze foreign direct investment (FDI) in China from several points of view. After putting the subject into an historical context, we use time series to illustrate the main trends of capital inflows. Our main finding is that the significant growth of FDI inflows since the beginning of the 1990s can be attributed to two factors: first, the strengthening trust in the irreversibility of the reform process, second, the gradually opening domestic market. The paper also deals with two specific, and very important issues: the so called round-tripping capital, and role of off-shore areas in FDI inflows. We show that these phenomena are strongly linked to each other, and based upon the different handling of domestic and foreign enterprises by the government. Another special feature we try to understand is the large volume of FDI compared to portfolio investments. According to our explanation this is a consequence of the relative backwardness of the Chinese financial system compared to that of in advanced economies, which makes FDI a much safer way of financing than the use of the underdeveloped Chinese capital markets.
JEL: F21

Introduction

One of the key elements of the Chinese reform process initiated in the beginning of the 70s was the constantly growing inflow of foreign direct investment (FDI). By the millennium these inflows got so significant, that China became one of the most important destination for FDI in the world. As it became evident that both Japan and the so called Asian Tigers had been extremely successful in applying an export-oriented development strategy, giving up its import-substituting strategy based exclusively upon domestic production, China made a 180 degree turn in economic strategy and policy, and bound itself to a more open approach with market elements. By the millennium China became an extremely open economy, where multinational companies (MNCs) and foreign capital play an extraordinary role. We cannot imagine China without them, and nobody could say that China is the "Factory of the World" if they did not produce so many so different goods.

In this paper we analyze foreign direct investment (FDI) in China from several points of view. The first part is about the evolution of FDI inflows, putting the subject into an historical context. We are also talking about the so called Special

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Economic Zones (SEZs), which were the only windows to the outside world in the initial phase of the reform process. The next section deals with the numbers concerning the capital inflows. We use statistics and time series to illustrate the main trends of capital inflows. In the third part we address two important issues of capital movements, the so called round-tripping capital, and the role of offshore areas in FDI inflows. The paper concludes with a brief summary.

Appearance of foreign capital in China

After the death of Mao the power-struggle in China ended with the success of reformist leaders, who initiated a new policy: reform and opening up. Learning from the experience of the Hungarian reforms in 1968 they believed that the bureaucratic planning mechanism had to be complemented by some market elements to achieve faster economic growth, and to narrow the gap between China and the developed world. Contrary to the Hungarian example, however, they did not mix up the different coordination mechanisms, but separated them completely. The planning system remained intact in the huge state enterprises, while market forces were allowed to play a bigger role in the burgeoning private sector, and, first of all, in the so called Special Economic Zones (SEZs).[2]

China in the end of the 70s has already had experience not only from the reforms in Central and Eastern Europe, but from the successes of export-oriented East-Asian economies. Deng Xiao Ping (the successor of Mao in the party central committee) thought that they could successfully combine the gradual development of market economy with export-oriented economic development strategy, but without changes in the political system of the country. As the first successes had occurred they became more and more brave in allowing foreign investors to invest in SEZs: the number these zones rose from 4 to 14. In these restricted areas there were mostly foreign enterprises producing goods exclusively for exports, using very cheap Chinese labor.

The pace of capital imports accelerated strikingly after 1992, reaching 20 billion USD in the next year. First, investors from Hong-Kong and Taiwan increased their investment, but Europeans and Americans soon followed them. The significance of FDI grew so rapidly that they began to transform the structure of the Chinese economy. What were the main factors that caused these radical changes? Deng in the spring of 1992 visited South China, and, in fact, rehabilitated the reform process that suffered a major setback because of the 1989 Tiananmen-square events. Of course this visit alone could not have changed the trends of FDI, there were other important factors, too.

Although China had already a decade of history of economic policy and institutional reforms in 1989, the bloody events in June disillusioned foreign investors. They became cautious and decided to wait. However, Deng's talks and visits in Southern China (as a sign of the irreversibility of the process) made them understood that the

[2] This approach is commonly referred to as "dual track system".

reform process had to be continued. Beside the return of the credibility the other most important factor was the opening up (at least in part) of Chinese markets for foreign investors. While before SEZs produced only for exports (and the volume of capital inflows was determined by this fact), from 1992 these factories began to produce also for domestic consumers. These changes had a huge impact on FDI inflows, because they opened up fantastic possibilities for international investors.[3]

Along with the capital inflows there were other effects, too. Chinese got access to modern management and marketing techniques, and up-to-date technologies. Perhaps this was the most important contribution of foreign enterprises in the process of economic development in China. Modernization without this technology transfer would have been impossible, and we can say that FDI became one of the most significant factor in China's growth and competitiveness.

As an evidence of the opening up process Special Economic Zones were set up in China. The first four such areas were in Shenzhen, Zhuhai, Xiamen, and Shantou, but, initially, they were not too successful. Foreign capital came in quite slowly, while the cost of building up adequate infrastructure were very high. After 1984 fourteen cities were designated as "open cities", where Economic and Technological Development Zones (ETDZs) where created. They were very similar to the initial zones. The island of Hainan declared as a SEZ, while the areas of the original SEZs were enlarged significantly.

SEZs in China are not unique in East and Southeast Asia. The first so called Export Processing Zone (EPZ) were opened in 1965 in Kaohsiung, Taiwan. By the 1980s their number had risen to 35, and they could be found almost in every country. One of the most successful was in Penang, Malaysia, and it became the heart of the electronics industry in the region. The structure of the EPZs were the same in every country. First, raw materials and semi processed goods could be imported without duties, second, they got offshore status with tax exemptions for 3 to 10 years, third, administrative barriers were reduced to a minimum level, and fourth, infrastructure building and raw material provision were the task of the Chinese government.[4]

One of the most important benefit of setting up EPZs was that the host country did not need to restructure either its domestic industrial sector, or its institutional setup to achieve favorable macroeconomic effects. At the same time there were setbacks, too. Tax income was very low, while organic linkages to the domestic economy were very rare. However, in some regions there were also very successive examples. Shenzhen, for example, became not only a regional industrial center, but the most dynamic growth center in China.

Chinese SEZs were in some respects very different from their Asian counterparts. The most striking difference was that China, in contrast to other countries in the region, remained a socialist country. On one hand this meant that it had to be applied a completely different institutional environment from that of used in the domestic

[3] Naughton, 2007, pp. 403-404.
[4] Naughton, 2007, pp. 407-408.

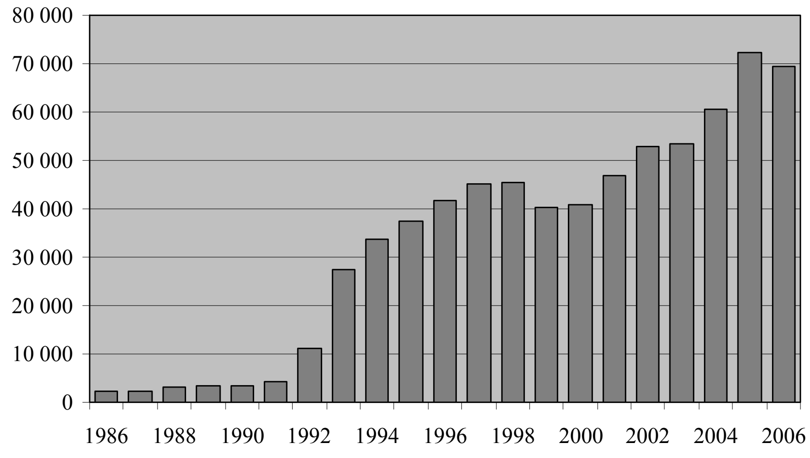
economy, on the other hand however, it gave a special opportunity to use these zones as experimental labs testing such institutional solutions that would have been very dangerous if they had been used elsewhere. The management of these zones were given quite big autonomy, which included the free use of taxes and profits (also in foreign exchanges). The zones were functioning as windows to the outside world, but they were the most important sources of technology transfer, too. As a new policy approach, from the beginning of the 2000s, the Chinese government tried to strengthen the development of the Western territories. The Western Development Program has been created, and by 2007 every province had opened up at least one ETDZ.

What do the numbers say?

China is one of the most important destination of worldwide FDI: Capital inflows in 2006 amounted to almost 70 billion USD. Inflows began to rise from 1992, and by the middle of the decade stabilized around 40 billion USD per year. The next bigger jump occurred after the millennium, and in 2005 inflows reached 70 billion USD. This is 5% of the total FDI worldwide, and 18% of FDI flowing to developing countries. Stock data are equally impressive: FDI stock reached 50 billion USD in 1993, 100 billion two years later, and 500 billion in 2003. Total stock of FDI was more than 700 billion USD in 2006. Figure 1 shows us the FDI inflows to China. The huge change in the beginning of the 1990s is very striking.

Figure 1

Foreign Direct Investment inflows to China (million USD)

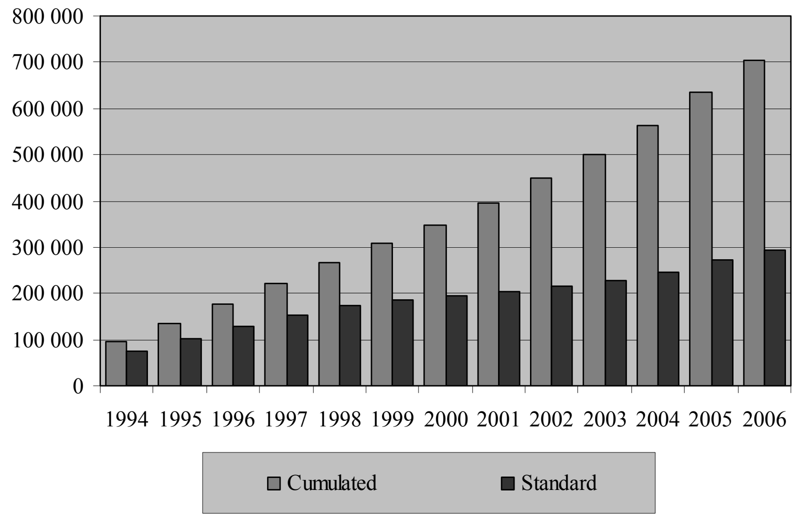


Source: UNCTAD [Web],
http://www.unctad.org/sections/dite_dir/docs/wir2007_inflows_en.xls.

Until 2005 yearly capital inflows to China were simply aggregated by the Chinese Ministry of Commerce to get the stock data. This approach, however, is not compatible with the statistical standards applied in the developed regions, because it omits both the changes in the market value of the assets, and depreciation. To solve these discrepancies the Ministry introduced a new accounting method in 2005, that was in accordance with the international standards. Unfortunately, these new data are available only on an aggregate basis, so we cannot use them to analyze either the regional or the industrial trends. In these cases we continue to use the cumulated data (we can do it because relative numbers are more important than absolute ones). Data according to both the new and the old method are shown in Figure 2. There are significant differences between the two series, and the difference is rapidly growing from one year to another. In 2006, for example, cumulated FDI reached 700 billion USD, while according to the standard accounting method it was less than 300 billion. In addition, FDI in China tends to be greenfield investment with large share of real fixed investment, which depreciates rapidly. This, however, is not deducted according to the cumulated accounting method.

Figure 2

FDI stock in China, according to the old and the new accounting method (million USD)



Source: UNCTAD [Web], http://www.unctad.org/sections/dite_dir/docs/wir2007_instock_en.xls.

It is very interesting to analyze the inward FDI stock by source countries. We may think that China, like other developing countries, imports capital from the most developed countries: the United States, Europe, and Japan. Of course these countries are among the biggest investors, the most important sources of capital are, however, East-Asian countries: Hong-Kong, Taiwan, Singapore, and Korea. From the 70 billion USD arrived in 2006, 20 billion came from Hong-Kong, and only 14 billion from the US and the EU altogether, and only 5 billion from Japan. Taiwan and Korea exported a total sum of 6 billion, while Singapore 2 billion. Stock data are equally interesting: the most investment came from Hong-Kong (40% of all FDI), while both the United States and Japan had only an 8% share. The next in the row is an offshore territory, the British Virgin Islands with a bit less than 8% share. However, if we count all the offshore territories we get a striking number of almost 12%. Other important investors are: Taiwan, South Korea, Singapore, the United Kingdom, and Germany. In China there are such special characteristics of foreign direct investment that are very different not only from other developing countries but also from developed ones. These phenomena stem mainly from the domestic environment, and they can be linked to domestic companies, not foreign ones. We will address some of these characteristics in the next section.

Industrial composition of FDI in China is quite one sided. In sharp contrast to other developing countries, the share of extracting industries are very low, while that of manufacturing is high. In 2006 nearly 60% of all FDI flowed to manufacturing industries, and only 1 into the primer sector. The most important manufacturing industries are: electronics (8 billion USD), automotive industry (2,8), and chemical industries (2,6). In the services sector the most important industries are the real estate (15,6), and the financial sector (6,7 billion USD).

Figure 3

Per capita GDP in Chinese provinces, in 2006 (RMB)

Source: NBSC [Web].

If sectoral composition is one sided, regional composition is even more so. As we can see in Figure 4, the biggest share of FDI concentrates in only a few provinces, like Guangdong, Jiangsu, and Shandong. The bulk of the incoming FDI in 2006 arrived here (with a share of 17, 15, and 14% of all FDI inflows, respectively). All three provinces are situated in the Eastern coast of the country. This part of China attracted 82% of all FDI inflows in 2006, and the stock data are similar, too. Beside these provinces other important destinations are Beijing, Shanghai, Zhejiang, and Fujian. It is not surprising that FDI inflows and per capita GDP are strongly correlated (as we can see it in Figure 3 and Figure 4).

Figure 4

Cumulated FDI stock in provinces at the end of 2004 (million USD)

Source: Invest in China[Web].

There are other important aspects of FDI in China, like the different types of investment forms. In countries with a functioning market economy this question is not relevant at all, because almost all investment are linked to companies with limited liability (first of all corporations), and majority owned foreign affiliates are preferred. In China, however, the situation is completely different, because China is still a country in transition (in contrast to the official standpoint of a socialist country), with a wide variety of ownership forms, and a strong aversion of private property. In the beginning majority ownership was prohibited, and still years after it was allowed only in a few sectors. Although these restrictions were in large part abolished, in 2006 less than half of all FDI stock was in majority owned affiliates. More important were different joint ventures, where the two sides have equal rights, and it was also more suitable to carry out state policies (with preferences of control and employment).

Some special characteristics of foreign investment in China

The share of direct investment in all capital inflows is unusually high in China. Portfolio investment were only one fourth of direct investment in 2005[5], while this

[5] SAFE [Web].

ratio was six to one in Taiwan between 2001 and 2007.[6] Generally, in more advanced countries portfolio investment tend to be much higher than direct investment. Why is this pattern reversed in China? The answer to this question lies in the characteristics of the Chinese financial system, which is far less developed than that of in traditional market economies, and in the huge return on direct investment, which is much higher here.

By sourcing out production facilities to China MNCs get access to valuable sources, first of all cheap labor, while retaining property rights defends them from the instability of the country's financial system. The incentive is very strong to manage financial transactions within the company, and to avoid unreliable Chinese services. It is not surprising therefore that most of them use institutions in Hong-Kong for that purpose, because trust in its system is still very high.[7] So the huge amount of foreign direct investment is partly due to the underdevelopment of the mainland institutions compared to the Hong-Kong ones, and until the risk is so much higher in the mainland, portfolio investment remain moderated.

The other main characteristic of direct investment in China is the so called round-tripping capital. Round tripping capital means that the capital basically created in China first leaves the country, then returns as foreign direct investment. So, the origin of these foreign investment are in fact not foreign but Chinese. But why has to leave this capital China if, in the end, returns there?

Motivations lying behind this phenomenon are very complex, indeed. Some of them are much more important, however, so, in the following section, we concentrate on them. The first cause that forces the capital to leave China is the difference in the handling of foreign and domestic investment. For more than one and a half of a decade the most important base of the Chinese development have been foreign investment. The government tries to attract foreign investors by creating such favorable conditions that are not available for domestic enterprises. Tax allowances or area use rights are among the most common ones, but government guarantees and simple ways of profit repatriation are very widespread, too.[8] These incentives are designed to create a very favorable environment for capital inflows, domestic enterprises, however, are not eligible for them. To make use of these opportunities they are searching for other strategies, like sending their profits abroad, and bring it back as foreign capital.

The significance of round-tripping capital is stressed not only by the aforementioned fiscal incentives, but also by institutional deficiencies. Lack of adequate defense of property rights, for example, is another factor to be count with. If a Chinese company make profits, it is not clear at all, how big part of it can it be reinvest, retain or distribute. It is much more safe to accumulate its wealth abroad (like Chinese official reserves in the United States). Of course there is a difference:

[6] CBC [Web].
[7] This probably remains true until China insists to the "One country two systems" principle.
[8] World Bank [2002], p. 41.

private money usually leaves the country illegally[9], while official reserves follow a legal way. In addition, capital accumulated abroad is more protected from speculations, and get access to much more sophisticated financial services than in mainland China.[10]

Round-tripping capital explains the significance of Hong-Kong in FDI inflows to China. After all, it is quite unusual that a mini state like Hong-Kong is the most important investor, exporting FDI of more than 20 billion USD per year. The solution is that a big part of capital inflows from Hong-Kong is round-tripping capital originated in mainland China. Unfortunately we have only rough estimates how big this part may be, but the most probable ones are between 30 and 50% of the total capital inflows. Of course there are other places where this type of capital can escape (though the most straightforward, the less expensive, and the simplest way is via Hong-Kong), the total share of round-tripping capital in total FDI lies somewhere between 25 and 50%.[11]

We can link the big weight of offshore tax-heavens in capital inflows to the phenomenon of round-tripping capital. We can find numerous explanations of it in the literature.[12] First, it is evident that round-tripping capital can find other ways than via Hong-Kong, like offshore islands, or the United States. Escaping capital in these cases, too, first goes to an export destination country, from where it returns to China through a tax heaven. On the other hand this opportunity is also very attractive for real foreign investors, not only for Chinese enterprises. This is one of the main obstacles that prevents us from having realistic estimations of round-tripping capital. Anyway, the share and significance of offshore islands prove that there are serious deficiencies in the regulation of the financial system in China.

Conclusions

Since the beginning of the 1990s FDI inflows to China have grown significantly. This can be attributed to two factors: first, trust in the irreversibility of the reform process in China has strengthened, second, domestic market slowly opened up for foreign investors. Though FDI inflows are substantial (even on a worldwide scale), compared to the Chinese economy they are not so large. FDI concentrate only in a few provinces (mainly in the East coast), where per capita income is high. To address this problem the Chinese government took steps to channel FDI to poorer provinces, too.

There is a unique feature of capital inflows: the large share of Hong-Kong and offshore areas. This can be attributed to the so called round-tripping capital. Chinese

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[9] E.g. underinvoicing exports or overinvoicing imports.

[10] Such services are available in Hong-Kong's advanced financial system, and the Stock Exchange.

[11] According to the analysis of the World Bank (World Bank, 2002, p. 41.) it is 25%, according to Xiao's estimations in his article (Xiao, 2004) its minimum is 29.2%, the most probable level is 40%, the maximum is 50.8%.

[12] See for example the articles from Gunter, 2004 or Xiao, 2004.

enterprises try to make use of the favorable conditions for foreign investors by "smuggling" their capital abroad, and return it as foreign investors. The share of round-tripping capital amounts to one fourth or one third of all FDI. Another special feature is the large volume of FDI compared to portfolio investment, which is a consequence of the relative backwardness of the Chinese financial system. In the form of FDI there is much less risk than in the stock markets, and, in addition, foreign investors in this case have much more control over their assets.

Anyway, one of the most important feature of the reform process in China was the large amount of foreign direct investment that entered the country. Foreign capital not only changed the Chinese export industries, it had a huge impact on the whole Chinese economy and society. Technology transfer along with other consequences have created a very competitive country from an underdeveloped, poor one, and made it possible to reenter the world economy. How far can China get with its current socio-economic system? It is very difficult to answer to this question. There are lots of threats and problems (like environmental pollution, and inequalities), and the outcome is still unclear, but the pragmatic and rational approach applied in the last decades may be a good way to handle them.

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SUMMARIES

Miklós Somai

WEALTH TAX: PROS AND CONS

In Hungary the eighteen years period passed since the change of political regime has seen the formation of a socio-economic pattern in which there are practically no middle class in that sense of Western European society. People are better off than in the past across a range of measures but the benefits are not spread equally: there are winners or losers of the transition but nobody between. Strong and increasing polarization of the society has now become an obstacle to economic and social progress.
The paper analyses the possibility to increase the efficacy of the national economy in a totally new way as it admits the very important – even if indirect – role of the social cohesion and solidarity. If one cannot require effective work, responsible and rational decisions from tired, frustrated and more and more indifferent people all those factors which are capable to stop and reverse this process have a strong indirect effect on the economic performance of the country. The reorganisation of the taxation system towards wealth tax and the decentralisation of decision making on public spending could boost Hungary's integration into Europe and its social and economic development.
JEL: H24, H26, E24, E26

Miklós Szanyi

CLUSTERS IN HUNGARY AND IN CENTRAL EUROPE

Regional clusters evolved spontaneously at various places in the world following different development patterns. Their success in enhancing competitiveness moved governments and entrepreneurs to copy the patterns. Later on cluster development became part of the European Union's long-term Lisbon competitiveness program in the form of innovative clusters. This article introduces the basic characteristics and features of regional clusters. Then, it argues that without paying due attention to the proper establishment of the basic features fulfillment of other policy goals, like curbing innovation process, cannot be expected.
JEL: F23, L52, O32

Stoyan Totev
Grigor Sariiski

RELOCATION OF INDUSTRIAL ACTIVITY – CONCENTRATION, SPECIALISATION AND CHANGES OF MANUFACTURE STRUCTURE IN EU COUNTRIES

This paper analyses the labour intensive industries relocation in EU-27 by exploring the industry concentration, specialization and countries competitiveness. The analysis is based on NACE classification data, Division from 15-37 for EU countries. It has been studied the structural adjustment of the industrial composition and the spatial distribution of the labour intensive industries over time by using various economic indicators and cluster analysis.
It has been found that the relocation process leads to specific spatial location of Labour intensive sector in the EU framework. It is argued that the formed countries clusters concerning employment and trade composition of the manufacture industries is not expected to undergo significant changes in the near future as the observed one in the last decades. The potential benefits for the different participants in the delocalisation process are discussed. Possible future scenarios and prospects are foreseen.
JEL: F14, P52, R12

Grigor Sariiski
Stoyan Totev

DELOCALISATION PROCESS AND CHANGES OF COMPETITIVE ADVANTAGES – A SURVEY OF ENTERPRISES

The aim of this paper is to examine the link between the industrial delocalisation and the changes of the competitive advantages based on results obtained from a Survey of 756 enterprises in five EU countries. The study is enriched by providing cross-country analysis based on some secondary data indicators. An attempt is made by comparing the results from the Enterprise survey and the secondary data analysis to summarize the findings and to outline the specific features and effects of the delocalisation processes on the competitiveness of the EU countries and their firms. Patterns of development of labour intensive industries, their trade performance and countries competitiveness are related to the delocalisation processes.
The study revealed that both sides participating in delocalisation processes, gain in terms of increasing their competitive advantages and profits. However, for countries like Romania and Bulgaria the delocalisation process can bring to problems in their future development due to their low profitability of working under subcontracting.
JEL: D21, F21, O52

Plamen D. Tchipev

WHERE IS THE BULGARIAN CORPORATE GOVERNANCE MODEL HEADING TO?

The paper critices two hipothetical trajectories for development of the Bulgarian corporate governance model (BCGM) as not feasible, and offers a different solution. The first opposed variant assertsthat BCGM would imitate a converging model, which follows the convergence of the two global CG systems. Its alternative strategy is formulated as adapting the corporate governance system to our national specific with its inherent cultural and political norms. The paper insist that both of the above models are discarding important national features of the BCGM; when taken into account they will reveal a quite different picture for that model, one of lagged model, with charackteristics already overcame in the present day developed countries. Respectively the trajectory it has to follow is quite different from those of the two critisesed hypothesses.
JEL: G30, G38

Yasen Georgiev

CORPORATE GOVERNANCE TENDENCIES IN BULGARIA: REPORTING ON CORPORATE SOCIAL RESPONSIBILITY (CSR) BY THE 40 LARGEST LISTED COMPANIES

The paper aims at revealing the corporate governance tendencies in Bulgaria as of 2007 and its findings are based on a country survey on Reporting on Corporate Social Responsibility (CSR) by the Forty Largest Listed Companies in Bulgaria, conducted by the Economic Policy Institute (Sofia) during the same year.
The research steps on internationally applied methodology by focusing on the annual reports and websites of the forty largest companies by market capitalization listed on the Bulgarian Stock Exchange (BSE) - Sofia. It sought to document the existing disclosure practices in the following specific areas – Corporate Governance, Environmental and Social Policy and last but not least to identify best practices in reporting by Bulgarian listed companies.
JEL: M14

András Inotai

THE GLOBAL FINANCIAL CRISIS AND ITS MACROECONOMIC IMPACT ON THE EUROPEAN UNION

The financial crisis started in the United States spread over to Europe and, for the first time after 1945, it developed to an overall macroeconomic crisis in the entire developed world. Social and ideological consequences of the deep recession are expected to follow. The article focuses on the impacts of the crisis on the European Union, with special regard to the economic policy answers on nation-state and community levels. It is stressed that the unprecedented challenges represent both a high risk of stopping or fragmenting the integration process and, at the same time, a unique chance to deepen and upgrade the European integration, as a key player of the changing global economic (as well as political and institutional) system. The answers to be given in 2009 will fundamentally shape the future of Europe in general, and that of the European Union, in particular.
JEL: E60, F02, F15

Garabed Minassian

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

Ivanka Petkova

ATTEMPTS OF THE EUROPEAN UNION TO CONTAIN THE FINANCIAL CRISIS

This paper centers on how after banks in mature economies worldwide failed to manage risk and allocating capital properly, both single national and joint efforts of the EU (with special focus on the Eurozone) were channeled to control the deepening financial crisis since September 2008.

The paper is analyzing the reasons for the financial crisis, simultaneously reviewing the discussions on the profound changes in the global financial system in recent years focusing on the excess capacities created in the system and their consequences (the more rapid growth in financial assets compared to the growth in global GDP, the new institutional structure, complexity in financial instruments, increased counterparty risks etc.). The evolvement of the crisis is presented.

The challenges to the implementation of the USA bail-out program as a response to the crisis are examined. Investigating the common and individual efforts in the EU to control the crisis

the decisions of the emergency summit of euro zones nations, the national rescue plans of euro-zone and non-euro-zone countries are studied. The EU stimulus package is evaluated, creating a greater flexibility of Eurozone countries with the Stability and Growth Pact, showing the big differences in the fiscal stances of individual countries, their impact on the contributions to the plan, and the heterogeneity of measures to be applied. Special attention has been put on the recapitalization schemes, the issue on state aid and their long-term impact within the EU. The outcomes of the meeting of G20 are also considered. On the basis of the study main concluding remarks have been drawn.
JEL: E58, F02, G15, G28

Plamen D. Tchipev

GLOBAL FINANCIAL CRISIS IMPACT ON BULGARIAN STOCK EXCHANGE

Bulgarian stock market experienced sharp and continuous decline in 2008 causing this way a heavy pressure and turmoil among its investors. The decline hit the confidence in the prospects for its development raising a lot of concerns. This paper addresses some questions about the contingency of the Bulgarian stock market on the development of Global Financial Crisis (GFC), the channels and magnitude of negative influence, as well as of the necessary measures to be taken in order to smooth and balance GFC's negative impact
JEL: G01, G18.G34, G38

Tatiana Houbenova-Delisivkova

THE FISCAL POLICY OF BULGARIA IN THE CONTEXT OF THE EU MEMBERSHIP

The fiscal policy of Bulgaria is revealed with regard to the progress made in the process of compliance with the EU requirements for membership and for the preparation for Bulgaria's entry in the EMU. The paper underlines the main trends of fiscal performance that has been an outcome of the Europeanization. Fiscal policy's contribution to the ongoing restructuring of the Bulgarian economy is discussed in the following main aspects: 1)changing the role of government in providing public goods and services; 2)reforming the public revenues and expenditures structure and policies in order to make efficient the use of public resources; 3) better management of public spending policies and improvement of public accountability of the public finances.
On the basis of comparative analysis the paper outlines the problems and the prospects of the fiscal policy with regard to the Bulgaria's preparedness for the entry in the European Monetary Union. Conclusions are drawn as regards: 1) the main factors and trends of the financial restructuring of the public finances; 2)evaluation of the process of the Europeanization of the public finance management.
JEL: E61, E62, E63, F42, H61

Tamás Szemlér

OLD AND NEW EU POLICIES IN THE BUDGET OF THE EU27 AND BEYOND. A SUMMARY OF SURVEY RESULTS FROM 2008

The enlargement of the EU in 2004 and 2007 has led to a significant increase in population and territory, but also a huge increase in differences regarding economic structure and development levels. Despite the traditions of the EU in dealing with such differences, the scope of the latest enlargements is a challenge for existing EU policies. In addition, potential additional tensions stemming from further enlargements would be added to the present unsolved debates on the EU budget.

After presenting the current situation and the main challenges regarding the expenditure side of the EU budget, it summarises the results of a recent survey on the perception of experts and decision-makers from different member states regarding EU budget expenditure. This is followed by a summary of the main findings of the same survey regarding preferences for the future; the paper is completed by the conclusions.
JEL: F36, H87

Nadya Yorgova

ENTERING THE EUROZONE: COMMITMENTS AND CHALLENGES TO BULGARIA IN TERMS OF FINANCIAL CRISIS

Establishing the currency board arrangement (CBA) in Bulgaria played a key role in overcoming the results of the last and pointed as one of the worst financial and economic crisis. This decision still remains a serious factor for Bulgaria in the terms of European Union membership. Related to the act of accessing EU the obligations Bulgaria undertook, are partially provided by the fiscal stabilization, successfully achieved thanks to the currency board arrangements introduced in the state. Price stability, however, further remains an impediment towards economic policy. It is tightly connected with the next main challenge: to overcome the inner obstacles for fulfilling the Convergence Criterion for a proper entering the Euro zone under the conditions of spreading world-wide financial crisis. This article aims to summarize the recent background which led to the nowadays economic development and related to it future advantages and challenges.
JEL: E42

Attila Hugyecz

GLOBAL ASPECTS AND A POSSIBLE CONTENT OF A COMMON EUROPEAN ENERGY POLICY

Many people say that the European Union needs to create a common energy policy. However, only a few of them gives details about its content. In this paper, we examine the global, long term aspects of the European energy situation. We base our proposals for the content of the common energy policy of the EU on the conclusions drawn from this analysis. According to our findings a common energy policy should incorporate foreign policy (including climate change diplomacy), educational policy, R&D policy and setting strict rules for building related energy consumption.
JEL: Q48

Iskra Christova-Balkanska

FOREIGN DIRECT INVESTMENTS IN BULGARIA: DO THEY HAVE AN EFFECT ON THE ECONOMIC DEVELOPMENT OF THE COUNTRY?

The article is trying to analyze the benefits of attracting foreign direct investments (FDI) and the supposed effect on the economic development in Bulgaria. The increase of FDI per capita is important for the penetration and absorption of FDI in the economy, as well as for the creation of new jobs. FDI's accumulation demonstrates the relative increase of the absorptive capacity of the Bulgarian economy. The regressive analysis shows that there is a strong connection between the attracted FDI and the increase of GDP. Despite that FDI are increasing in processing industry and financial intermediation, the last years they are directed to the real estate, building and acquiring industrial, logistic and trade projects or to companies with intermediation or leasing activity. Thought the macroeconomic indicators in Bulgaria are relatively stable, the deficit in the current payment balance is deepening and the attraction of

FDI is considered as a source for financial assistance. At present, and regardless of the strong relation between FDI and GDP, it is not possible to affirm that the increase of FDI in Bulgaria is contributing to the development of export-oriented economy. The global financial crisis also is creating an unfavorable economic environment, influencing negatively on the inflows of FDI in Bulgaria and on the economic development.
JEL: F21, F32

András Székely-Doby

ON SOME CHARACTERISTICS OF FOREIGN DIRECT INVESTMENT IN CHINA

In this paper we analyze foreign direct investment (FDI) in China from several points of view. After putting the subject into an historical context, we use time series to illustrate the main trends of capital inflows. Our main finding is that the significant growth of FDI inflows since the beginning of the 1990s can be attributed to two factors: first, the strengthening trust in the irreversibility of the reform process, second, the gradually opening domestic market. The paper also deals with two specific, and very important issues: the so called round-tripping capital, and role of off-shore areas in FDI inflows. We show that these phenomena are strongly linked to each other, and based upon the different handling of domestic and foreign enterprises by the government. Another special feature we try to understand is the large volume of FDI compared to portfolio investments. According to our explanation this is a consequence of the relative backwardness of the Chinese financial system compared to that of in advanced economies, which makes FDI a much safer way of financing than the use of the underdeveloped Chinese capital markets.
JEL: F21

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КЪМ ЧИТАТЕЛИТЕ И АВТОРИТЕ

Списание ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ се издава от Икономическия институт на БАН. В четири книжки годишно се публикуват резултати от научни изследвания, посветени на важни и интересни съвременни икономически проблеми. Списанието публикува и студии на английски език. Всички студии се рецензират анонимно от двама рецензенти.

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