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## **SYSTEMATIC APPROACH TOWARDS THE RISK FROM EXTERNAL FINANCIAL IMBALANCES IN THE BULGARIAN ECONOMY**

A systematic approach to exploring the external financial imbalances and the profitableness of the internal economy of Bulgaria in the conditions of the global economic crisis is applied. The analysis is conducted on the base of official statistical data from the National Statistical Institute (NSI) and the Bulgarian National Bank (BNB), various research centers and branch organizations in Bulgaria, as well as reputable international authors and sources. The situation is observed from the position of the information asymmetry and the turnover of risks under the conditions of globalization. A number of conclusions and recommendations are made for decreasing the critical levels of the external financial imbalances of the country and increasing the capacity of the economic system to generate profit through ensuring new segments on the market, purposeful draw of active investments and improvement of the quality of work, starting with the public policy and services.

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Despite the sincere optimism of many of our politics and officials, the global economic crisis is affecting Bulgaria more and more. It is now clear that the Bulgarian economy has entered a phase of slowing down economic development, i.e. *recession*, which is the main social-economic risk for our country. The crisis is increasingly revealing the nature of the complete disruption that has been occurring in the past few years, between the systems for macro-regulation of the national economies and the reality of the global economic processes – a disruption, specific for the particular countries, and calling for certain differences in the actions, undertaken by the different governments.

### **The Crisis and the Disruption**

One of the most accurate characteristics of the contemporary information society is the fact that it is a risk society. The current world is a world of modern exchange of risks, of a constant risk turnover, i.e. transformation of the risks, in which the probability for one or other event to occur is changing, and the consequences from it vary from the initially forecasted. Hence the present-day uncertainty, related to the global economy crisis, *cannot and must not be considered caused by external factors only*.

The official authorities in Bulgaria reacted negatively on each evidence of the fact that our economy is entering a recession and there are internal factors for that until the middle of 2009. The focus in public communications is on the availability of big surpluses in the current budget, the significant fiscal reserves, the low foreign state debt and etc. and the risk (probability) of recession is reported to be equal to zero. Thus a part of the population was relieved from the

feeling of uncertainty, but the uncertainty of the market has increased. Certain risks were avoided, but other types of expectations and risks were created for the contractors, the investors, the employed and the other internal and external agents on the market. The so-called “*moral hazard*” phenomenon emerged vigorously.

The term “moral hazard” is introduced by Kenneth Arrow<sup>1</sup> on the basis of analysis of the insurance market in the USA, and was developed later for the credit and financial market by the Nobel Prize-winner in Economic Science Joseph Stiglitz. According to K. Arrow and J. Stiglitz, the moral hazard in information society is related mainly to the information asymmetry of the market and the participants in it. In the conditions of the contemporary information asymmetry the concept moral hazard is connected to the search of reciprocal relation between processes and parameters of different social spheres and refers not only to the conduct of the traditional market agents, but to transfer of risks between various principals, regulators and guarantors – government, central bank, international finance organizations and etc. The moral hazard, with all the associated threats, is very often a conscious search of the desired smaller harm by the various participants in the market.

The summarized parameters of the already unfolding recession in Bulgaria is the GDP drop. According to data of NSI, in the first quarter of 2009, GDP amounted to 13.9 billion BGN at current prices. The real GDP shows a decrease of 3.5% compared to the first quarter of 2008, while the drop during the fourth quarter of 2008 is 1.5%, compared to the previous quarter.<sup>2</sup> According to preliminary data in May 2009 the industrial production has dropped 1%, compared to the preceding month and is expected to continue to shrink, while the unemployment increases avalanche-like and more and more companies are going bankrupt.

During the Great Depression in the USA (1929-1933) these indications of the crisis were compared to a downward spiral. The same indications are present here and now.

If we look back at the past three years, we will see that initially the analyzers and the economists were defining the situation as a “financial crisis”, or a banking sector crisis. Shortly afterwards the definition changed to “economy crisis”; then the crisis started to display in economic slowdown, or “recession”. This clearly shows the presence of generalized classical stages in the cyclic recurrence of the market economy.

The periods of cyclic growth of the market economy are analyzed by a variety of scientists and most substantially by Karl Marx. The large-scale American economist and Nobel Prize winner John Kenneth Galbraith points out that the recurrent periods of crisis are in the very nature of the market economy and the problem with the new conditions is in learning to regulate them, instead of denying

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<sup>1</sup> Arrow, K. *Essays in the Theory of Risk Bearings*. Amsterdam: North-Holland Pub., 1971.

<sup>2</sup> National Statistical Institute. *National Accounts, GDP*, Internet, June 10, 2009.

that nature. According to him the most successful economy will be the one that is steady and minimizes the probability of economy instability and recession.<sup>3</sup>

The questions on the agenda now are “When will the recession be over?” and “How long it will take the economy to recover in the contemporary conditions of an information society?”

Most of the economists are unanimous that the different types of recessions could resemble the letters V, U, W and L. What are the characteristics of these types of recessions?

*V-shaped recession*

In a V-shaped recession, the economy suffers a sharp decline and reaches the bottom fast, but recovers shortly.

*U-shaped recession.* The U-shaped recession starts with a relatively smooth economic decline. After reaching the bottom, the economy stays there for an extended period of time prior to start growing again. In this case the governments and the central banks have the possibility to intervene through the mechanisms of the fiscal and monetary policy – by reducing the taxes, the interest rate, or increasing the money supply; budgetary expenses increase.

*W-shaped recession.* In the beginning it is similar to the V-shaped recession, but the first signs of economic recovery are misleading. Then follows a second sharp decline in the economy prior to the beginning of its actual recovery.

This type of recession is also called “double dip”, as the economy shrinks two times before the actual growth begins. It is very painful, since the investors enter the markets considering the economy has reached the bottom and as a result they suffer losses twice.

*L-shaped recession.* In this case the economy shrinks drastically, and a prolonged period of economic stagnation follows. This is the worst variation of recession, since there are no conditions for recovery of the growth for years.

It is however too early to determine the type of the recession, which started by bursting the credit bubble in the USA in 2006-2007. Most of the experts think that the recovery of the economy will start in 2010 for the developed world and a year later for the developing countries.

For some regional markets there are indications for longer L-shaped recession, with periods of growth and drop, which may continue for five to ten years. Currently such an indication is the development in the stock exchanges in Eastern Europe, where the initial recovery moves upwards and downwards at leaps.

Under such circumstances, a highly negative effect might be produced by the accumulated imbalances of the countries' economies, in regard to the external markets and the financial factors, which transform into other risks, increasing the uncertainty of the participants. Let's analyze these imbalances in details.

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<sup>3</sup> Galbraith, J. K. The federal reserves cannot influence efficiently USA economics. Internet, April 26, 2004.

### The Current Account Deficit and the Role of the Capital Flows

Research shows that for many years, our country has been conducting a policy, leading actually to significant *foreign trade imbalances*, which is the main reason for the current account deficit in our payment interrelations with other countries (see Table 1). According to data from BNB in 2008 the deficit reached 8.3 billion euro or 24.3% of GDP,<sup>4</sup> with a tendency to increase, although at a lower pace, which is an important reference point with reference to the financial imbalances. The level of the current account deficit in view of GDP is generally not a direct and simple risk event, but a sum of a variety of particular precarious decisions, made in the economy. In international comparison there is no ideal point stated by experts at what value this indicator signals the entry into critical and catastrophic zones.

To make an assessment of the amount of the current account deficit of the countries, it is very important to consider the elements, namely foreign trade, services (tourism and transportation), income and international transfers. In Bulgaria, except for the foreign trade, all other financial flows have a positive balance, as regards the annual interrelations of the country with the other countries, but they do not offset the current account deficit.

Table 1

Balance of payments in 2008 (in mln. EUR)\*

Account	Revenue	Expense	Balance
<i>I. Current Payments</i>			
1. Goods	15 272.8	24 105.6	-8 832.8
<i>2. Services</i>			
- Tourism			+935.2
- Transportation, etc			+208.0
3. Income (payments ) on FDI			-1096.6
4. Current Transfers			+507.8
Total:			-8278.4
<i>II. Capital and Financial Account</i>			
1. Capital Transfers (EU)			+277.3
2. Financial Account (movements of capital and credits)			+10 176.3
Including :			
- Investments abroad			
- Home Country Direct Investments (+ 5 430.2)			
- Change of Foreign Deposits in Banks			
- Other Investments (company loans, etc.)			
Total:			+10 453.6
<i>III. Errors and Omissions</i>			
			-1501.0
<i>IV. Change in Gold and Foreign Currency Reserves</i>			
			+674.2

\* The figures of the Balance of payments are adduced by the author, based on particular statistical data from the official publications of BNB.

Source. BNB. Balance of payments of Bulgaria. Internet, July 14, 2009.

<sup>4</sup> BNB. Balance of payments of Bulgaria. Internet, July 14, 2009.

The import of goods in the country significantly exceeds the export, both in view of the total amount, and the rate of growth, which is certainly a negative tendency. The quantity and the tendencies in that deficit are not treated as an object of specific purposeful interventions, by means of corresponding programs and projects by the regulatory authorities. It follows in essence the doctrine of Nigel Lawson,<sup>5</sup> British Chancellor of the Exchequer for the period 1983-89 in Thatcher's government. In his midterm finance strategy, Lawson reckons that if the deficits of the foreign trade are due to increased import of investment goods, this is not a risky situation, as through the imbalance, economic growth will be achieved and the accumulated external debt will be paid off with that higher growth. Such a monetary view, without a profound consideration of the very process of interaction of the finance sphere with the real economy in an economy growth, has been dominating in Bulgaria for a decade already. A systematic trade balance deficit has been allowed, which through the company loans and credits, which cover the import of investment goods, is leading to another financial deficit, which becomes apparent with the increase of the external debt of the country (accumulated debt) to an amount, exceeding almost double the limit of admissible risk, set by the EU, under the Treaty of Maastricht at a level of 60% toward the GDP.

This statement might not be accepted by all economists. The analysis of the structure of imports and exports of Bulgaria at first glance seems to confirm the conclusion from N. Lawson's doctrine. According to data, published by the NSI, the structure of the export of the country for 2007 and 2008 is the following:

*Table 2*

Export Structure – 2007-2008 (in billion BGN)

Account	2007		2008	
	Amount	%	Amount	%
Finished Products and commodities, according to type of the material	12.6	47.7	12.7	42.5
Machinery & Equipment and transportation vehicles	4.0	14.9	4.7	15.9
Mineral Fuels, Oils, etc	3.8	14.7	4.9	16.1
Chemical Substances and Products	2.1	8.0	2.4	8.1
Prime and Raw Materials	1.8	6.8	1.9	6.4
Food and Other Products	1.6	6.0	2.7	9.0
Beverages and Tobacco Products	0.5	1.9	0.6	2.0
Total	26.4		29.9	

Source. NSI. Foreign Trade, Internet, July 10, 2009.

<sup>5</sup> Lawson, N. Biography. Internet, April 4, 2009.

The export is included in the gross domestic production, which differs from GDP and represents all the goods, produced in the country. For 2008 this production amounts to 79.8 billion BGN, i.e. the export (see Table 2) is 37.5% from it. That points that our economy is much more widely open to the global markets, compared to other countries like France, Spain, etc., which have a developed international tourism, but their export is not exceeding 15% of the GDP.

The import participates in defining the GDP, but not the gross domestic production, moreover only with the difference between its value and the export. According to the NSI data, the structure of the import of the country for 2007 and 2008 is the following:

Table 3

Import Structure – 2007-2008 (in billion BGN)

Account	2007		2008	
	Amount	%	Amount	%
Finished Products and commodities, according to type of the material	12.2	28.5	13.1	26.5
Machinery & Equipment and transportation vehicles	12.6	29.4	14.6	29.5
Mineral Fuels, Oils, etc	8.5	19.9	10.7	21.6
Chemical Substances and Products	3.8	8.9	4.3	8.7
Prime and Raw Materials	3.2	7.5	3.5	7.1
Food and Other Products	2.1	4.9	2.8	5.6
Beverages and Tobacco Products	0.4	0.9	0.5	1.0
Total	42.8		49.5	

Source. NSI. Foreign Trade, Internet, July 10, 2009.

The data from Tables 2 and 3 show that of the difference between the export and the import for 2008 totaling 20 billion BGN, only about half is due to import of machinery and equipment (i.e. investment goods), including personal vehicles, which have a relatively insignificant volume for 2008. Approximately 6 billion BGN from the other half are non-compensated import of mineral fuels and other goods in a smaller scale.

Comparing the actual facts with Lawson's doctrine, we could logically assume that it is possible to keep a high negative balance regarding the foreign trade, as it is in Bulgaria, even with a considerable import of investment goods. At macro level it is due to the non-critical attitude to the specific implementation in practice of such doctrines, which, although being logical, ignore actual regularities of economics, displayed with other figures than the ones they are based on. Even general regularities, such as the spiral-like development regularity, proving the inevitable aging and replacement of every basic model of development of the economic system, with a preceding model that is made consistent with the new

historical level, are neglected. In the case of the neoliberal model, which representative is N. Lawson, the development is only seen as ascending, “reflex” regulated by the world financial market, as it had been from the beginning of the 80 years of 20<sup>th</sup> century to 2006. *It had not been considered that in the admission of disproportions between the financial “new economy” and the real sector there were specific limits, related to the information asymmetry and the moral hazard. Therefore the system-forming sources for probable crisis had not been revealed in time, prior to the emerging of the problems.*

N. Lawson’s doctrine, which examines the theories from a global point of view, was allowing the particular countries and governments to define on their own the restrictions in the imbalances in the foreign trade, and their influence on the real sector. This was not happening. A number of economists consider that one of the reasons for the government blindness is due to the drop in the relative weight of the intellect of the government on the economics, including here in Bulgaria, which has led to negligence of the creative and critical approach in the assessment and the implementation of various objective development tendencies.

*In a systematic approach towards the “communication” with the critical levels of trade imbalances it is required: first, the trade deficit on the trade balance to be commensurate with the import of investment goods and second, at a certain level, if growth is indeed stimulated, the export to start exceeding the import.*

The development of the Bulgarian foreign trade for the last decades has not met these requirements for commensurability. During the last three years, for example, the data from the publications of NSI and BNB show the following:

Table 4

Bulgarian Foreign Trade Development

Year	Import of Investment Goods (in billion. EUR)	Total Deficit of the Trade Balance (in billion. EUR)
2006	5362.8	5562.3
2007	6452.5	7302.8
2008	7485.2	8832.8
2009 (January-May)	1550.0 (assessment)	2060.5

Source: NSI. Foreign Trade. Internet, July 10, 2009; BNB. Payment Balance of Bulgaria. Internet, July 14, 2009.

The data clearly point out that in Bulgaria the trade balance deficit is used also for current consumption not only for investments, which impedes achieving a trade equilibrium and reflects negatively the current balance of payments with the foreign countries. This is also valid for the first five months of 2009, when we had a significant drop in the investment flows due to the economic crisis, but a preservation of the overall deficit on the trade balance at a relatively high level.

In a global economy another reason for the trade deficits is the export (direct or indirect) of productions abroad. In such circumstances, and analyzing the condition of the American economy, the Nobel Prize-winner in Economy Sciences for 2008 Paul

Krugman states that it is highly ineffective to conduct policy which leads to mass export of high-demand goods productions to plenty of other countries, instead of concentrating on a smaller number of countries, considering the advantages and the savings.<sup>6</sup> With this position he follows the classics of the political economy of comparative advantages and sharply criticizes Bush's policy for export, mainly in China, of productions with mass, viable demand (such as electronic elements). By the way, the Nobel Prize-winner defines himself as an economist-liberal but from West European social-democratic type. According to him the policy, conducted by Bush artificially increases the trade deficit of the US. This deficit is now considered a structural factor in the acute crisis in the US real economy. In general, Krugman's idea is that in the global economy each country should specialize in the production of less but competitive products, and exchange them with the other countries. He even creates his own model for the effects of the savings on the country and the companies, on the structure of the trade and the territorial location of the economic activity, which is an undeniable contribution to the theory of the International Trade relations.

A part of the current account, the second major element of our balance of payments with the foreign countries is *the capital and the financial account* (see section II of Table 1). Not only the volume, but also the structure of the funds in this account is important for assessment of the aggregate risk. Its surplus must cover the deficit in the current account. The capital account, according to BNB's definition, includes all types of investments (shares, portfolio, etc.), loans and trade credits (banks and companies), etc. Actually the aim is to decrease the deficit of the balance of payments, as well as the growth stimulation by a flow of external funds in the envelopment of that account.

The analysis of the figures on the capital account for the last years shows the following:

*First*, due to the crisis in the last two years the external flow into the account of the so called direct investments is decreasing. They differ in amount from the import of investment goods, and include, according to BNB's reports, all types of investments, except the company credits. In this range the direct investments reach, according to the data of BNB for the period from 2006 to May 2009, the following amounts (Table 5):

*Table 5*

FDI by Year

Year	Amount (in billion EUR)
2006	5.7
2007	6.5
2008	5.4
2009 (January-May)	1.1

Source: BNB. Payment Balance of Bulgaria. Internet, July 14, 2009.

<sup>6</sup> Wikipedia. Paul Krugman, Internet, April 04, 2009.

*Second*, in 2006 FDI covered 92.1% of the current account deficit, in 2007 – 103.4%, in 2008 – 65.6%, and for the first five months of 2009 – only 57.5%. The last means that soon the growth, which was based mainly on the foreign investments, will be decreasing.

In principle, for the last few decades two policies for economic growth have been dominating in the leading economies – liberalization of the capital markets with attraction of foreign investments, and development of the export through expansion in foreign markets. Bulgaria adopted both approaches without the needed balance of the internal investments and other factors, like attraction of considerable amounts of foreign capitals, and stimulating the export at the same significant level of gross domestic production, which reached in 2008 approximately 37.5% of it.

*Actually, the overall easy access to foreign financial resources of all types (including company loans), as a source of economic growth, and the inability to control the credit expansion in the country by economic means, in the conditions of crisis has led to destabilization of the economic situation instead of limiting and restraining the negative effects from the crisis abroad.* This is another display of the disruption between our macro-economic policy and the reality of the global economic processes.

*Third*, in the analysis of BNB of the annual balance of payments, the foreign financial inflows are not distinguished by function – for example, share holding in Bulgarian companies, loans and deposits of banks, or real estate investments. Practically each movement of foreign financial flows to the country is considered an investment and a direct factor for economic growth. This is unjustified both in theoretical and practical aspect. Significant differences are apparent in the information from BNB and NSI in view of the accounting of foreign financial resources and investments, which disturbs the timely substantiation and assessment of the problems and risks on the financial imbalances and the adequate decision-making.

In international comparisons as *foreign direct investments* are considered only the share and joint-stock partnerships, as accounted by NSI.

### **The Amount and the Structure of the Total External Debt**

The amount and the structure of the total external debt, i.e. of the *external liability*, also contribute to the deepening of the crisis in Bulgaria. It's amount and structure, along with other factors are a major precondition for restricting the flow of the foreign capital. Thus, in the end of 2008, the total external debt composes over 36.6 billion Euro (including the liabilities of the banking sector),<sup>7</sup> and as a total exceeds the amount of GDP. The total amount of the debt has not changed until May 2009. According to the international comparisons this indicator is in the critical zone for the country, and is a restrictive factor for the economic growth and the

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<sup>7</sup> BNB. Gross Foreign Debt in Bulgaria. Internet, July 7, 2009.

level of solvency of the economy. The flow of foreign capital into the country was decreased by 1.1 billion. Euro in 2008, or with approximately 16.5 %, compared to 2007.<sup>8</sup> This negative tendency is likely to keep on for a long period of time.

As for the solvency of the country, I will mark that in view of the security of the foreign investors, the external liability of each country supposes an *assessment of it's solvency as a system*, in view of official (state) or private debt. For this reason the international agencies, that have been created specially for that purpose, define the so-called "countries ratings", as to reflect the aggregate risks both in view of the state and the private liabilities.

Not long ago the total external financial risk of the countries at macro-level was identified with the bank credit relations, which were prevailing. But as I have already mentioned, in the conditions of globalized markets the former international economic relations have become much more diverse: they now include shares, company loans, and stock exchange investments, as well as the moral hazard of principals and regulation authorities.

New numerical coefficients for external financial risk assessment were added to the "alphabetical" denotations of the ratings, as to mark the relation of the liability to the export and the GDP. The new coefficients define the external financial risk of the country as an ability of the national economy to mobilize the necessary amount of foreign currency for serving its external liability. That ability is related directly to the terms for payment of the external debts from all types of participants in the market, and indirectly with the state authorities' collaboration in the process.

According to the data published by BNB by the end of 2008, the long term liabilities of the country amount to approximately 28% of the total external debt of 36.3 billion. Euro; the short term liabilities (for 1 year period) – 36.5%, and the so called by BNB "direct" investments – about 35.5%.<sup>9</sup> It is clear that the short term debt, which is significant and is to be paid out shortly, is almost close to the annual amount of the export. *This means that the liquidity risk here, according to the expert assessments, is near to the threat of a sharp drop of the economy and default.* The options are very limited due to the fact that the total indicator of the external debt to the export is disadvantageous, with correlation for 2008 2.4:1 in favor of the external liability, and with a tendency to even grow higher.

The systematic approach to the risk assessment requires consideration of one more circumstance. As the coefficients for external financial risk in the conditions of globalization affect not only the institutional relations between the countries, but also all non-residents, who have financial claims to the country, with the lack of the needed foreign currency all types of foreign claims will fall under the risk of default. The only resources that could be mobilized are *the official gold and currency reserves of the country*, concentrated in BNB. The possibility of paying off external debt with the reserves is shown by the data of BNB (Table 6).

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<sup>8</sup> BNB. Balance of payments of Bulgaria. Internet, July 14, 2009.

<sup>9</sup> BNB. Gross Foreign Debt in Bulgaria. Internet, July 7, 2009.

Table 6

Official reserves of BNB (in billion EUR)

Year	Official Reserves	Amount of the External Debt	Reserves towards Debt (%)
2006	6.8	20.1	33.8
2007	12.0	28.8	41.6
2008	12.7	36.6	34.6
2009 (05 months)	11.8	36.4	32.4

Source: Balances of Money Supply Department (December 31, 2006; December 31, 2007; December 31, 2008 and May 31, 2009). Internet, July 1, 2009.

In the conditions of the expanding global crisis and the declining export it is only natural to expect a negative development of the reserves of the country, and specifically their decrease not only as a percent towards the debt, but as an absolute amount as well. *It does not only increase the risk of default, but brings the level of the risk of a prolonged recession to a critical point.*

In the assessment of the external financial imbalances and the risk of recession, it is necessary to account *other indicators of the socio-economic and political development of the country, closely related with them.*

From this point of view, the researches of Euromoney magazine from 2008 for the rating of the former socialist countries in CEE – now more of them EU members or candidates for accession, are interesting.

The Euromoney analysis includes nine economic and non-economic indicators assessed by international experts, some of which are: economic growth (as perspective), political risk, external debt, solvency (credit rating), access to bank and other financial resources, and etc. The total assessment of these criteria is 100. For 2007 Bulgaria is ranked 8<sup>th</sup> out of 12 countries in the region, with assessment of 58.47, which ranks it after the candidate for accession in EU - Croatia, but in front of Romania. The first place is occupied by Slovenia with a grade of 81.75.

The analysis of Euromoney was prepared in the eve of the upcoming crisis. In another analysis, made by UniCredit Group from October 2008 pointed out that the unstable situation of the international financial markets will strongly reflect on the economics of all the countries from CEE, and the pace of their economic growth will be delayed, but to the point of contraction.<sup>10</sup> That included Bulgaria as well, with expected GDP growth of about 4.7% vs. 6% growth in 2008. These expectations did not take into account the inactivity of the authorities for reduction of the imbalances. On the grounds of formal calculations, it was forecasted that the gradual slow down of the pace of economy growth and the presence of fiscal

<sup>10</sup> The bank market of CEE – growth opportunities in the conditions of non-stable financial markets. Internet, econ.bg, April 02, 2009.

reserve with an opposite of the imbalances sign, will naturally lead to reduction of the imbalances to more sustainable levels.

As soon as the industrial production here dropped down by 24% in May, 2009, compared to the same period in 2008, and for the first five months in 2009 the export decreased by more than 30.7%, under the new circumstances the UniCredit Bulbank economists forecasted change of the GDP from +4% to -6% during this year, and -3% for the next 2010.<sup>11</sup>

According to their forecasts the Bulgarian economy will go through a continuous period of economic recovery, which will be shorter than the one forecasted for the rest of the Central and Eastern European countries. *The experts consider that the long period has a positive side as well, and it is related to the reduction of the current account deficit to amounts that will be acceptable for the markets in the period after the global financial crisis is over.* According to them, for the moment a winning proposition would be the development of a balanced model of growth of the Bulgarian economy, the main contribution to which continues to be the net export (the export to exceed the import), and not the internal demand but also with a change in the economic incentives, as to allow the transfer of production resources from internal demand oriented sectors, which are characterized with reduced capacity for further growth to sectors, producing medium and high technology products, which are characterized with medium and high added value, and lower extent of labor and energy consumption.

Recently in other countries a different policy could be noticed from the one proposed above. *First*, in the current crisis conditions it is more and more delineated that the most effective way to support the economics is the increase in the share of the public sector, which has not been taken into consideration by the UniCredit experts. According to the assessment of the disruption English magazine "The Economist" the share of the public sector in the developed countries in the near future will reach 40-50% of the GDP.

Second, actual assistance for new loans from the private bank sector should not be expected, as the sector has its problems, related mainly to the liquidity, due to the considerable increase in the "bad" credits. Here, for example, after the amount of the bank loans (advances and claims) of the non-financial organization reached in September 2008 54.7 billion. BGN and approached the annual amount of the GDP, the credit activity dropped down into latent condition and its increase is non-essential: for the fourth quarter of 2008 – with 1,1 billion BGN, and for the period January-May, 2009 – again approximately 1.0 billion. BGN.<sup>12</sup>

At third place, the practice shows that the crises have a weaker effect on the countries that are in the "golden mean" of the globalization processes, i.e. which are not so much dependent to the flow of foreign capitals and the disposal on external markets. This is especially specific for the BRIC countries.

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<sup>11</sup> The Bulgarian Economics: The grip of the recession tightens. Internet, econ.bg, July 14, 2007.

<sup>12</sup> BNB. The Banks of Bulgaria. Internet, April-June, 2009.

In India the internal resource, i.e. the savings, is widely used as an effective way to avoid the crisis. Brazil is also conducting a policy to increase the internal credit, at the expense of own resources, by which it brings back the consumers' trust. Special attention is paid to the cooperation with the public financial sector. Thus for the period September, 2008 – January, 2009, the business credits from foreign and local private banks were increased by 3%, and those of the public banks – by 14%.<sup>13</sup>

Russia, on its side, as a country with a strongly centralized decision making, follows with a great attention the development of its external trade under the conditions of the crisis, in view of its structural accordance. As an example, in April, 2009, the export had decreased by 47% (on annual base), but the import had been regulated to decrease by 43% for the same period. These actions for controlled increase of the positive balance on the trade balance (which increase amounts to 26.4 billion US dollars for the first four months of 2009) are also targeted to better management of the crisis, and maintaining the entity of the currency reserves.<sup>14</sup> Another measure, undertaken in Russia, is related to the steady growth of the household income, as to increase the internal consumption. The personal income is linked bundled more and more to the degree of increase of the labor efficiency, which was not accounted in the conditions of growth of the prices of the energy sources and the profusion of low cost financial resource.

Yet another factor is that the BRIC countries had liberated less their internal capital markets, thus preventing them from the immediate effect from the world economic crisis.

The critical levels of the financial imbalances presuppose that in Bulgaria we must also determine *measures for increasing the role of the internal demand for the economic growth*, although the scales and the character of our economy are different, and such measures for re-direction of the growth cannot be copied. However it must be noted that in the current plan, the state authorities and mostly BNB, *are debtors to the business environment, as although the latter gathers data for the flow of foreign investments in the country, mainly in the form of company loans from abroad, it did not succeed in systemizing them, and transpire them to the media and the society in a definite form, as to provide the business the option to direct to the most efficient investments and activities.*

### **Adequacy of the Public Services and Decisions, in View of the Situation**

The analysis shows that the external financial imbalances are not a result of direct imaginary external influences, but of the way in which the decisions within the country are made and implemented, in view of the external and internal factors of the development. The interaction between the financial sphere and the real economy requires *the external and internal financial flows at macro level to be in*

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<sup>13</sup> The recession deepened the separation between the developing markets. – Pari, July 9, 2009.

<sup>14</sup> Russia reserve fund is emptying fast. - The Economist, London, 24.07.2009.

*correlation with the mechanisms for profitability of the economy, including its internal component, which expresses mainly in the indicator labor efficiency. Bottom line, precisely the labor efficiency in the society as a whole, is what defines both the increase of the income of the population, and the investment attractiveness of the country.*

According to statistical data and researches of the Bulgarian Industrial Association (BIA)<sup>15</sup> the growth of the labor efficiency during the last four years remains modest, with an average of 2% per year. The reasons are found in the extremely low efficiency of the public investments, in the organization of the public procurement, the unduly administration, the corruption, the uncontrolled outflow of budget and public resources, etc. Therefore the first factor for the low efficiency of the labor is that *few people are producing extended product*, which is significantly reduced through the corruption channels, the padded administration and the unreformed sectors of the economy, such as education and health care.

The other major factor for the low productiveness is that *the added value of the products and services, produced by the workers in the Bulgarian real economy is small*. Surely, this does not mean that the productiveness of the worker in Bulgaria is eight to ten times smaller, compared to that of his colleagues in the rest of the EU member countries, as is the disproportion in the remuneration.

From financial imbalances point of view, the relation between the imbalances and the labor efficiency of the worker is in *what financial income is generated by the economy system for a period of time (throughput)*. In order to resolve the problem with the higher labor efficiency, the state authorities must reform the organization of the work in the main public sectors, and its own structures, thus increasing the efficiency of the public decisions and public finances, which have a *system-forming* role. This is why the strategic problem, which could reduce or increase the recession and the transformation of the examined financial risks into a threat of default is *what decisions are made and what public services are provided by the authorities now, in the distribution and support of the business and the active population with financial resources*. This is a very serious issue, considering the non-successful account of the attempts of our country in developing modern mechanisms for operation of the Ministries and the other public departments, based on the principles of "program budgeting", and thus for the good spending of the resources provided by the EU funds. *It is impossible for the administration to require from the other sectors to operate by successfully applying the system principles of program and project management, which involve achievements and payment, based on specific targets, while the Administration itself is operating by outdated models of financing, credit and stimulation.*

Naturally, in the current crisis one of the priority sectors, requiring state support, is the bank sector. The months following the beginning of the world crisis confirmed that after the first incurred difficulties, in 2008 the bank sector in Bulgaria

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<sup>15</sup> Labor Productiveness – efficiency of public finances. Internet, expert.bg, April 2, 2009.

remained relatively stable. From the fourth quarter of the same year, the sector sharply reduced the credits to the business and the population. This tendency, as already noted, has not yet been overcome, despite the alleviations made by BNB to the commercial banks, as regards the usage of a considerable part of their compulsory reserves in the Central Bank. The intervention of the state was required for reviving the credit with the state guarantee fund of 500 mln. BGN, the operations over which were entrusted to the Bulgarian Development Bank.

In this regard some international observers consider that the bank crisis from 1996-97 in Bulgaria has helped our system to learn the lessons for reaction in crisis situations. It is not recognized that at the time the commercial banks were with entirely Bulgarian capitals, and provided credits mainly to Bulgarian state organizations, while now the banks have prevalent foreign capitals and provide credits mainly to private companies and persons. They follow the policies of their head office abroad, which liquidity is heavily affected by the US financial crisis. According to the assessment of the UK gazette Telegraph, the European banks have a capital hole of 2 trillion US dollars, due to their aggressive policy worldwide, and therefore they cannot slow down the credit process, and are likely to demand part of their resources from abroad; the Bulgarian banks owe them over 8.5 billion Euro as of the end of May, 2009.<sup>16</sup>

*The bank priority for intervention from the executive power, in principle can help, but cannot guarantee the orderliness of the public decisions in the country, and that is a basic condition for successful recovery from the crisis, and for further development. We do not share the concept of some authors,<sup>17</sup> that the state's intervention in the real sector always has harmful consequences, irrespective of the technology of the intervention: through a guarantee fund for support of the banks in Bulgaria, based on a well taught system of responsibilities, through a transpire subsidizing of the agriculture for achieving concrete results, through state guarantees to large-scale international, and mainly energetic projects, that will bring real revenue for the country, or other technologies. The ultimately monetary view that in contrast to the state administration, the free market always functions efficiently, and the state intervention, even with the conditional infusion of funds from the fiscal reserve into the commercial banks is wrong<sup>18</sup> is still flourishing through a major part of the Bulgarian elite. In the conditions of the current global crisis, defined by many economists with the metaphors "avalanche" and "pandemics", such statement is totally inadequate. The situation does not allow the market to regain stability on its own or at the base of bank credits only. Direct engagements of the state authorities are required, like guaranties for development of the conditions allowing achievement of concrete results, projected in the*

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<sup>16</sup> BNB. Balance of payments of Bulgaria. Internet, July 14, 2009.

<sup>17</sup> *Mladenova, A.* Review of the Economic Policy. Published by the Institute of Market Economics, August 2008, pp. 1-2.

<sup>18</sup> *Angelov, G.* Two of the anti-crisis measures of GERB won't work. – Sega, August 5, 2009.

international financing of large-scale system-forming objects. With a passive policy of the state authority, the country will be predestined to a gradual isolation from the international capital and energy markets, with long term negative consequences.

It is important to direct our efforts, and mostly these of the authorities straight to surmounting of *the main structural disproportion* in the Bulgarian economy, namely between the profitability of the financial flows from one side, and the profitability of the flows of products and services, from the other side. The overcoming of main structural disproportion should not happen with spilling of the state resources in the economic sphere, counting on the currency and fiscal reserves that we currently have, but by pouring investments in those sectors which will be the base of an uplift, for ensuring new working places and growth of the labor efficiency.

*From system-technology point of view it means that we need such decisions at all levels, which will synthesize the social-economical, the administrative and the business aspects in the technologies of the public authorities and the public services.* This should not be following of a written strategy, but a conscious synthesis on the surmounting of the servitude to common administrative and market principles, on the account of a concrete economical responsibility of the decision-makers in the public, the administrative and the business structures. The science has already developed specific principles and technologies for the making and the implementation of such synthesizing decisions, such as the system for total quality management (TQM), the Business Processes Reengineering (BPR), the theory of overcoming constraints (TOC), the new audit technologies, etc. In the conditions of globalization there is a worldwide spread tendency for applying these principles and technologies, and the crisis creates the unique opportunity to accelerate the implementation of this tendency in Bulgaria.

As for the further intervention of the state authority in the credit-financial activity, as seen by the analysis it will be purposeful if it's targeted to the clear objective to provide *regulated incentive of the credit for the business and the population specific projects and programs*, and not for direct pouring of financial resources, including those in benefit of the banks' liquidity. This distinction in the financial flows by their efficiency requires new, effective mechanisms, both for financing and monitoring of the resources distribution and utilization.

For example through the realization of an integral *program for application of the Bulgarian Standards* (made for the dairy products only), the import of low-quality textile and agricultural products from Turkey and China could be decreased. This will also contribute to decreasing the level of the unemployment in Bulgaria.

In the new conditions programs and projects are also needed for state stimulation of the production and export of agricultural products and medical goods, which consumption in the world has maintained high levels, despite of the crisis. Other Bulgarian economists also find the idea of increasing the share of the agriculture output for the economic development.<sup>19</sup> There are numerous options to do

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<sup>19</sup> Nikiforov, V. How is the creative market economy in Bulgaria formed? Sofia, 2008.

that, especially since the agricultural production might be anti-import means for decreasing the imbalances in the foreign trade. Currently the food import in Bulgaria amounts to approximately 2.8 billion BGN annually, with  $\frac{3}{4}$  from it coming from the EU, and the export – to approximately 2.6 billion BGN, 62.5% of it for the EU.<sup>20</sup>

In that group of programs and projects, special attention should be paid to the production of *ecological products for export* to the developed world, which more and more direct from the excessive consumption of less-essential commodities and services with a relatively low added value, to consumption of more ecological products.

Market researches show that the necessity of implementation of *projects for stimulation of the production and export of high demand Bulgarian goods to the countries out of the EU*, where we have long term strategic interests, and where the effects of the crisis are limited, should not be neglected or politicized.<sup>21</sup> In midterm plan a basis for the stimulation of the production and export both to such countries, and to our major partners in the EU, might be the development of a *programme for supporting the industrial-logistic network* that is necessary for the purpose: purchase-preparatory stations, warehouses, free zones, direct transport lines and other structures that will optimize the transaction expenses of the agents-producers.

Bulgaria is ranked last in the EU by the energy efficiency indicator, yet no attempts are made for decreasing the risk of the external financial imbalances and increasing the efficiency of the system for resolving the energy problems of the country. From the point of view of the accounting of the economic expenses, currently the price of the electric energy in the country is too low. It is an illusion that the price increase could be avoided. We need stimulation from the state (for example through tax relieves or with a special fund), of *an integral program for protection of the population from the energy prices shocks*. The programme should cover such directions like installation of solar-energy water heaters, heat insulation of the lodgings, wider usage of biomass for energy production in the thermo-electric power-stations, etc. Such a programme has already been implemented in the Check Republic, with financing fund of 1 billion US dollars, generated by the sale of 100 million tons of green house gas emissions.

In short and middle term *it is essential to finance and stimulate by programs and projects the demand, supply and organization of high quality health, educational and insurance services in the country*. For example, the national financial accounts and tourism would benefit from combining of the EU funded incentive of the advertisement and marketing of Bulgarian tourist services with the conduction of an *integral program for prompt implementation of a total quality management system in the main units in this sector*.

An important precondition is all programs and projects to be transparent and accessible to a wide range of specialists, users and other interested parties, unlike now, when even on the internet sites of the authorities of the National Operative

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<sup>20</sup> NSI. Foreign Trade. Internet, July 10, 2009.

<sup>21</sup> Georgiev, R. New situation – new risks and opportunities. - Pari, May 25, 2009.

programs, with few exceptions, there is no information published for the annotations and the good practices on the EU funded projects through operative programs. Except for the direct effect for the population, this will lead to increase of the trust both *in the stability of the finances and in the justice of the institutions in Bulgaria*. These are the two main indicators for the presence of a state and its role in the economy and society.

The resources from the European funds for Bulgaria might and should be used to add up significant part to the resources, needed for the implementation of some of the proposed here, as well as other initiative programs at micro and mezzo levels. For that purpose it is necessary to put into practice the technologies of project management and program budgeting for all parties that operate with financial and public services, not only for the EU funded services, but also those, funded by the Bulgarian budget and other own resources. From the point of view of the system vision for the resources it could be stated that practically we do have European management technologies and not a small amount of European funds for *additional* effect, but the own resources of both material and non material character, which provide the basis for upgrade, i.e., which guarantee the *fundamental* effect, are insufficient. The major drawback of the public services and administrative decisions in the country cannot be overcome by recruitment of European experts for the key positions in the administration, as proposed several times by the Bulgarian government till the middle of 2009. The only way out of the current situation is through a complete change in the organization of the processes and the units, with an accent to the responsibility in decision making and implementation. For now, unlike other EU member countries, we still do not have a law, regulating the management and utilization of the EU and the other donors' funds, to provide systematic and concrete juridical grounds for assuming such responsibilities.

The systematic "communication" with the financial imbalances should also cover measurements for ensuring continuity of the payments between the economic contractors out of the finance sector. The problem is that the current intra company indebtedness amounts to 120 billion BGN and exceeds almost double the annual amount of GDP for 2008.<sup>22</sup> By now the executive authorities have not succeeded in finding mechanisms for decreasing the indebtedness, and the branch organizations, in accordance with their current commissions are limited to cooperation in public researches and information only. With the more and more clear symptoms of recession, the passivity in this aspect might lead to chain bankruptcies of companies and to negative economic development. And this is one of the major system risks for the Bulgarian business circles in the conditions of the current economy crisis.

We need a public discussion on the opportunities for more dynamics in the privatization and/or the temporary nationalization of enterprises in trouble, as to

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<sup>22</sup> BIA. 32% growth of the inter-company debt and 2.5 times more bankrupts in 2009. Internet, July 29, 2009.

release the network of the company indebtedness. In the last years the processes of privatization had been stopped and strongly influenced by corruption practices and the problems of the temporary nationalization have not been made public. Non-systematical approach and isolated actions on the problems have been applied from ministries and municipalities (for example in the cases of Toplofikacia Sofia, Kremikovtzi, etc). The situation in the country at the moment is systematic, with complex risk relationships, synthesized in the critical and demanding mutuality of the measures with generalized formula of the financial state of the Bulgarian economy:

*GDP: Foreign debt of the country/ Intra company debt = 1:1:2*

### **General Conclusions and Recommendations**

1. In the conditions of the contemporary information asymmetry and risks turnover, the developed world approaches the management of the economics more and more from the pragmatic positions of the risk management and the evidence management procedures, as opposed to a blind following of postulates from political-economic models, non-systematic application of external experience and own habits, not coordinated with the situation.

2. In the enlarged economic crisis the work on revealing and assessing the risks of the external financial imbalances should transform from a research process into regulated system for generating, assessing and applying share information in the national economics management. The non-regulated and non-systematic approach towards the financial imbalances leads to wrong management decisions at all levels, including in international negotiations and engagements. In a globalized market the disbalances in the foreign trade flows and engulf of products from the other economics will be tolerated less and less.

3. At their last meeting in London (April 2009) the leaders of the top 20 countries in the world coordinated measures which will ensure through the IMF financial resource amounting to 1.1 trillion US dollars to the developing countries, if they need support for exiting the crisis. The systematic analysis of the external financial imbalances and the public technologies, required for their management are a good ground, which should be used for development of adequate policy for the incentives and limitations in the movements of capital, goods and work force between our partnering regions and countries.

4. The research clearly shows that for achieving a tendency of decrease of the critical levels of the foreign imbalances of the country, it is required to increase the capability of the economic system to generate profit. In the current conditions increase of the efficiency of the throughput along with decrease and rationalization of the investments and the operating monetary expenses which the country can afford to make in the conditions of the crisis, as to turn the investments into efficiency of the system. The relatively low life standard of the population and the poor development of the industrial-logistic network do not allow a significant decrease of the operating expenses, except for some expenses of the administration. The main efforts should be

directed to capacity of the system to generate profit through ensuring new segments on the market, purposive draw of active investments and increasing the quality of work, starting with the public decisions and services.

It is necessary the authorities and the society to be engaged in well-grounded programs and projects that meet these requirements, some of which are proposed in the research.

5. BNB is a debtor to the business environment, as although it gathers data for the inflow of foreign investments in the country, mainly in the form of company loans from abroad, it did not succeed in systemizing them, and transpire them to the media and the society in a definite form, as to provide the business the option to direct to the most efficient investments and activities.

Since the exit of the crisis is promising to be slow, and banks here have been gathering bad loans that now can only be restructured due to the liquidity, the development of the participation of state funds for incentive of the credit of certain enterprises, companies and households in the country is needed, based on program and project management.

6. The financing and implementation of a large scale system-forming for the Bulgarian economy projects should be approached not with political considerations, but with increased attention and complex risks assessment. The systematic evaluation of the external financial risks of the country has proved that whether an externally financed project is built with private or public resources, the risk for the foreign investors is expected to be the same.

At the same time the presumption that system-forming projects could be built only on the basis of private interest does not correspond to the modern views for the evidence management.

7. The state participation in the various organizations for fund raising through their stock exchange sale in a transparent way, as opposed to the widely spread hidden deals and corruption schemes, should be more rational. This way preconditions will be made for improving the activity of the companies and development of the Bulgarian Stock Exchange, and also for gathering funds for the state budget, which are needed in the current crisis. As to unclog the companies' indebtedness there might be a necessity of a temporary nationalization of companies, but with a premeditated technology for doing so.

8. The utilization of the EU funds could be turned into a major channel for external support and assistance only if its based on implementation of clear program and project management, both at micro level, and in the ministries and departments. The concentration of efforts and the achievement of success in this area would be a positive indication that our country has the determination and the vigor to manage with the situation. If other international institutions are approached for relief funds, with no evidence provided for the efforts made for the utilization, this could result in bad reputation and even harder socio-economic after-effects for the country.

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