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MONETARY DYNAMICS AND ECONOMIC ACTIVITIES

The article is attempting to analyze the development and the various manifestations of the financial and economic crisis in Bulgaria and on this ground some macroeconomic policies are being recommended. The liquidity crisis imposes significant restrictions and hampers economic growth. More and more expectations are being directed towards the BNB's potential to attenuate the liquidity crisis and to the government to increase the country's attractiveness as an investment destination.

JEL: O11; E52; E58; E65

The current global financial and economic crisis started differently in the individual countries. Despite the similarity in the main causes for its emergence, it manifested itself and developed in a variety of forms in the various countries. In 2008 and the beginning of 2009 there were no signs of a liquidity crisis in Bulgaria. The economy was obviously overheating but the inflow of foreign capital took the edge off the unfavorable effects. The government failed to duly appraise the possible risks of the inadequate macroeconomic management. The EC reported an increase in corruption practices in the country and suspended the grants planned. The herding behaviour of foreign investors brought about a sudden withdrawal of foreign investments and the country gradually entered on a phase of a deepening liquidity crisis. Under these circumstances the issue on the agenda becomes the type and nature of macroeconomic management required, the more so given the currency board arrangement in operation.

Theoretical grounds

The quantitative theory of money postulates a dependence among three major macroeconomic indicators – rate of growth of money supply, rate of growth of GDP and inflation. The Central Bank is able to control the nominal money supply and through the monetary policy pursued to have control over economic developments in the country – most of all inflation, as well as the overall economic activity.

The availability of such a dependence underlines the behaviour of leading central banks in the world (FED, ECB), especially in the situation of the financial and economic crisis experienced by the world at the end of the first decade of the 21st century. In order to counteract the recession strain the leading central banks in the world have relieved the refinancing of the banking system by means of providing fresh financial resources – through a conscientious and purposeful reduction in their own interest rates, i.e. in the price of the financial resources provided to commercial banks (CBs). Monetary restrictions were loosened, so more financial resources were dealt in with one and the same objective – to counteract the financial and economic depression and to create propitious conditions for boosting investment activities, economic growth respectively.

Experience has shown that the influences in these two directions have not given an equivalent outcome – increasing money restrictions (reduction in the money supply) has had a more direct and immediate impact on the development of economic processes, whereas the results of loosening money restrictions have been ambiguous.

Finding out the right balance between price stability and economic growth is an element of the art of central banking. The ECB used the possibility for spilling over and balancing the impacts on inflation (targeting) and economic growth with a view to emphasizing on the necessity topical at the given moment and took on the respective responsibility.

The current financial and economic crisis has shown that the balance between investments and economic growth (economic recession) is an element of art of a higher class – that of macroeconomic management as a whole.

Monetary restrictions and parallel developments

For the period 1998 till the autumn of 2008 the nominal money supply in Bulgaria followed a steady ascendant development (Figure 1), completely in line with the requirements of forward economic development and making up for the country's delay, being far behind generally in terms of its financial and economic development from the European one.[1] From that time on there has been a pronounced trend of consecutive shrinkage in nominal money circulation, the logical output of economic recession. This shrinkage was much bolder in real terms (Figure 2) – the average annual rate of growth in money supply for 2008 was 3.1%, whereas the same growth for the following 2009 was already minus 6.9%. The good news is that for the first half of 2010 the contraction in money supply has gradually slowed down.

The consequences from the shrinking money supply have manifested themselves in different ways and fields.

The money circulation directly correlates with the dynamics of major macroeconomic indicators.

GDP has fallen for the first time since 1997 and quite significantly at that – by 5.1% (2009 г., Figure 3). Industrial output tumbled during the second half of 2008 by over 30%, although that in the following 14 months it managed to keep its reduced level (Figure 4). And worse (but quite expectedly) has been the situation in the sector of construction, where the recession, emerging in the middle of 2008, went on in 2009 and 2010 unabated (Figure 5). For a year and a half output in construction has plunged by over 40%, but will probably start bottoming out in the coming months.

[1] Most of the information used in the study is from official sources (publications and the Internet) of NSI, BNB, MF. If other information sources were used, these were explicitly mentioned.

Figure 1

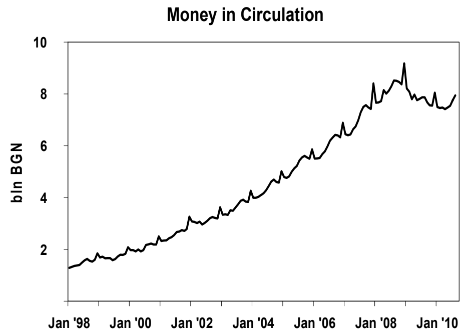
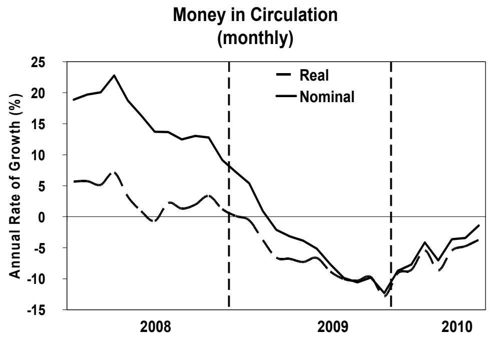


Figure 2



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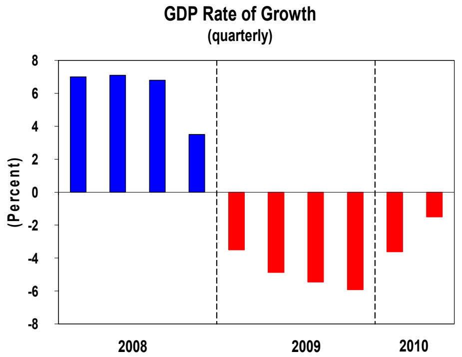

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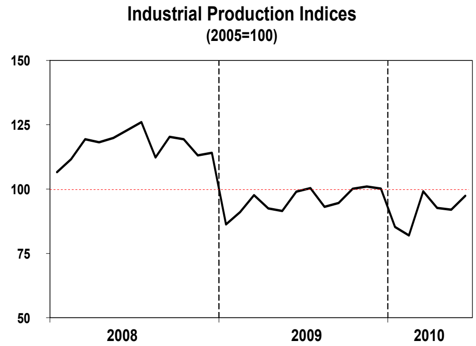

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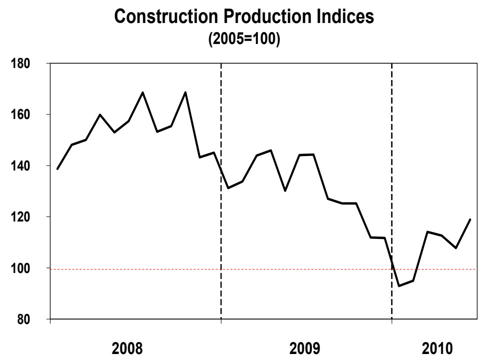
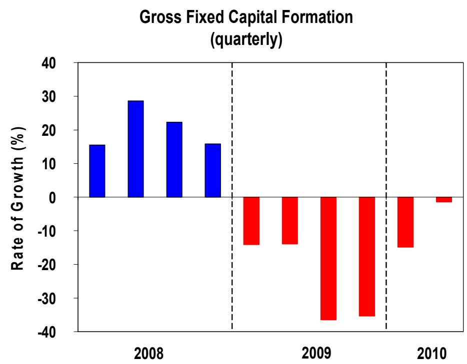


Figure 6



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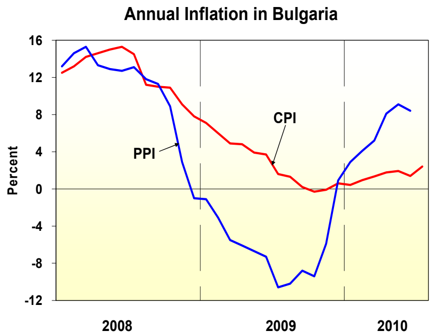

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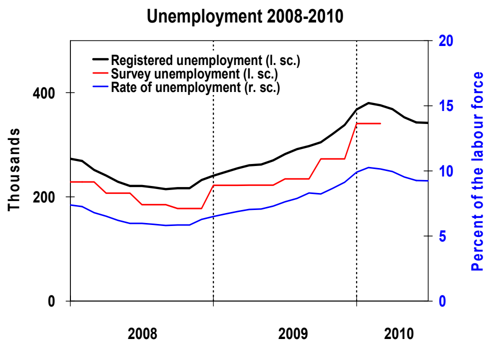
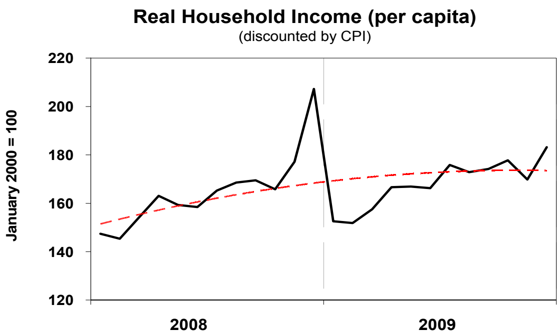


Figure 9



The situation with investments looks dramatic – while in 2008 gross fixed capital formation grew by over a fifth on the previous year, in 2009 it contracted by nearly a quarter (Figure 6)! In addition, this happens when Bulgarian economy feels a glaring need for an overall technological renovation.

CPI has crashed to critically low values and entered the dangerous zone of deflation (Figure 7), where it began holding up economic recovery. The dramatic fall in PPI has also brought about the latter, primarily because of the lower demand for raw materials and resources on the international commodity markets, i.e. the outcome of external influences. Until the fall of 2009 the gap between CPI and PPI, on the other hand alleviated the strain in financial structures of production, but later on the situation changed. Since the autumn of 2009 the level of producer prices was restored and this exerted a tangible pressure for rationalizing the production costs structure.

Unemployment has definitely started going up without reflecting the seasonal (summer) growth in employment, traditional for market economies (Figure 8). The increase in unemployment has been checked by the growing gap between

CPI and PPI, which enabled producers to rationalize their costs structures under a transformation of employment. This transitional period is obviously over, so the pressure on employment has become more evident. Still, in March 2010 unemployment fell slightly, which might signal the beginning of economic recovery. Macroeconomic management has to take into account these special developments.

It is worth noting that the curve on Figure 8, describing unemployment in accordance with periodic statistical representative surveys lies below the curve of officially registered unemployment. People still manage to find some kind of employment in these hard times, which remains unrecorded. It, however, contributes in some ways to taking the edge of the financial crisis on the population off.

The country has managed to avoid massive social unrest mainly because of the short-term impact of the inbuilt automatic stabilizers in the economy. Hidden redistribution effects have managed to hold back the decline in real income of households per capita at a bearable level (Figure 9). This phenomenon exists but it is hard to explain logically, although it has manifested itself in Bulgarian experience under a reverse context. Thus for instance, GDP in our recent past has stayed at around a real rate of growth of 5-6%, whereas the real income of households per capita has risen twice more slowly.

During all the 2009 the economy cashed the negative effects and domestic pressure grew. The prerequisites for such a development evolved and found some expression in the previous year but became obvious in 2009. The beginning of the economic 2010 went on presenting many problems.

Under a CBA in operation the shrinking money supply can be accounted for but it is irrespective of the specificity of macroeconomic management.

Banking intermediation

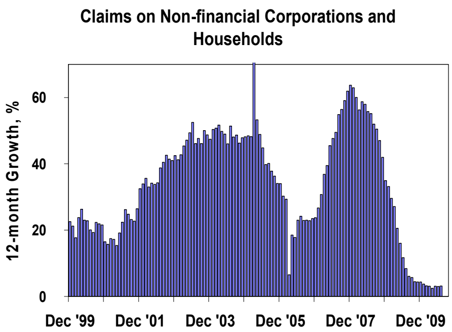
Lending expansion

The lending euphoria in the years preceding the crisis has contributed to the problems. Right after privatization of the banking sector was completed, the new banking management decided that the conditions for a lending expansion were propitious and holding out bright prospects for making money. The European future of the country was the main prerequisite for these favorable expectations. So lending grew gradually and in 2004-2005 it settled at about 50% annual growth rate. Such a dynamics held quite a few risks with a view to the restrained annual growth in GDP (5-6%). The BNB assessed the potential danger and in the spring of 2006 it took the necessary restrictrive measures for cooling lending down. The market reacted positively and in the middle of 2006 lending to the non-financial sector settled at the targeted level of 25% (Figure 10).

Then the BNB decided a bit hurriedly that the lending market was calmed permanently and it removed lending restrictions in the second half of 2006. The market did not take long to reply – lending euphoria was unleashed to reach and even exceed the unbelievable 60% rates of growth on an annual basis at the end of 2007. The major share of lending granted had gone to construction and business services. BNB was late in issuing its regulatory measures and obviously did not manage to find the right dosage. BNB's regulations proved insufficiently adequate and firm. In September 2007 the minimum reserve requirements were raised from 8% to 12%, but this time the market did not react and the BNB remained a passive observer. The explanation lies in the unwise lending race of CBs, whose profits seemed never failing (Figure 11) and whetted inconceivably the appetites for profits of banking management and banking shareholders. The BNB's regulations did not prove adequate nor strong enough.

In 2008 the germs of the coming financial crisis began to show up. Lending went on expanding much more by inertia, supported by the bankers' belief that the positive trend could not be reversed just like that (Figure 12). However, the mechanism of servicing the unwise lending granted began to seize up. In the last quarter of 2008 it became definitely clear that the financial crisis was imminent and unavoidable and lending gradually subsided.

Figure 10



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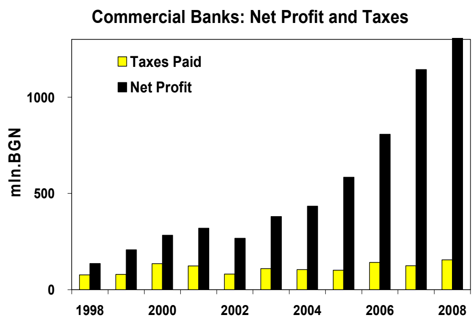

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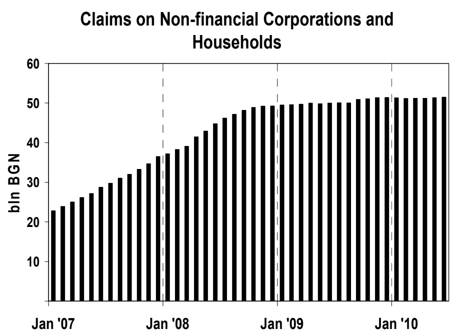

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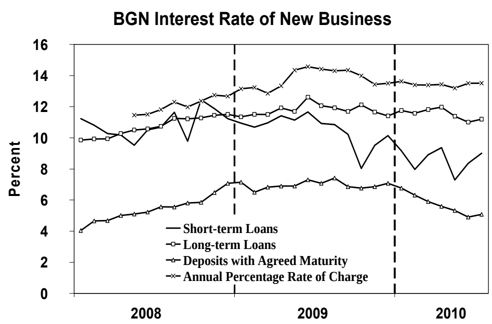


Figure 14

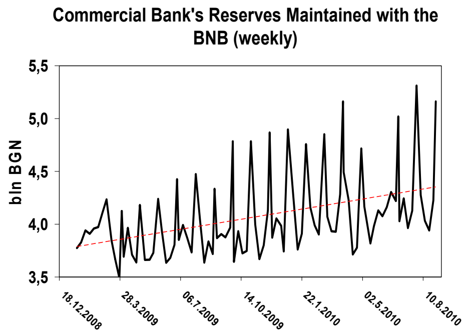
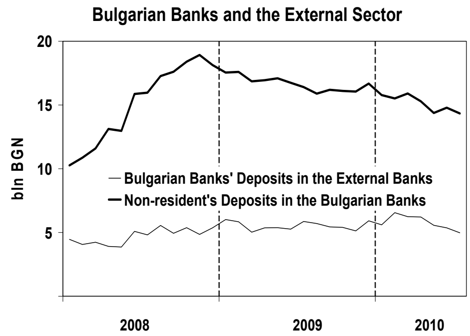


Figure 15



Again, with some delay, the BNB loosened the money restriction by cutting down the MRR percent by two percentage points since December 1st 2008. Other accompanying alleviations were introduced too in keeping the MRR. However, these measures proved insufficient to maintain an acceptable level of lending and prevent investment activities from a disastrous fall (Figure 6).

During all the 2009 and the first half of 2010 the BNB did not set any policies to regulate lending.

Liquidity problems

CBs obviously experienced liquidity problems. The average annual return from term deposits in levs in the early 2008 stood at about 4% and in the following 18-20 months this return rose to almost 7% (Figure 13). Under an insignificant inflation rate registered depositors made nearly 7% real annual income which had no alternative under the circumstances. The accelerated lending over the previous years slowed significantly their reverse move to the lending sources and CBs felt the need for fresh financial resources to fill up the emerging liquidity vacuum. Under a passive attitude on behalf of the BNB the home deposit market became the only source of fresh financial resources.

The intensifying liquidity difficulties of CBs can be clearly traced on the weekly dynamics of MRR (Figure 14). Article 11 of BNB Ordinance No 21 reads: "*... banks may use without any restriction of the funds available on their accounts with the BNB, on the basis of which minimum required reserves are reported over the maintenance period …*" (para 3), so that "… *should a bank use over 50 per cent of the lev equivalent of the payable minimum required reserves on its accounts with the BNB, it shall pay interest in levs to the BNB for the excess over 50 per cent for each day of use in an amount as determined according to the methodology approved by the BNB Governing Council*" (para 4).

The periodic peaks on Figure 14 correspond to the MRR value at the end of the accounting period when CBs are obliged to offset the use of their own resources during the month. Right after this a massive withdrawal of reserves began and the cycle was repeated with a growing amplitude. In the last months of 2009 and the beginning of 2010 the difference between the maximum and the minimum of the reserves within a month reached and exceeded a billion BGN!

On the background of the manifested liquidity problems of the CBs by the end of the first decade of the 21st century, it seem illogical for the BNB interbank money market interest, which forms the base interest rate, to fall below the level of half a percent (base interest rate for the second quarter of 2010 was 0.18%!). The explanation lies in the content of the interbank money market.

Figure 16

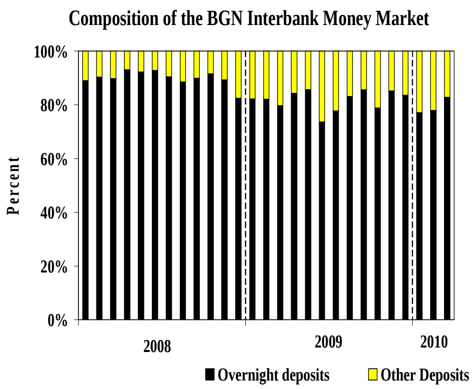
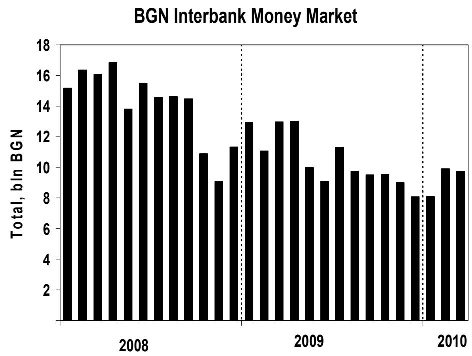


Figure 17



The prevailing part of the BGN interbank money market deposits offered are overnight ones (Figure 16). The maintenance of such a maturity structure on the interbank money market is to be looked for in the current mistrust among the CBs, as a result of the crisis developments manifested. The situation was not always like this - in 1999 for instance, overnight deposits accounted for 42% of all deposits on the BGN interbank money market, and in 2002-2005 – about three quarters. Then and later on the interbank money market was used by the CBs to settle current liquidity problems – resources were borrowed mainly for three days, maximum for a week. During this time the intensity on the interbank money market was much higher.

This is not the type of financial resources needed by CBs by the end of the first decade of the 21st century. The CBs liquidity problems in 2009-2010 have a very different nature – they need long-term financing. This is the reason why CBs strenuously tend to attract time deposits on the domestic deposit market (of 3-6 month deposits and longer) and are ready to pay for this quite a lot. Another indication is that the traded volumes on the BGN interbank money market tend to diminish (Figure 17), i.e. the demand for overnight deposits declines. Hence the fall in the base interest rate, which in this specific case does not carry out any managerial functions. Hence the fall in LEONIA, i.e. in the base interest rate, which in this specific case does not carry out any managerial functions.

The results from the one-sided efforts of CBs for overcoming their own liquidity problems are ambiguous.

On the one hand, by offering high return on time deposits CBs have managed to concentrate in themselves a large part of the money available. The strain on the money market was alleviated, the internal forex market functioned without substantial clashes (a stable CBA), the lack of free money resources suppressed inflation rates (even more than necessary). The high yield has held the foreign banking capital in the country too. In the early 2007 the deposits of non-residents in Bulgarian CBs (essentially deposits of foreign owners of resident Bulgarian CBs) were estimated to stand at about BGN 5 billion and reached their maximum of BGN 19 billion by November 2008 (i.e. 6% average annual rate of growth within 22 months!). Provided this capital (nearly 30% of GDP, Figure 15) had left the country because of the financial crisis, the consequences would have been very hard indeed. Since the end of 2008 a certain withdrawal of foreign banking capital has been recorded but it cannot be said to be very substantial (by the middle of 2010 the non-resident deposits fell to under 15 billion BGN).

On the other hand the high interest on deposits pushed up the interest on newly granted credits (Figure 13). It cannot be otherwise. Borrowers find themselves in an unenviable position and the potential new borrowers are forced to restrain from getting new lending. The consequences affect both investment activities and deepen economic recession.

The government financial policies

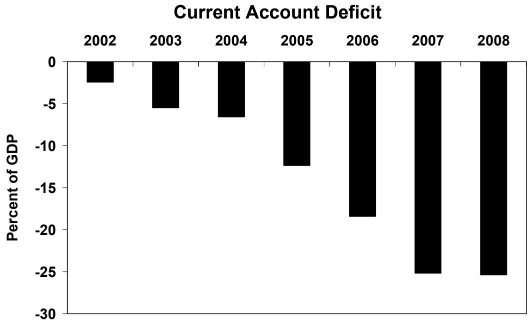
Under a CBA in operation the money supply is affected by the government policies too, by the budget policies in particular. The monetary policy stops being the monopoly of the BNB only, but in any case it has to be pursued under the BNB supervision.

The government, on its behalf, has been carrying out policies affecting the money supply, without always projecting all the possible consequences in a committed way and far from fully realizing their impact all over the financial and economic front.

No twin deficit allowed

The problem for macroeconomic management until 2008 was the difficulty in controlling the growth in the current account deficit of BoP (Figure 18). This process is typical of the countries with a CBA in operation, but it was manifested more strongly in Bulgaria. In 2007-2008 for instance more than a quarter of GDP left the country along the line of current settlements! The BNB does not have any instruments to sterilize the growing money supply, so the government had to keep to a restrictive budget policy.

Figure 18



Economic theory recommends that the so called twin deficit should be avoided – a deficit simultaneously in the current account and in the CFP. The more so when one of the deficits is quite high. This was the situation in Bulgaria with the current account deficit. The governments complied with this recommendation and maintained a surplus in CFP.[2] The outcome was a declining public debt and growing FRA. Through its budget policy the government withdrew some of the money supply in circulation and filled up the FRA, kept with the BNB (out of money supply). Thus the pressure on the foreign payment structures was reduced, respectively on the current account.

After 2008 the picture changed. The current account deficit in 2009 (according to preliminary data) fell to 9.4% of GDP, which did not look so threatening and even was in accordance with the overall European context. It was logical to change the concept of the budget deficit too, in line with the changed circumstances. This was effected but chaotically rather than purposefully.

Fiscal Reserve Account

FRA was opened in accordance with the agreements with the IMF under the implementation of the CBA to guarantee payments on the public external debt. The scope and methodology of calculations were determined by the Ministry of Finance. In keeping with the preliminary clauses FRA’s volume should be no less than the average annual payments on the public external debt. In operational terms, the lower threshold of FRA is determined by the respective State Budget of the Republic of Bulgaria Act. In para 6 of the *Transitional and Final Provisions* of the 2010 *State Budget of the Republic of Bulgaria Act*[3] a threshold for FRA for

[2] An unpleasant moment, connected with the CFP statistics, is the existent and still maintained difference between the so called national methodology and the accepted methodology on an international level (EU). As a result, the officially published data for the condition of the CFP often differ significantly from the international assessments.

[3] *Darjaven vestnik*, N 99, 15.12.2009.

2010 was envisaged - it was set at BGN 6.3 billion. By February-March 2010 FRA came close to the low limit set by the law (with an excess of less than 1%).

The FRA consists of:

(1) The balances in levs and foreign exchange of the following bank deposits with domestic and foreign banks, including the central budget, ministries and agencies, central government extrabudgetary funds as defined in Annex N 9 of the 2010 Budget Law, the National Social Security Institute, and the Health Insurance Fund;

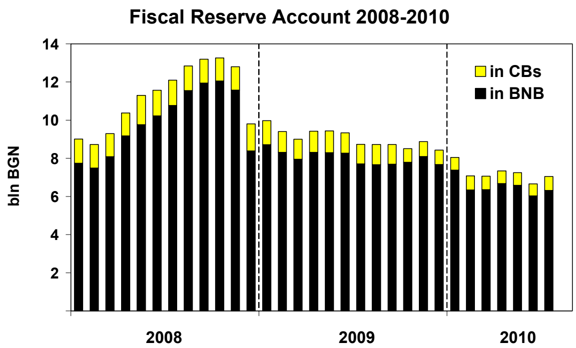
(2) Temporary deposits and means of disposal, included in the Single Account and other highly liquid foreign assets of the central government.

FRA involves too the foreign exchange denominated assets of the government such as lending given by the IMF, gains from global and other bonds issued in foreign currency, receipts from privatization of state-owned financial and non-financial enterprises. The FRA depends on the state budget revenues and expenditures, domestic and external public loans raised, payments made to external and internal lenders.

By 31.12.2009 the overall amount of FRA of BGN 7.7 billion a little over one billion BGN (13%) were social security funds, which the government was not allowed to operate with.

It is not allowed for FRA funds to be used by the government by expedience or discretion. The Law for the Structure of the State Budget (Organic Budget Law) explicitly states (Article 3, para 3) that "*the excess of the state budget shall be used for redemption of debts or shall be remitted as a reserve for urgent expenses which have not been planned*". Despite that, however, the government has afforded spending the accumulated funds in FRA by their own discretion.

Figure 19



FRA grew steadily to (the maximum) over BGN 12 billion in October 2008 (Figure 19). During the last months of 2008 the government spent BGN 3.7 billion on programs to counteract the financial crisis. A large part of these funds is not quite accounted for yet. This money flowed into the money supply then, when the

BNB went on pursuing its restrictive monetary policy, i.e. the desired and necessary coordination between the BNB and the MF was not carried out.

An issue, which has twice attracted the attention of financial analysts over the last four years, is the size of the financial resources at the disposal of the government, held with the CBs (and not the BNB). In 2004, on the initiative of the then minister of finance M. Velchev, EUR 250 million from the fiscal reserve were withdrawn from the BNB and invested with the CBs as deposits with a view to providing a higher income for the government budget. Little thought was given to the fact that this would expand the money supply, i.e. a given monetary policy was carried out without thinking about its implications. During the same year the government budget was meant to realize (and it did so) a surplus of EUR 330 million, i.e. the money supply was reduced through the government budget, but increased, on the other hand, through the deposits with the CBs. This has made the idea of keeping a budget surplus pointless - the reduction in the money supply with a view to alleviating the pressure on the current account of the balance of payments.

Under the BNB's insistence the Ministry of finance gave up the idea but a little later on it still transferred about 1.2 billion levs to the CBs.

Five years later, in the fall of 2009, again on the suggestion of the minister of finance (this time S. Diankov) the same idea was launched again. It quickly suffered fiasco after the active opposition of the BNB's management but in the early 2010 it was officially announced that the Ministry of finance would deposit part of the fiscal reserve with the CBs to get higher income. The details were not made known.

The issue of FRA has many-sided manifestations. Our global bonds at the amount of EUR 818.5 million mature on January 15, 2013. Two years later (15.01.2013), the next issue of global bonds of USD 1086.4 million will mature.[4] By the current exchange rate by mid 2010 this is about BGN 3.3 billion. This money is to be provided from FRA, from the financial resources available to the central government in particular.

Meanwhile it is not quite clear how domestic social and economic conditions will evolve over the coming 4-5 years and if, and how far the government will able to build up new financial resources. GIR are at a sufficiently high level (about BGN 24 billion levs by mid 2010), but the government has at its disposal only that part of it which corresponds to the Government and government budget institutions deposit with the BNB (the liabilities of the Issue Department, i.e. around 85% of FRA). At the same time the sources for filling up FRA are being consecutively exhausted.

Foreign capital

The main concern of the government should be restoring the interest of foreign investors to Bulgaria. The country has turned into an attractive destination right before and after its accession to the EU (Figure 20). The prospects for integrating into the

[4] Government Debt Management, Monthly Bulletin MF, May 2010, 53-54 pp.

European economic structures with the imperative enforcement of European rules for internal management behavior sounded quite tempting and appealing. The suspended European grants in 2008 because of corruption found out in government circles had a sobering impact on investors and they sharply contracted their activities. It is exactly the foreign capital that underpinned the domestic money expansion over the previous years and its withdrawal accounts now for the shrinkage of the money supply to a great extent, with all the ensuing negative outcomes.

The withdrawal of the foreign investors correlates with a significant improvement in the current account deficit. The bad news is that the capital and financial account shrank further and finally there has been recorded a total BoP deficit (Figure 21) – for the fist time since 1998. This unfavorable development went on even stronger in the early 2010 too – for the first quarter the total deficit in the balance of payments amounted to (by preliminary data) to EUR 790 million (given a deficit for the whole 2009 of EUR 650 million!). This deficit is financed from GIR. Such a situation could only exist in the short term, not in the long one. It puts the unimpeded CBA operation to the test.

The unfavorable situation in the BoP can (has to) be overcome in two ways. *First*, through still greater reduction in the current account deficit, which might be obtained by promoting and expanding the domestic exports output (i.e. higher domestic investment and economic activities), and/or *second*, by an increase in the capital and financial account, through actively assimilating and putting to use the European funds and restoring the interest of foreign investors. Both options come to making sure domestic macroeconomic policies are being carried out efficiently.

Figure 20

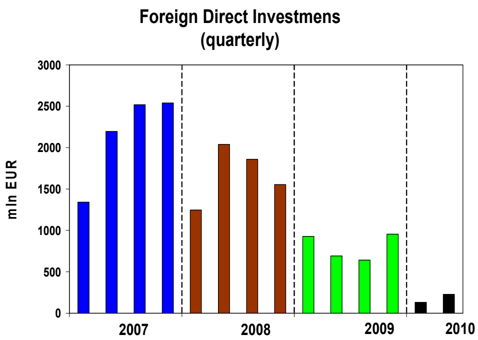
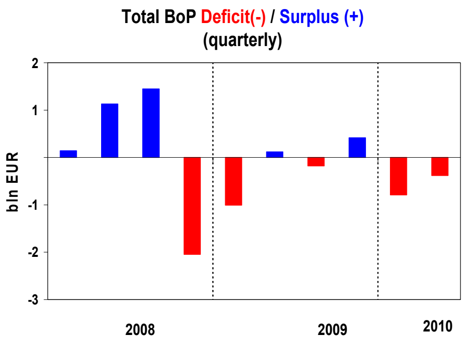


Figure 21



Macroeconomic management is called upon to improve the social and economic environment and make the foreign investor come back to Bulgaria. All investors are interested in availing themselves of prospects for stable social and economic conditions but they lack an overall macroeconomic vision, which is competent enough. For this reason they stick to what is called *herding behavior* – they follow and copy the behavior of those who are capable of such a macroeconomic assessment. They are the international institutions such as the EU (as well as the IMF before) – provided the EU remained committed to the financial and economic programs in a given country, then the outlook would be good enough and it would be worth investing in it and vice versa.

The return of the EU back to the country and the assimilation of European funds has a multiplying impact. The money in the Euro funds is an important item in the investment program of the country, respectively in expanding the domestic money supply, but not only that. Restoring European financing means too attracting (engaging) other foreign investors and an overall improvement of the domestic investment landscape.

FDI are needed not only and not so much for the sake of investments but also as a prerequisite for future economic growth. The structural characteristics of FDI are even more important than the purely quantitative indicators. The prevailing part of FDI in the transition period was directed to the service sector (about two thirds and more!), whereas the long-term involvement of foreign investors in key sectors and outputs is still ahead in the future. The country is now full of malls and other outlets of global chains of shops but it is impossible to point out even a single output of an established brand produced here, which is sought as a brand of quality on the international markets.

It is sad to say that for the last two decades macroeconomic management has not managed to attract a single strategic investor with a lasting economic participation in the country. Bulgaria has remained one of the few countries in Europe without developing transportation machine-building and one can take but with a split mind the fact that the popular series The World Factbook (an annual publication of CIA) mentions first of all the production of electricity, gas and water as sector specialization for Bulgaria.

The euphoria with small and medium-size enterprises as the backbone of the economy requires rethinking. The skeleton of the economy is made up of large-scale outputs while small- and medium-sized enterprises are a kind of satellite formations. If you have a whale, it will naturally attract a passage of small fish who will feed on it and follow it for ever, but no matter how many small fish you raise, they will not be able to breed a whale and will eventually disperse. Keeping SME as an end in itself might suppress the present social and economic tension in the short term, as well as fill in successfully tiny gaps in economic harmony but SME are unable to form the backbone which will hold the modern economy (in the long run) in an upright position. Each large output and company (for example General Motors, or Boeing and many others) is surrounded by a multitude of SME servicing it. The latter exist thanks to the large-scale production and would disappear if the large company is wound up.

Budget structures

Budget structures and budget discipline have an impact on the money supply and on the general social and economic environment.

Tax revenues in the 2008 CFP were BGN 22.2 billion, but in 2009 – BGN 20.2 billion, i.e. 9% lower. At the same time the nominal 2008 GDP was BGN 66.7 billion and – BGN 66.3 billion (preliminary data) in 2009, i.e. a nominal drop in GDP was recorded of (only!) 0.8%. The tax revenues share in GDP fell from 33.2% in 2008 to 30.5% in 2009.

This model of absolute and relative reduction in tax revenues can be accounted for and is expected in countries of progressively growing tax scale – in a year of recession there is a general falling through to the lower income brackets with a respective lower proportional taxation, respectively relatively lower tax receipts. In Bulgaria, however, the system is “*flat tax*”, i.e. there is no dependence of the relative tax revenues on the income level. The tax is always a tenth irrespectively of the monthly income, be it 500 levs or ten times higher. Therefore the relative reduction in the tax revenues in the CFP is due to poor collection and shakes the myth of the flat tax’s contribution to higher tax collection. The level of tax collection is the result above all and most of all of good and well functioning tax administration, not of the subjective wishes of taxpayers.

The situation with the equilibrium in the state budget became dramatic in the early 2010 (Figure 22). The revenues and grants drastically shrank under a continuing expansion of expenditure.

The abrupt downturn in the situation in the early 2010 is hard to explain logically. There was nothing unusual in the first months of 2010 which could cause such a large scale change in budget structures. The increase in the expenditure side was somewhat expected, in view of the performance of the automatic stabilizers in the economy. The financial and economic crisis brought about higher unemployment, the need for social welfare allowances and subsidies grew, capital expenditure too (Table 1). Still, the disastrous shrinkage of the revenue side was obviously due to problems with the efficiency of the tax administration. The more so that there were already some signs for recovery of the economy and often various economic forecasts of different national and international organizations did not anticipate a smaller GDP in the current year.

Figure 22

The Accumulated CFP Revenues and Expenditures
(monthly)

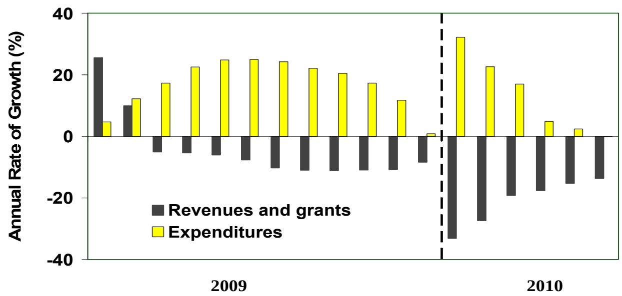


Table 1

Consolidated Fiscal Program
(Rate of growth, 1st quarter 2010 to 1st quarter 2009), %

I. Revenue and grants	*-19.2*
II. Expenditure	*17.0*
Social expenditure, scholarships	22.8
Subsidies	55.2
Capital expenditure and net state reserve gain	25.2

It seems a paradox but the problems in the state budget have supported rather than hindered economic recovery. No doubt it is question of short-term effects only. Spending part of FRA for financing the budget deficit causes a growth in money supply and helps economic activities – either through encouraging demand or direct financing of production. However, in the long run, the consequences would only be disruptive.

In 2009 the MF made some heroic efforts to settle the year with the smallest budget deficit possible (at all costs). The formal explanation was that thus the country would improve its international image and create more favorable conditions for joining the ERM II. The means used, however, were not completely legal, economically justified and morally admissible. It was a question of not settling within the year of financial funds legally to be at the disposal of the judicial system and keeping from settling financial liabilities of the state to companies with duly signed and executed contracts with it.

Eventually, 2009 stroke a balance (formally) with a budget deficit of 0.9% on GDP, but in accordance with the so called national methodology. Applying the generally accepted methodology of EUROSTAT has raised the budget deficit to 3.9%. So, the bitter taste of a desire for wrong reporting and manipulation is still lingering.

For an EC member-country to abide by the letter of the law is an obligatory condition, subject to no discussions at all. This holds equally true both for individuals and government officers and institutions. A government officer who does not adhere to the law should not have the moral right to require this from other (ordinary?!) persons.

What happened at the end of 2009 by ignoring the state budget obligations was like a personal administration of justice. It should not be tolerated nor passed over in silence. The issue has had its economic implications and these are not to be neglected at all.

First, the use of the funds of the judicial system cannot be the subject of personal assessment because of a given position held. In a purely human perspective each individual is entitled to their own assessments, but this is all. The large scale bonuses in the judicial system are no doubt annoying on the background of the financial crisis, but this has not been the only case.

Second, the failure of the state to meet its liabilities to its accurate counterparts has a snowball effect. If *A* owes some money to *B*, who in turn owes money to *C*, who in turn owes money to *D* and so on and if *A* does not fulfill his duties, the overall amount of the debt in the system grows up like an avalanche. If *A* settles his liabilities to *B*, this actually cancels the debt in the system, i.e. the multiplying effect of *A'*s actions.

According to the official data of the MF (on its Internet site) the overdue liabilities of central and local authorities at the end of 2009 stood at almost BGN 800 million. If we assumed the usual multiplying effect to be at least ten, then we could calculate that the government's policies had blocked settling BGN 8-10 billion liabilities between companies. In addition, clearing some debt to the government could be reflected in greater economic activity and so tax revenues should have been higher.

Third, since the government failed to settle its liabilities, then it used illegally some financial resources at the expense of the client, i.e. without paying the rent required (interest). If the government wanted to settle its liabilities to its economic counterparts, then it should issue its own debt (external or internal) to meet its needs in the same amount and respectively service it regularly. Breaking legal obligations distorts the financial condition of the government and abuses of the rights and authority given to the financial administration.

There is no such a thing as a single macroeconomic indicator whose dynamics (only) is supposed to determine the condition of the economy. The complex assessment of the economic condition necessitates tracing down changes all along the front of key macroeconomic indicators. GDP might increase by high rates but then other accompanying key indicators come to the fore – the condition of the environment, of distribution and redistribution of the national product created, etc. CFP might be well-balanced but at the expense of social strain etc. What determines the condition of the economy is the behavior of all the complex of macroeconomic indicators.

It is naïve to assume that things will look polished and appealing to the outside observer. Such attempts at blurring things are not new in our experience (they have even become traditional), but the results have never been encouraging. We still have to learn from our own experience.

The market is the institution to make the best assessment of the situation, no matter how glossy it looks.

The prices of the Bulgarian global 2013 bonds, issued in EUR can be seen on Figure 23, and on Figure 24 – the spread between "*bid*" and "*offer*" prices for the same bonds. A drastic collapse in prices and a flight away from our bonds was registered in the last quarter 2008, and since the early 2009 a process of slow and cautious (not smooth) recovery has started. This development was more pronounced in the second half of 2009 but in the last quarter of 2009 interest seems to have levelled off.

Figure 23

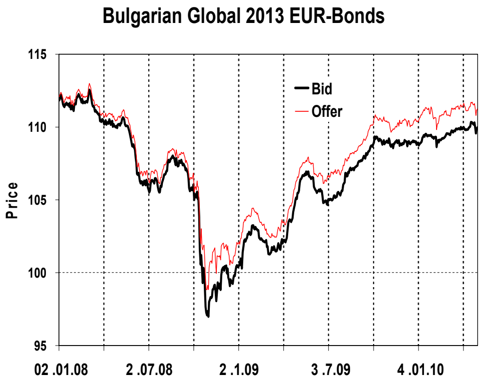
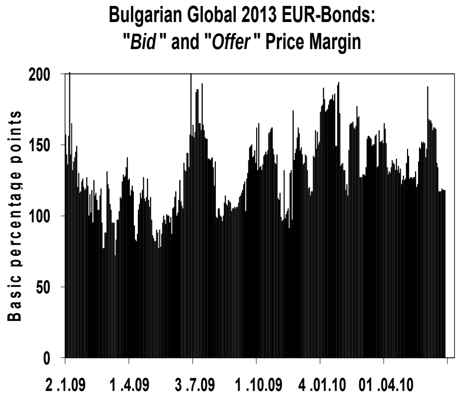


Figure 24



The margin between "*bid*" and "*offer*" prices indicates how the risk taken is assessed. Higher values of the margin describe higher risk available and vice versa. One can see on Figure 24 that the market assessed the risk of possessing Bulgarian bonds at the end of 2009 and the beginning of 2010 as high as that in mid 2009, i.e. the appraisal that Bulgaria has increased its attractiveness for the outside investor seems blurred. Irrespective of and despite the illegal efforts for giving the budget a polish.

Keeping a budget surplus in the context of not letting a twin deficit should not become an end in itself. Deficits on the current account of the balance of payments of over 15% of GDP (still more than a quarter) are really embarrassing and might have (but not obligatorily yet) very unpleasant consequences, connected with the stability of the financial system and they should be prevented on time. But deficits on the current account of less than a tenth of GDP are widely known in global experience and do not necessarily correlate with financial and currency instability.

Given the changed situation in 2009 macroeconomic management should have thought over its tactics in accordance with the specific environment. A well-advised deficit available does not any longer represent a risk hard to swallow for the financial system. What it comes to is to make the right assessment of advantages and disadvantages. Encouraging aggregate demand through wisely targeted injections of government expenditure might create propitious environment for pulling the economy forward and out of the freezing embrace of financial restrictions as well as for making the conditions for investment activities easier.

The state budget has no doubt difficulties in coordinating the revenue and the expenditure side. Problems abound in both.

Tax collection seems to be the Achilles' heel of the present tax administration. The share of revenue and grants in GDP was 40.9% in 2008 and fell to 37.8% in 2009 (Table 2). EUROSTAT set this indicator at 43.9% for the EU-

27.[5] The lion's share of this reduction was due to VAT, which took over half of the relative fall in tax collection. The official explanation of this fact was that imports and its receipts from VAT had gone down. The other half of the relative fall in collection was connected with the reduced collection of the other types of tax revenues, as well as of nontax revenues. So, given that there was no change in the tax collection system, the lower collection was the outcome of failures in the performance of the tax administration only.

Table 2

Revenue and Grants in the Consolidated Fiscal Program
(share in GDP), %

	2007	2008	2009
Total Revenue and grants	42.6	40.9	37.8
Tax revenue	34.2	33.2	30.4
Profit taxes	3.2	3.3	2.7
Income taxes	3.2	3.0	3.1
VAT	11.7	11.2	9.7
Excises and fuel duties	5.9	6.1	5.8
Customs duties	0.3	0.3	0.2
Social and health insurance contributions	8.7	8.1	8.0
Other taxes	1.2	1.2	1.0
Non-tax revenues	6.3	6.0	5.3
Grants	2.1	1.7	2.0

The expenditure has been maintained within 38-39% of GDP. For 2009 this level of expenditure (38.7% of GDP) incurred a budget problem, as far as the revenue side was not sufficient. Looking for a solution macroeconomic management kept blindly to the standard managerial stereotype – aiming at achieving a budget equilibrium by reducing the expenditure side, and not through better tax collection. More generally, one could wish for the introduction of a fairer taxation from the social point of view, both along differentiating the tax rates and improving the overall tax discipline (no doubt there is a lot of room for improvement here).

The expenditure side of the state budget certainly needs improving. However, the question is not how to reduce it further, but rather how to rationalize it.[6] The quality of public services in Bulgaria is too low and making it better needs and involves providing material and financial resources.

[5] The EUROSTAT estimate for 2009 Bulgarian state budget revenues and grants is even lower – 36.9%!

[6] The EUROSTAT estimate for 2009 Bulgarian state budget expenditures is 40.7% from GDP (50.7% for EU-27). Three countries in the EU (Bulgaria, Romania and Slovakia) were at the lower limit in 2009 in the EU by this indicator.

Bulgarian experience of the last decade unambiguously revealed that CFP has followed much more bureaucratic requirements for creating comfort and ease in its implementation rather than pursuing some adequate and efficient macroeconomic budget policies. This is in contradiction with the overall economic and institutional environment of the EU and it should be discontinued.

BNB regulations

Objectives of Central Banks

Experience showed and theory summarized that a modern central bank is supposed to closely monitor economic developments in the country and react respectively. It is impossible to maintain the stability of the financial system when investment and economic activities shrink dramatically, unemployment rises and social characteristics worsen. Financial stability directly correlates with the condition of the social and economic environment.

Social and economic stability and financial stability, on the other hand are to a great extent the two sides of one and the same coin. Harmony can be disrupted in the short run, but in the long one processes should necessarily converge.

Processes are interconnected and for this reason central banks are involved in monitoring a much larger circle of social and economic indicators. The objectives of the central banks are structured and ramified. As a rule, money circulation is permanently in the field of vision of central bankers since the dynamics of money supply reflects major features of the social and economic developments.

Table 3 illustrates three types of objectives of leading central banks in the world (the information dates from the time before the creation of the Eurozone, i.e. the Bundesbank was a central bank functioning independently). Central banks operate with their own instruments of management, follow the dynamics of financial indicators under their own control, but all this takes place in the context of the desired social and economic dynamics. A telling fact is that changes in money aggregates hold always a leading position in the system of targeted indicators.

BNB's potential for influencing the money supply, under a CBA in operation, is restrained. Money supply is determined mostly as the outcome of the performance of the automatic rules of CBA. Despite that BNB's duties as the central bank of Bulgaria do not drop off, carrying out the right monetary policy including neither.

BNB's functions are defined by the Law on the BNB (LBNB). Article 2, para 1 of LBNB states that "*The primary objective of the BNB shall be to maintain price stability through ensuring the stability of the national currency and implementing monetary policy*". In para 2 of the same article it is pointed out that the BNB is "*favouring an efficient allocation of resources*". The next para 3 reads that "*... the BNB shall support the policy of sustainable and non-inflationary growth*".

Table 3

Targets of leading central banks

Banks	Operational	Intermediate	Final
Bundesbank	Control over money market interest rates via repos.	1. Annual target for broad money (M3) at the end of the year; 2. The external value of DEM .	Price stability (inflation 0-2%).
Bank of England	The level of commercial banks' base rate	No intermediate targets. Still it keeps an eye on: •GBP dynamics compared to the other global currencies; •The money supply (M0, M4); •The asset prices.	Price stability (retail prices, excluding mortgage interest payments).
FED	Reserve pressures associated with the Fed funds rate	No officially set intermediate targets. Monitors a large number of indicators including monetary aggregates, real interest rates, forward-looking price indicators etc.	Price stability and steady economic growth.

Source: Ferris, K., M. Jones. The Reuters Guide to Official Interest Rates. Second Edition, Probus Publ. Com., 1995.

LBNB does not preclude the BNB from pursuing monetary policy. On the contrary, it involves carrying it out in the interest of "*price stability*", the "*efficient allocation of resources*" and obtaining "*sustainable and non-inflationary growth*".

LBNB does not specify the parameters of "*price stability*" and "*non-inflationary growth*". Price stability for the ECB for instance is keeping the average inflation rate in the euro zone not higher than 2%, but close to 2% (i.e. it does not let any slipping towards deflation). So, it is not advisable for Bulgaria to copy the figures characteristics of ECB's monetary policy, since keeping close to the inflationary developments in the eurozone, under a pegged currency, would freeze cross-country price proportions. Under the circumstances the latter means keeping a general price level in Bulgaria of about 40% of that in the eurozone (the lowest in the EU!), which no doubt is inadmissible. In this context the current acceptable inflation rate (respectively price stability) in Bulgaria should be understood as a figure exceeding the one in the eurozone, for example within 2-4 percentage points.

Managing the gross international reserves

The basic function of the BNB is managing the country's GIR. Under CBA in operation, the changes in GIR concentrate in it and reflect the specificity of social and economic developments in the country.

One can see the changes in NGIR during the last three years on Figure 25.

Bulgaria has a stock of monetary gold, whose money estimate is also included in GIR, but it is subject to variable prices on the international markets.

Thus, for one and the same physical volume of monetary gold its value in GIR in 2009 was on average about BGN 1.8 billion, whereas in the previous 2008 it was BGN 1.5 billion, and in 2007. – BGN 1.3 billion. The international price of gold is reflected on the volume of GIR and leads to changes in its size without observing essential quantity or quality changes. For this reason NGIR. has been preferred on this figure.

The changes in NGIR for the period under consideration were directly caused by external factors. So, in 2008 Bulgaria finalized its negotiations with Iraq for settling the mutual debt relationships and managed to get USD 360 million directly from Iraq, thus canceling a debt of USD 1.9 billion. In the following 2009 Bulgaria got from the IMF SDR 474.6 million (BGN 1.3 billion), representing a distribution according a resolution of the Executive Board of the IMF of 2009. In both cases mentioned NGIR grew without any connection with the home economic condition.

Figure 25

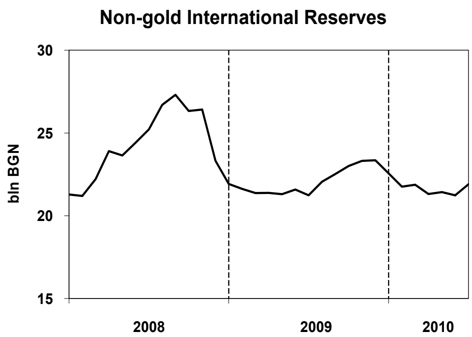
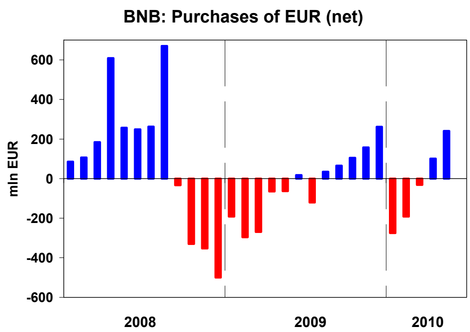


Figure 26



Bulgaria adopted its currency board arrangement in mid-1997 with gross currency reserves of less than BGN 3 billion. Over the following ten years its gross currency reserves grew more than nine times to reach a peak in September 2008 – BGN 28.9 billion (BGN 27.3 billion non-gold international reserves). This growth correlated with the economic boom in the country - in 2008 GDP was three quarters higher than 1997 in real terms.

The last quarter of 2008 was dramatic for the condition of NGIR – for three months they fell by nearly BGN 4 billion and went on falling until the middle of 2009. Changes in NGIR no doubt reflect the condition of the domestic economy, but this has not been all the story.

The abrupt reduction in NGIR during the last quarter of 2008 startled central bankers. It was accounted for with the behavior of the government (the use of FRA in particular), and the behavior of the foreign owners of resident Bulgarian CBs (withdrawal of banking capital), on the other hand.

The figures, however, are not convincing (Table 4). For the last quarter of 2008 the deposit of the Central government administration with the BNB dropped by BGN 3637 million, only BGN 316 million out of which in foreign currency. The deposits of CBs fell by BGN 1286 million, of which BGN 1665 million in forex. CBs really availed themselves of the loosened restrictions to withdraw mainly reserves in foreign currency, but still this accounted for 42% only of the overall reduction in NGIR for the same period. Blaming the CBs for the shrinking NGIR was not justified. This explanation, however, acted a as a brake on the further loosening of monetary restrictions.

Table 4

Deposits in BNB (liabilities of the Issue Department), mln. BGN

	September 2008	December 2008	Growth
Central Government	10349	6712	-3637
BGN	8301	4980	-3321
Forex	2048	1732	-316
Commercial banks	6292	5006	-1286
BGN	2246	2625	379
Forex	4046	2381	-1665

A measure of the advisable amount of GIR accumulated is the cover in months of exports of goods and non-factor services. Both experience and theory say that GIR can be considered sufficient if it covers a three-month imports of goods and non-factor services. By the end of 2009 the reserve assets of the BNB covered almost 8-month imports of goods and non-factor services. Keeping such a GIR starts bordering with doing it as an end in itself at the expense of home economic development.

It is to be noted that a falling part of GIR covered the domestic money aggregates at the expense of the increase in the rest, called, "*Banking Department deposit*". In 2004 90% of GIR were put aside for covering the domestic money aggregates (money in circulation, CBs reserves, Central Government and budget institutions deposit and other depositors), while at the end of 2009 this share became 80%. GIR is increasingly breaking off the domestic money aggregates and slipping to something as an end in itself.

Domestic Forex Market

The good news that supported the concept of loosening the monetary restriction has been the upturn in the dynamics of net purchases of currency from the BNB (Figure 26). Since the last quarter of 2008 the BNB began making massive sales of foreign currency on the domestic forex market. For the period September 2008 – July 2009 as a whole the BNB sold net EUR 2.2 billion from NGIR. In the second half of 2009, however, the process of net purchases of foreign currency from the domestic forex market was restored which can be considered a good sign for animation of the investment process. It has to confirm the grounds for taking responsibility for loosening the monetary restriction.

In the early 2010, however, a new tendency for a flight away from the domestic currency was noticed. This time the reasons are to be sought in the confused and confusing messages of the macroeconomic management, which aroused concern in the people and economic agents, relieving them instead.

Conclusion

Economic theory and practice are not unanimous with respect to the soft monetary restrictions' capacity to act as an incentive to economic growth. The negative findings, however, cannot be doubted, namely that:

Economic growth presumes greater money supply available. Increased monetary restrictions hinder the full development of investment and economic activities.

From this point of view macroeconomic management has to look for ways and means to loosen up the monetary restrictions in a consistent and committed way, given that the condition of the economy and its dynamics all along the front of macroeconomic influences are tightly monitored.

It is sure that the economy imperatively and urgently needs a flow of fresh and vital financial resources. Without this inflow economic development will be highly embarrassed.

There exist some possibilities and options:

1. Reduction in MRR.

This possibility is the most realistic and the most immediate one. The managerial policies of the central bank have a direct influence on economic developments, which accounts for the traditional conservatism of the banking regulator. The BNB's objective is to take charge of the money supply and the liquidity parameters of the financial system and the BNB has to take responsibility for carrying out elements of the monetary policy.

It is not justified for the BNB to stay complacently as an outside observer of the changes in the money supply in circulation. The CBA operation does not revoke the BNB's duty to set and pursue a committed and responsible monetary policy. By the beginning of the current 2010 the percentage of minimum reserve requirements was 10%, given that the standard in the EU is 2%. The CBs keep about BGN 4 billion with the BNB and if the minimum reserve requirements were reduced to 7.5%, there would be about one billion levs available to relieve the liquidity difficulties and enable loosening the monetary restriction. No other measure could give such a large-scale and immediate effect.

2. Restoring the interest of the foreign investor into the country.

It is naïve to think that the foreign investment inflow correlates only with the fiscal incentives given and reacts positively to fiscal incentives only. What is important for the foreign investor of long-term goals and objectives is above all and most of all the clear and predictable institutional environment available, strict abidance by the supremacy of the Law. No fiscal incentives can make up for the mess and chaos in macroeconomic management, still less clearly transparent corruption practices.

It is of utmost importance to achieve a substantial success in attracting strategic long-term investors.

3. Strictly meeting the financial commitments of the government on economic contracts and agreements concluded with domestic parties.

The government is obliged to assess its own policies in the context of the overall social and economic development of the country and not from the point of view of misunderstood establishment interests and motives. Keeping from regularly settling accounts with the other party on a contract looks at first sight an attractive and simple solution for the government to the difficult financial and economic problem of balancing the CFP, but the overall consequences for economic life are more than unpleasant. There are no easy solutions to difficult economic problems. Difficult problems require and presume difficult solutions. Solving institutional problems by violating legally binding commitments at the expense of accurate parties is a vicious practice.

4. Providing government credit lines.

In 2008 the government allocated BGN 500 million to stimulate SME. This amount was designed to increase the main capital of BDB. The money was used as meant and gave its contribution to relieve the monetary restriction and helped promote investment activities.

What is a problem is the form chosen to encourage investments. The government preferred to increase BDB's capital, i.e. to leave permanently the capital in question at the disposal of BDB, respectively with the banking system. The government financial resource could also be given in another form – in the way of a time debt or simply by opening a time deposit. The difference is in the fact that the government could withdraw at a given moment in the future the resources provided to BDB, which have already achieved their noble goal and use them for another purpose. It is not normal for the government to get involved for a long term in the banking sector, it should act purposefully in accordance with the specific conditions. The BDB have their own possibilities for attracting capital (mainly foreign) and have successfully managed to do it.

The government could commit itself to providing a credit line under strictly fixed conditions. In any case the financial commitment of the government should be for a given period of time, not a timeless one.

5. Redirecting part of FRA from the BNB to the CBs.

This option is highly contradictory. This way money supply will really be increased but the problems that go with it are many and not insignificant. The government should be aware that this act is a form of carrying out monetary policy for which it (the government) is not ready and does not have the competence required. At any rate the causes for such a deed should be in the desire for encouraging investment activities and not in the search of higher return. Therefore the most acceptable option is providing part of the money in FRA at the disposal of the BDB, i.e. opening a time deposit or issuing d subordinated debt which is to be administered and serviced by the BDB.

6. Bonds issue on the international financial and capital markets (euro- and /or global bonds).

This is an extreme option and it is only possible provided the bonds are issued for domestic needs (for instance financing the budget deficit), not to support the balance of payments. In the second case the attracted foreign currency resources will fill up the country's GIR and will be used to finance the deficit in the balance of payments (i.e. they will leave the country again), whereas in the first case they will increase the money supply and support the home economic processes. At any rate it has to be a well-thought option and its timing for the appearance on the international markets chosen responsibly with a view to taking (not losing) advantage of the conjuncture.

*

Whatever measures are taken on macroeconomic level in order to regulate money supply and relieve liquidity difficulties in the interest of economic growth, they have to be coordinated well enough between the two main centers of financial power in the country – the MF and the BNB. Experience and outside observations have shown that there is much to be wished for in this type of coordination.

3.05.2010