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BREAKING THE BALANCE OF PAYMENTS MODEL

Three distinct periods can be outlined in Bulgaria's most recent history: (1) 1990-1997; (2) 1997-2008 ; (3) after 2008. The particularities of these periods show up in the structures of the balance of payments too. The changes have become especially sensitive over the last period. There has been a reorientation in both domestic and external cross border capital flows. As a result the country's economic problems have acquired substantially different dimensions. The study makes an attempt to find out the special features of these dimensions and reveal their nature and driving forces. The main conclusion is that the emerging and current economic problems are to a great degree the outcome of wrong domestic macroeconomic policies. Some suggestions how to overcome the present economic failures have been made.

JEL: E52; E65

Macroeconomic policy is a sophisticated creative activity requiring and presuming that a great multitude of indicators and relationships will be traced. There is no such a thing as a single indicator to independently determine fully enough the whole condition and dynamics of economics. Indicators have to be followed out and evaluated all through the front of economic manifestations.

The balance of payments (BoP) concentrates in itself almost all that takes place in the economy. There is not a single country in the modern world that can develop independently and remain isolated from the external environment. Present day communications lead to having all kinds of models of human behavior mingle and interact. Not a single activity or result can be assessed from the point of view of domestic, national criteria. The inevitable question that we are faced with sooner or later, irrespective of our wishes, is how developments are viewed from international positions. And how far, almost all that man does, comes to a kind of quantitative money estimates and the latter correspond to international estimates. All this finds its place in the BoP. In a sense the BoP is the final mirror reflecting the achievements of the national economy.

The BoP is the major instrument of macroeconomic management to trace through the cross border flow of financial resources and to assess the degree and quality of integrating the national economy into the international economic structures. The data in the BoP gives an idea of the nature of financial and economic relationships in the national economy with the external environment. A great part of the processes emerging in the national economy find their reflection in the BoP' structures. Identifying these types of manifestations is the basis of evaluating the efficiency of macro-economic policies and projecting possible developments in the short and mid-term especially.

The BoP reveals how almost all kinds of macroeconomic balances are interwoven. The BoP' structures reflect explicitly or implicitly everything that takes place in the country's economy so that the BoP' figures correspond to all the information in all the other balances.

The condition of the BoP is the outcome of both the characteristics of the domestic macroeconomic policies and the behaviour of a number of exogenous factors. The choice of the foreign exchange regime and the forex behaviour play a substantial influence on the foreign balance composition.[1]

The general condition and development of the BoP relationships are materialized in the deficit/surplus in the BoP.

Three periods can be outlined in the most recent economic history of Bulgaria (following the democratization of the late 90s of the last century), namely: (1) 1990-1997; (2) 1997-2008; (3) After 2008. These are reflected in the BoP composition too.

During the *first sub period* there was carried out an adjustment - to a great extent chaotic and without any priorities - towards a radically different system of management of the economy and society. Everything took place and changed in the conditions of learning by doing but with the active support and assistance of international organizations and foreign government agencies. There was neither reliable statistics available, nor experience, skills, knowledge. Structuring the BoP was actively assisted by the IMF. This was the institution which assessed the various types of deficit and strain in the economy, suggesting and bringing home some management policies.

During this period the BoP suffered an almost chronic deficit. Mistakes were made in macroeconomic management both in pursuing the monetary and fiscal policies. Finally, the landing that took place in the critical years of 1996-1997 was too harsh but managed to clear the ground for a further development and integration into the EU.

The second sub period was characterized by a steady progressive economic development. A substantial advance was achieved in mobilizing the domestic material and labour resources. The real GDP of the country grew by almost 80%. The foreign capital inflows became more active, especially in view of the evident outlook for joining the EU.

By the end of the sub period some overheating of the economy was allowed and this coincided and combined with the beginning of the global financial and economic crisis. The nearly automatically growing economy blurred the vision of the macroeconomic elite, corruption expanded and in the middle of 2008 it was followed by a severe and uncompromising sanction of the EU – suspension of the planned EU financing of the Bulgarian economy in the way of grants and co-financing. Foreign capital withdrew and there emerged prerequisites for financial and economic strains that would be hard to overcome.

After 2008 (the third sub period) there occurred radical changes, hard to predict, in the external financial relationships with consequences that we will still have to clearly face.

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[1] Specialist literature has analyzed various possible approaches to achieving equilibrium in the BoP (*Stern, R.* Balance of Payments: Theory and Economic Policy. 2009). The objective of the present study is to assess the changes observed in the BOP.

Figure 1

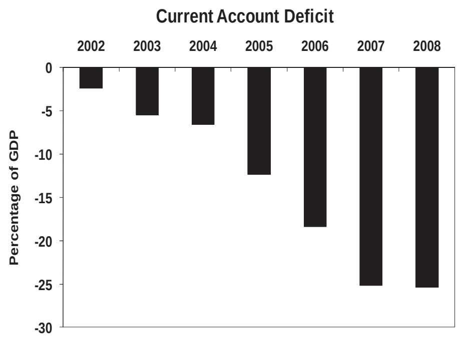


Figure 2

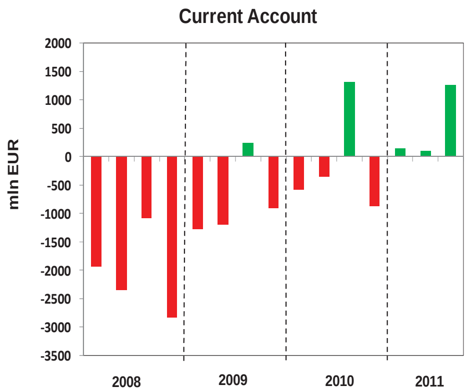


Figure 3

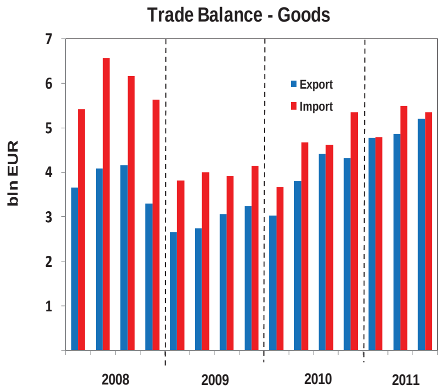
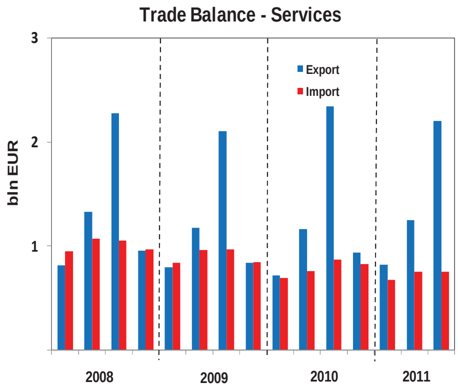


Figure 4



By the end of the second sub period a major problem of the BoP was the uncontrollable growth in the deficit on the current account (Figure 1). Macro-economic policies were aimed mainly at neutralizing the possible negative consequences from the high deficit. A similar situation during these years was typical of the countries of Central and Eastern Europe, accounted for with a number of factors, psychological ones including, such as the temptations ot increased supply of both quantity and quality of goods, which had made people turn their backs to the concern for accumulating savings for the future.[2]

The effects of the financial and economic crisis and their impact on the current account had begun to be felt in Bulgaria since the early 2009. The items of

[2] On this see a detailed study by *Stojkov, A.* Current Account Deficit and Economic Growth: Evidence from the South Eastern European Economies. Instinianus Primus Faculty of Law, Ss. Cyril and Methodius University in Scopje, 2009.

the current account started to quickly improve and it did not take long before unbelievable so far positive values of the current account had appeared (Figure 2).

The key item of the current account – the trade balance (goods) – began to significantly improve. Imports fell sharply, mainly because of reduced investment activities – the rate of accumulation in 2009 dropped by more than 8 percentage points on the previous year. Exports shrank too because of lower external demand but to a lesser degree, so the trade balance improved. Since 2010 there had started a gradual recovery of foreign trade activities. The increased producer prices (PPI) had a beneficial impact on exports, respectively the prices of raw materials on the international markets. Investment activities went on shrinking (in 2010 the rate of accumulation fell by another five percentage points on the previous year), but imports rose together with exports. The latter expressed the high import intensity of our exports, which placed restrictions on improving the trade balance (goods).

Foreign trade with services (invisible trade) had almost remained untouched (Figure 4).

The export of services had kept its values of 2008 and even marked some increased revenues. The overall visits of foreigners to Bulgaria fell by about 8% in 2009, but in the following year of 2010 it recorded an increase which had almost reached the pre-crisis level (8532972 foreigners visiting the country in 2008 against 8374034 people in 2010). Restoring the status quo was made possible thanks to visitors(tourists) from traditional destinations for Bulgaria such as Greece, Germany, Russia, Macedonia and Poland.

The recovery of revenues from tourism was enabled by the improved attractiveness and competitiveness of Bulgarian resorts.

There was a more evident negative impact on the import of services (tourism again, but of residents). The expenses for travel of residents were evaluated at EUR 1.6 billion in 2008 (a record high value for Bulgaria), which fell by a fifth in 2009 and of over a quarter in the following year. The cause is to be looked for in the reduced home demand and the people’s decision to put off in time making higher expenditure.

The outlined characteristics of intangible trade contributed to a still greater improvement of the total trade balance (goods and non-factor services). The maximum deficit in foreign trade with goods and factor services was incurred in 2008 (EUR 7.3 billion), it plunged in 2009 (to EUR 2.9 billion) and continued to shrink in 2010 (to half a billion EUR). During the first half of 2011 even a surplus of trade in goods and non-factor services was recorded (of about EUR 170 billion).

The logical question is if and how far the dynamics outlined of the trade balance was steady. The official data recorded positive rates of real growth in GDP for the last six quarters (Q2 ’10 – Q3 ’11) of an average of about 1.6% (on the same quarters of the previous year). At the same time the final home demand fell by about 4% on average by quarters and gross capital formation – by about a fifth on quarter. The only compensator had been foreign trade.

Table 1

Export of goods (fob), percentage

	2009	2010	H1 '11
Consumer goods	32.3	29.4	25.4
Raw materials	49.0	50.7	54.2
Investment goods	18.6	19.9	20.4
Total non-energy goods	*100.0*	*100.0*	*100.0*

The substantial part of exports of goods was provided by "*raw materials*" (Table 1). For the time after 2008 the contribution of this item to the growth in exports of goods grew by around five percentage points! More than half (about 55% for the first five months of 2011) of the exports of "*raw materials*" consisted of metals (most of all non-ferrous) and of materials for the food industry.

A substantial share of the growth in exports was accounted for by the global conjuncture, by price changes on the global commodity markets especially. In BNB's estimate about three quarters of the growth in exports of non-ferrous metals for the first five months of 2011 (about EUR 500 million) was due to the price effect and only a quarter – to natural growth.[3]

A contribution to the nominal growth in exports for the period under review can be given by the real effective exchange rate (REER).

Since the introduction of the Currency Board Arrangements (CBA) in 1997 till the middle of 2009 REER had steadily risen by 75%! The growth in REER can explain a lot of the changes observed in the foreign exchange correlations in the economy of this period, to a great extent the dramatic reduction in the relative size of the government external debt. It is attributed to the higher estimate of domestic labour from the international point of view.

The positive dynamics of REER had improved the financial situation of the local population, but deteriorated the financial and production structures of producers and decreased the competitiveness of imports on the home market[4]. This is the market's logic – a more efficiently performing economy increases the comparative financial and economic characteristics of the domestic population and vice versa. The reserves available for raising production's efficiency enabled the economy to better deal with this kind of difficulties.[5]

The global financial and economic crisis had altered the real correlations in the forex market. REER recorded a containment and even a reduction (Figure 5),

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[3] The balance of payments of Bulgaria, January-June 2011, the BNB, p. 40.

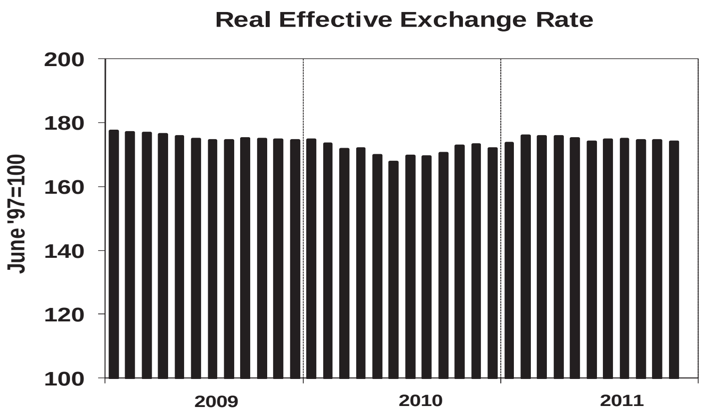
[4] For this reason the imported goods in Bulgaria by 2009 were much more accessible for the people compared to ten years ago.

[5] It is indicative that for example for 1998-2008 the GDP rose by 80% given almost the same level of consumption of energy at a national level – something impossible to do before the 90s of the 20th century in Bulgaria!

which proved beneficial to the competitiveness of exports and suppressed the competitiveness of imports on the domestic market.

REER's dynamics depends on a number of factors whose impact is hard to measure in quantity terms. A significant influence was played by the gap between the price level in Bulgaria and in the euro area. Bulgaria had continued to maintain a significant USD-share in its financial relations with external partners, which means that adjustments in foreign exchange correlations between the EUR and the USD had also had an influence on REER.

Figure 5



When the various types of influences are compared, however, one can see what is logically expected in the future – namely, domestic inflation to get ahead of that of the euro area, which all things being equal has to be connected with a positive dynamics of REER. The latter will create difficulties in increasing exports, which the national economy will have to timely deal with too.

These peculiarities, related to the dominating influence of the trade balance for the growth in GDP observed, revealed that this trend cannot be a lasting one. The resource possibilities of the country for export of raw materials are highly restricted and the accompanying favorable conditions of the conjuncture would not act for a long time. In the near future it is logical for the trend observed of substantial contribution of foreign trade to the improvement of macroeconomic indicators to break and the economy has to get ready for this situation.

The item "*Income*" on the current account had improved too. This position almost traditionally maintains negative values (i.e. deficit), which with the financial and economic crisis on the way was reduced in absolute terms. In 2008, about EUR 440 million on average was exported from this item each quarter and for the time after 2008 this leakage was reduced to about EUR 300-350 million a quarter with not very great fluctuations.

The structural changes in the item implied some modifications linked to the influence of the financial and economic crisis.

The active part of item "*Compensation of employees*" records the income of residents, working on a temporary basis abroad. Not a few of the Bulgarian citizens had availed themselves of this type of temporary employment provided by an existing EU clause. In 2007 there came along these lines about EUR 316 million each quarter, with almost half of it (EUR 151 million) only in 2008. In 2009 the amount was reduced by another third (EUR 106 million) and settled at about EUR 75 million the following two years. This decline illustrated the additional difficulties which the country had experienced and had to comply with as a result of the reduced possibilities of residents to earn money as temporarily employed in the EU countries.

The credit part of "*Investment income*" comprises mainly the revenue from resident portfolios and other investment, connected most of all with investing the GDP in the form of first class government securities and deposits, also in first class commercial banks (in accordance with the requirements of the law for the BNB). There the situation is relatively steady.

The debit part of "*Investment income*" records a fall (in the negative segment) in the income from foreign direct investment (FDI), which in its major part is repatriated. Here too interest is accounted, paid by the country on the global bonds issued in 2002. Interest was fixed so there was not much movement along this item.

Figure 6

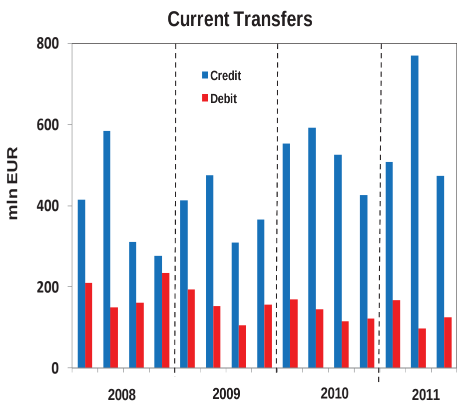
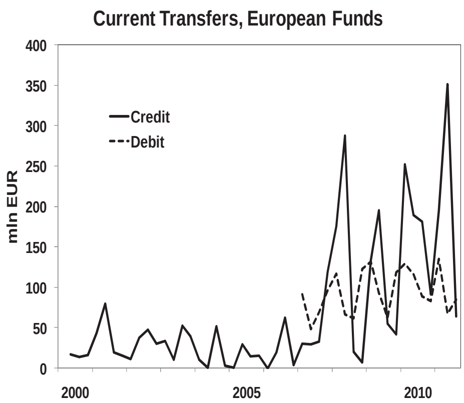


Figure 7



The item "*Current transfers*" had also contributed to the improved current account (Figure 6). The remittances accounted for the key components of the current transfers - credit on the one hand, and transfers from the EU funds on the other hand (Figure 7). These represented about 70% of the total amount. The clearly outlined trend of increase in the current transfers-credit over the last two years was due to both greater assimilation of the European funds along the line of current payments and the increased remittances by the Bulgarian emigrants. The latter was obviously the outcome of the material difficulties experienced by the local population over the last few years and the restricted possibilities for local emigrants to invest in the developed countries.

Bulgaria had begun to use the EU funds in the form of current transfers (credit) since 2000. Till the third quarter of 2007 these amounts stood steady at about EUR 30 million a quarter. A significant increase was recorded in the last quarter of 2007, which was due to Bulgaria's joining the EU. In the following years there was repeatedly recorded a kind of cycle – a significant transfer during the first half of the year which sharply decreased over the second part of the year. This cycle began to shape in 2008, when the EU had found out in the middle of the year that the amounts granted were not used as earmarked for and the requirements for spending them were not met. Real transfers were respectively sharply reduced. There was a certain improvement in the following two years but the model of assimilation was kept.

Along with credit, statistics recorded a debit of current transfers from the EU funds too. It was linked with the reimbursement of the money unassimilated and the necessity to make installments into the European funds. This debit was relatively steady over time.

As a whole the local macroeconomic management does not enjoy many possibilities for an active impact on the items of the current account. The active macroeconomic policy with relation to the current account is linked most of all with encouraging exports, which should involve an ever increasing number of consumer and investment goods. This is a complex issue which is connected with the creation of attractive investment conditions both for the internal and especially for the external investor.

A key element of macroeconomic policy is improving the environment for assimilating the current EU transfers. There is a lot to be done in this respect although statistics revealed a certain improvement in the last one or two years. The degree of assimilation is still unsatisfactory, though.

However, keeping in touch with Bulgarian emigrants and the Bulgarian temporary workers abroad lies within the authority of macroeconomic management. The data illustrated that the economic effect of the financial resources of local emigrants was not to be neglected at all and there is a lot to be done in this respect.

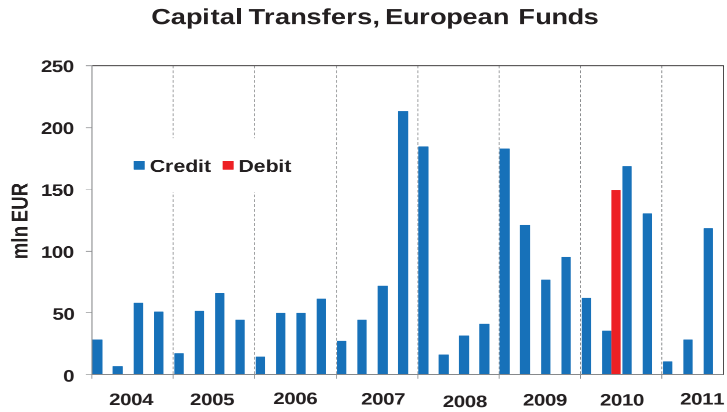
By definition the capital account of the BoP includes: (1) Capital transfers; (2) acquisition or provision of intangible, non-financial assets. Capital transfers are formed out of various investment subsidies, for example from the EU funds. In case of in-kind transfers, they include: transfer of property of principal assets; Debt forgiveness.[6]

The major (prevailing) part of the capital account is formed out of capital transfers from the EU funds. These had been transferred as grants since 2004. Till mid-2007 they were relatively steady (with some variations) at about EUR 40 million on average by quarter (Figure 8). For the period 2000-2006 Bulgaria received a total of EUR 1173 million from the EU funds in fulfillment of the

[6] Balance of payments of Bulgaria, January-June 201, the BNB, p. 66.

accession programs, with EUR 676 million as current transfers and EUR 497 million – as capital transfers.

Figure 8



During the second half of 2007 capital transfers recorded a significant increase, due to Bulgaria's accession to the EU. This process of intensification was broken in the mid-2008. Then the EU judged that corruption in the country was too high, the money of European taxpayers was not used as allocated and therefore the capital flow was reduced until order was to be installed in the usage of EU money.

Even after 2008 the process of assimilating capital transfers from the EU did not return to normal. On Figure 8 one can see the quarterly cycle of incoming resources. During the first half of the year the capital flow was much more intensive while in the second one it slowed down, which is obviously the outcome of problems with their assimilation. Provided financial resources had been evenly assimilated such a cyclicity would not have existed.

In accordance with the agreements with the EU for the period 2007-2013 there are envisaged for Bulgaria a total of EUR 16 billion, out of which EUR 6.7 billion along the lines of the National Strategic Reference Framework, EUR 3.2 billion for the European regional development fund, EUR 2.3 billion for the Cohesion Fund, EUR 1.2 billion for the European Social Fund, EUR 2.6 billion for the European Agricultural Fund for Rural Development.[7] The application of these funds by years is presented on Table 2.

[7] The national strategic reference framework of Bulgaria, 2007-2013, MC of the RB (http:// www. europe.bg/upload/docs/NSRF_English.pdf); *Oresharski, Pl.* Bulgarian economy: Condition and outlook. Presentation at the Economic University, Varna 17.05.2007 (http://www. minfin.bg/bg/pubs/2/2310). A report of the Commission to the European Parliament and the Council for Management of EU Funds in Bulgaria. COM (2008) 496, Brussells, 23.07.2008 (http://ec.europa.eu/bulgaria/documents/news/230708-funds.pdf).

For 57 months the financial resources received from the EU funds in the country were in real terms (net) about EUR 2.3 billion. Suppose an equal distribution by years the total amount allocated for transfers for the same period would have been about EUR 10.1 billion. This would be equal to an use of European financial resources of less than a quarter.

For the same period EUR 7.8 billion was not assimilated. The total produced GDP for the period was estimated at about EUR 164 billion, i.e. the money not assimilated from the EU funds was on an annual average of 4.6% of GDP. If we take into account that the real usage of European funds would have been accompanied by an inflow of additional accompanying foreign investment, then we could assess that because of the unassimilated financial resources from the EU the country had lost each year at least five percentage points growth in GDP. This is the cost of the government administration's incapability – incapability which involves lack of skills, knowledge, corruption and incompetence.

Table 2

Real movement of financial funds from the EU Funds (million EUR)

	2007	2008	2009	2010	I-IX 2011	Total
Current transfers, credit	211	491	425	714	706	*2547*
Current transfers, debit	-304	-367	-405	-417	-370	*-1863*
Capital transfers, credit	356	274	475	396	287	*1788*
Capital transfers, debit				-149		*-149*
Total (net)	*262*	*397*	*495*	*544*	*623*	*2323*

One should point out, however, that there is a progress in using the EU resources, as illustrated in Table 2, but it is reckoned that the process is still far from being brought to normal.

There is another peculiarity of our lending-financial relationships with the EU outlined in Table 2. For the period under consideration there was received along these lines a credit of EUR 4.3 billion and at the same time the money reimbursed (debit) was about EUR 2 billion. This movement back of financial resources suggests that there exist reserves for improving the assimilation of EU assistance, which no doubt represents a substantial positive incentive for accelerating economic growth.

The problems with the financial account of the BoP had started since the second half of 2008. Following the introduction of the CBA a steady growth in the financial account had been recorded till the moment the consequences of the financial and economic crisis began to manifest themselves.

A sharp deterioration of the financial account was recorded at the end of 2008 and since then the condition of the financial account had not managed to be brought back to normal (Figure 9).

The financial account of the BoP consists of three components: (1) Direct investment; (2) Portfolio investment; (3) Other investment.

Direct investment of residents abroad are still in an embryonic stage and are unable to have a substantial impact on foreign payment structures. With the development of the economy and the country's integration into the global economic community it is normal for this type of financial and economic contacts with the external world to intensify. For 2000-2006 the total amount of the financial resources that left the country in the form of direct investment abroad stood at about EUR 300 million. The country's membership in the EU had slightly encouraged this process but not very much. Only a few individual larger investments were recorded (for example EUR 414 million in the first quarter of 2008) but as an exception rather than a rule.

Figure 9

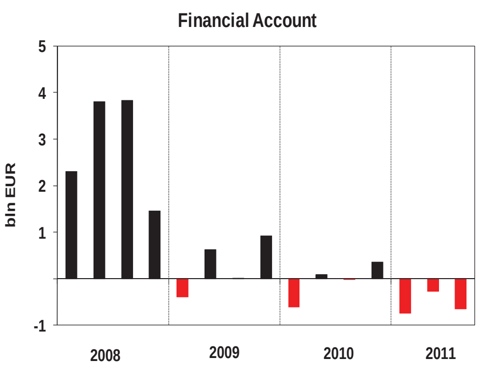
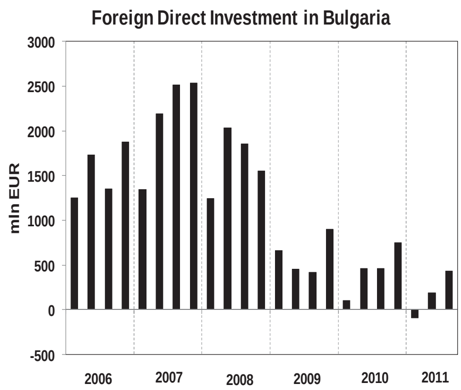


Figure 10



It has been foreign direct investment (FDI) in the country that played a substantial role in the domestic economic development and the changes taking place in this connection in foreign payment relationships.

The country's attractiveness for FDI grew significantly after the details connected with the EU accession had become clear. Bulgaria's membership in the EU created favorable opportunities for foreign investors as far as the well-known and accepted principles of behaviour in the EU are universal and applicable to all member-countries. Bulgaria is relatively undeveloped which means that it is faced with a continuous process of gravitating towards European economic levels. No doubt an overtaking development of the economy provides good opportunities for doing business and banking on good profits.

The increased interest of foreign investors in the country started a year before its official accession to the EU (2006, Figure 10), as far as Bulgaria enjoyed a clear European outlook. In the following year (the first year of Bulgaria in the EU) a local peak was reached in terms of inflow of capital as FDI. Meanwhile the negative financial and economic developments in the world made the foreign investor more cautious. This is the usual practice - investors are cowardly creatures. There is always a risk for the respective investment and if there is a danger for it becoming uncalculated the investment process slows down, reserves in the judgment multiply and the wait-and-see policy outweighs until the situation gets clear again. Such an element of go-slow policy was observed in the behavior of foreign investors in 2008.

Meanwhile the EU made public its own estimates for the use of the financial EU resources in Bulgaria as being done not as earmarked and the existence of a high level of corruption and so they froze the usage of European funds. This was an additional reason for higher suspicion on behalf of foreign investors and the process of investment restraint was intensified.

FDI went on diminishing over the following years with growing rates. Macroeconomic management emitted chaotic signals in assessment of the situation and its own policies, insecurity grew and foreign investors' restraint also.

In the search of compensation mechanisms the government declared its firm stand to maintain the system of flat tax of 10%. This size of the corporate tax is the minimum for the EU. In every other country of the EU investors pay a higher corporate tax. Despite that however, foreign investors continued to actively avoid the country.

This fact illustrates the limited possibilities of individual incentives to attract FDI. The financial tax relief offered is not enough to increase the investment attractiveness of the country. Each individual type of incentive has a limited field of action. There are no universally stimulating measures as well as there is no universal medicine. It is not possible for weaknesses in the system in one field to be redressed by providing incentives in another field.

Another special feature of investors is their herding behaviour. Each investment is a risky business. It is connected with the judgment of the immediate outlook and incorporates these judgments in its specific decisions. The investors are clear about the processes in their own production sphere. They are committed to forecasts about the market's development and the search of the specific product but the successful finish of the investment process depends substantially on the domestic political and social and economic conditions of the respective country. As a rule, the investor does not know how to assess this type of outlook, so they follow the behaviour of a subject (institution), which is able to do this projection. Such a subject (institution) is the EU as well as the IMF. If the EU remains committed financially and by all means with a given country, then this represent a serious guarantee for the investor that the processes in the country will go in an ascending line and risks will decrease. Otherwise restraint outweighs.

The EU stated clearly and definitely its negative assessment of the conditions for business in the country and in the middle of 2008 they withdrew their financial assistance. Later there repeatedly arose scandals in connection with the problems in assimilating European funds. All this no doubt had an impact on investors' decisions to prefer a country or not. The decline in foreign investment is a sure sign for the essence of their estimates.

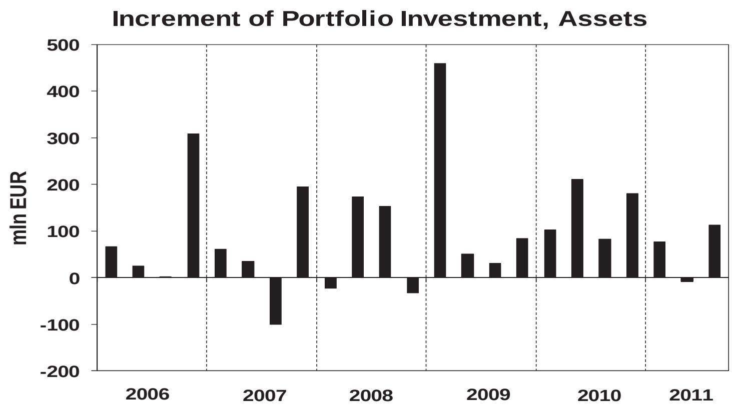
The item “*Portfolio investment*” on the financial account is almost traditionally negative (net outflow of foreign currency). In the near past the repayment of the foreign debt issued was dominant and in the recent years - the investment of local investors in foreign debt securities.

There are some special features that need discussing.

The active part of this item contains operations (purchase and sale of shares and bonds on the international markets), made by residents. Until 2006 this type of operations was of incidental nature. For example, for the period 2000-2006 there was recorded a total of EUR 47 million portfolio investment of residents abroad.

The dynamics changed right before Bulgaria’s accession in the EU (Figure 11). Local investors became more active. These were mainly investment funds and various types of institutional investors. It is indicative that three quarters of the portfolio investment made were in the way of long-term securities (bonds, not shares).

Figure 11



It is worth noting the behaviour of the local portfolio investors in connection with the impact of the financial and economic crisis. Right after 2008 (the first quarter of 2009), when it became clear that the country could not manage to escape from the financial cataclysms, local investors put in a record high amount in foreign debt securities. Their high investment activity was maintained all through 2009-2010 (EUR 575 million each year), but relatively dropped in the first half of 2011.

The government has no instruments to administratively restrict this type of leakage of currency resources out of the country, since the financial account of the BoP is fully liberalized. The only option for regulation comes to indirect economic influences, most of all improved domestic environment through greater investment attractiveness of the country itself.

The behaviour of local institutional investors shows that whenever it is a question of money the notions domestic and foreign become blurred. The problem is the following: Why do local investors prefer to invest in foreign debt securities and not in the national economy? The answer to this question has to be looked for in two directions.

On the one hand, confidence of local investors in the national debt securities does not seem high enough. In addition one should say that too often formal rules require investing in securities reliable enough - an indicator for reliability being the official credit rating (not very high for Bulgaria). And on the other hand, the domestic financial authorities do not seem to issue securities attractive enough and in the needed volumes in order to attract local capital. The first case has to create a feedback to the overall macroeconomic management, and the second – to the financial authorities.

Led by its own narrow institutional interests, the Ministry of Finance did not manage to assess the consequences from its restrictive behaviour. Not a few financial resources are accumulated in various money funds and these have to be managed in a way that will earn an acceptable income. As a rule security requirements restrict investment to only the relatively unrisky securities. This type of securities is issued by the government.

Table 3

Results of the auctions for the sale of Government securities and the portfolio investment abroad by residents

	Currency	2009	2010	I-VI 2011
Government securities issued	Million BGN	545	615	440
Government securities issued	Million. EUR		140	60
Portfolio investment abroad	Million EUR	575	575	63

For two years and a half (2009, 2010 and the first half of 2011) the government issued government securities of BGN 1.6 billion and EUR 200 million (without specifying their maturity dates, Table 3), i.e. a total of BGN2 billion. At the same time for the same period BGN 2.5 billion left the country, invested in portfolio investment abroad. A telling indication of the liquidity potential of the institutional funds in the country is the extent of the cover coefficient of the auctions of government securities (the relationship between the aggregate nominal value of the orders allowed to participate in the auction and the aggregate nominal value of the quantity of government securities offered by the Ministry of Finance), which is around three, i.e. the demand for government securities is about three times more than the supply. Looking for possibilities for efficient management of the financial resources available institutional investors direct their attention to investing abroad by which the country deprives itself of life-giving investment. The obviously higher volume of government securities issued during the first half of 2011 accounts somewhat for the lesser intensity of investment in foreign debt securities.

For the same period the country's fiscal reserve dropped by BGN 3.5 billion, i.e. there was a transformation whereby a substantial part of the fiscal reserve was no more kept with the BNB, but had left the country and assisted foreign economies.

The overall reformatting of macroeconomic policy inevitably comes to the essence of the fiscal policy. The highly restrictive budget policy carried out, connected with maintaining a budget deficit of a much lower size than its average level in the EU, actually drives out financial resources redirecting them towards other countries. Resources go where they can be put to use. This is the meaning of the saying that the best behaviour of an individual member of the herd (i.e. the EU) is to be within the herd, not outside.

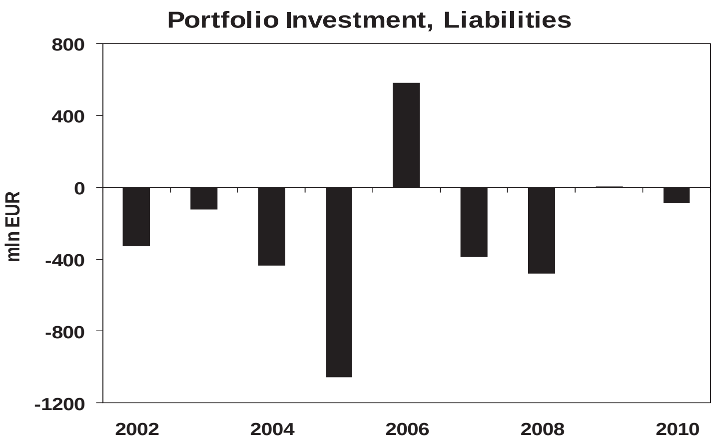
The banking sector had also contributed in a way for the situation observed. In 2010 only the Bulgarian Bank for Development issued five-year bonds in EUR at the total amount of EUR 40 million. These issues were aimed at financing new and refinancing existing infrastructure projects, in the field of production of energy from renewable energy sources including. Not a single other commercial bank made any attempt at attracting financial resources through a bonds issue although there were signs for some liquidity strains.

The specificity of foreign portfolio investments (liabilities) is slightly different. The difference is the outcome most of all of the government foreign debt relationships (the issue of debt securities on the international financial markets – Brady bonds, Euro- and global- bonds.

For the period 1994-2001 the movement of financial resources from this item was relatively quiet – statistics recorded repatriation of money at an annual average of EUR 17 billion. In 2002 Bulgarian global bonds were issued meant to exchange and buy back the Brady bonds already in circulation.

The financial policy of the Bulgarian government after 2002 was to gradually buy back the available Brady bonds in circulation. This accounted for the repatriation of financial resources from non-residents during the period 2002-2005 when this process was over (Figure 12).

Figure 12



In 2006 a net inflow of foreign currency resources was observed in this item (obviously linked to the pending accession to the EU), after which the repatriation of financial resources was resumed over the following two years, this time most likely because of the financial and economic crisis.

For the time after 2008 foreign investors' portfolios did not get rid of Bulgarian debt securities. In the first half there was more movement but still it was not something to worry about from the national point of view.

Statistics showed that there were no serious grounds to blame foreign portfolio investors for attempting to repatriate financial resources in connection with the financial and economic crisis. Local investors seemed to be much more suspicious about the financial and economic condition of the country in times of crisis. As usual these are the people who know their country best as well as what they can expect. For this reason local investors can be regarded as showing higher rationality than the foreign ones.

The item "*Other investment*" of the financial account of the BoP shows the cross border movement of any other financial resources meant for investing – commercial lending, loans (government and private ones), deposits of legal and private persons.

Four stages can be outlined in the changes in the item.

For the period 1991-2001 there was some movement but the net leakage of financial resources outweighed at an annual average of within EUR 16 million. There existed a number of administrative restrictions for the cross border movement of investment during this period (the BoP was not liberalized), and the country did not represent a preferred destination for capital inflow. This accounted for the low volumes.

In 2002-2006 there came an obvious animation. It was the time when the overall privatization process of large-scale enterprises of national importance was completed and especially of the banking system. The outlines of the political and economic outlook became clearer and the country withdrew from the IMF tutorship and started independently on its way. The real gravitation towards the European economic structures became apparent too. The privatized companies needed new investment and the prevailing share took the shape of loans from the non-resident parent company as well as commercial lending from foreign banks. The net movement of capital passed from the negative to the positive sector with an annual average of net inflow of capital of about EUR one billion (EUR 983 million).

The first two years of the country's membership in the EU came and the annual average net inflow of currency in this item rose on the same indicator for the previous five years almost six times! EU membership revealed good economic opportunities, a continuous period of getting closer to the average European economic levels was ahead. Enticing investment opportunities arose inducing efforts for timely taking place in a promising economic environment.

At the end of 2008 there came a dramatic downturn (Figure 13). The multibillion capital inflows crashed in the last quarter of 2008 and since then definitely went into the negative semi-plain. There were even grounds for a further deepening of the capital crisis over the following years.

The financial and economic crisis began to shake the world during the second half of 2007. Investors in Bulgaria did not seem worried during the first three quarters of 2008 (Figure 13). Something unusual must have happened during the second half of 2008 in order to bring about this sharp downturn. What had happened actually was the definite statement of the EU about the high corruption level in the country and the availability of significant deficiencies in macroeconomic management. EU withdrew and the herding behaviour of investors was immediately triggered.

Figure 13

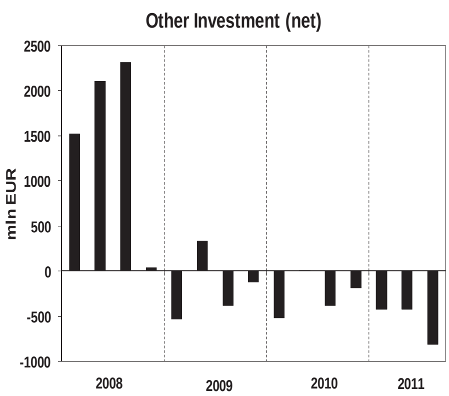
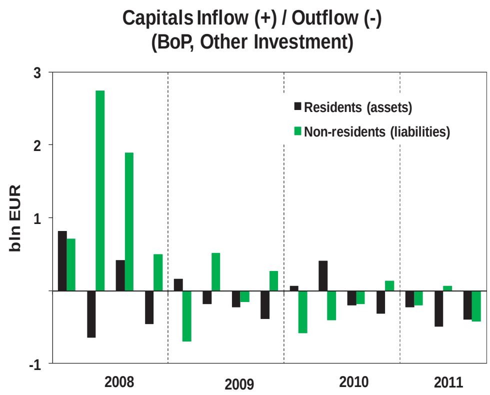


Figure 14



When you get deeper into the structure of the process some special features become clear. The capital inflow in this item effected by non-residents was significantly reduced and turned into a leakage of capital in the first quarter of 2009, but the downturn in the behavior of residents was not less significant either (Figure 14). From a return of resident capital to the country it transformed itself into a net export of resident capital. In 2009 for example residents exported capital in the form of commercial lending, loans to non-residents and currency deposits at the amount of EUR 628 million, whereas the repatriated capital by non-residents of the same kind was hardly EUR 91 million. This trend was broken in 2010, but during the first half of 2011 the export of capital of local investors became very active again. Over the last two and a half years (2009, 2010 and the first half of 2011) some competition between residents and non-residents for the export of capital was open: residents exported EUR 1142 million, while non-residents - EUR 1357 million.

The export of capital, both by residents and non-residents, was dominated by currency deposits abroad. With the residents this was almost the only form, while the non-residents although timidly kept some positive values (as a whole) as commercial lending and loans.

As with portfolio investment and this form of capital the participation of residents in the composition of the overall deficit in the BoP is very significant. A problem of macroeconomic management is to find ways to overcome these difficulties.

Before we go to the general balance of foreign payments it is necessary to make an important reservation. The accounting information about the items in the BoP should be taken to a great extent as given for orientation purposes and so needing additional corrections. This is because of the size of an often substantial component – "*Errors and omissions*".

Figure 15

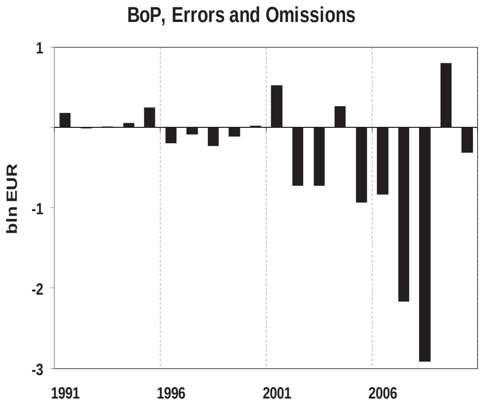
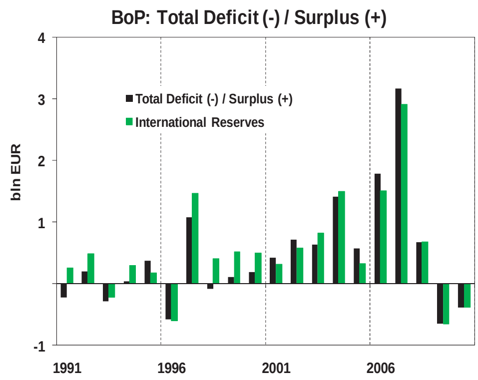


Figure 16



The reason for the existence of this annoying component is that by far not all elements and items in the BoP can be determined accurately enough. What is even more unpleasant is that "*Errors and omissions*" varies within exceptionally large limits (Figure 15), which raises problems with the juxtaposition of the items in the BoP over time. To overcome this difficulty the compiler of the BoP (the BNB) makes a lot of efforts to accumulate additional information and resort to various analytical techniques to enable the spreading of as great a part of this item as possible over the individual parts of the BoP. The process takes time and is not always satisfactory. The BNB systematically introduces corrections to the input data which sometimes go four or five years back. At the same time the need for reliable and timely information about the condition of the cross border movement of financial resources is undoubtedly very important for the assessment of the current macroeconomic policies. Finally the claims of the respective financial and economic analyses come to delineating the engine forces, characteristics and trends in foreign payments rather than building up and presenting accurate statistical and analytical figures.

Life is too dynamic and periodically creates new phenomena, not encompassed by statistics which imposes a change in the methodology techniques This can account for the growth of "*Errors and omissions*" in the last five years. Its size for individual years is really impressive and worrying. Thus for example, for 2008 it was estimated at about EUR three billion (minus), given that the amount of the current and financial account was EUR 3.3 billion.[8] The latter means that the negative value of the current account, as well as the positive value of the financial account should be reduced for instance by half! But then the correlations would have looked very differently, i.e. in 2008 there was probably a higher deficit in the current account and substantially less total capital inflow.

The good news is that for the first half of 2011 the size of "*Errors and omissions*" was much less - only EUR 133 million.

The accounts for the condition and dynamics of the last part of the BoP – "*Reserves and other financing*" – are reliable enough. Mistakes can hardly be made there since it is a question of transferring financial resources from and to the gross international reserves and the receipts from IMF tranches or another extraordinary financing, most often to support the BoP. These data can be the subject of very accurate recording, which predetermines the satisfactory accuracy of the total deficit/surplus in the BoP.

During the first half of the 90s of the last century the overall balance of foreign payments was not steady and fluctuated around zero. This period was dominated by the IMF in determining the national macroeconomic policies and adjusting to radically different foreign economic and financial conditions. The crisis years of 1996 and particularly 1997 were more special, especially 1997 which is a textbook example of the positive influence of a highly devaluated local currency on the growth of gross international reserves. The devaluation of the national currency is a radical and extreme measure to strengthening the equilibrium in the BoP and is really efficient.

Following the introduction of the CBA a ten-year period began of gradual growth in gross international reserves. The deviation from the trend in 2005 resulted from the buy back and final withdrawal of the Bulgarian Brady bonds still in circulation. The end of this positive trend was in 2008.

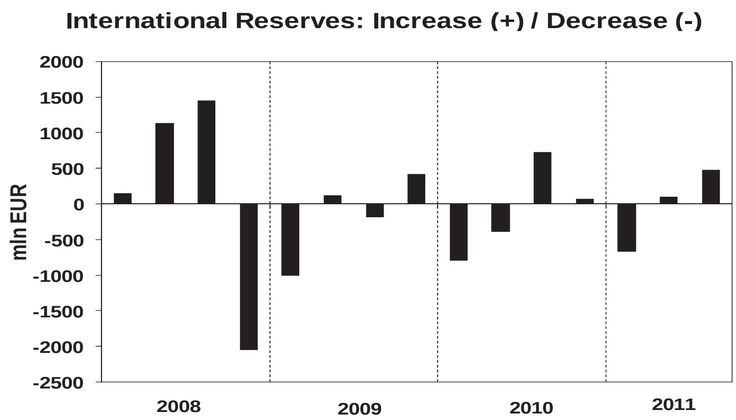
At the end of 2008, to counteract the emerging financial crisis the government decided to avail itself of a substantial part of the fiscal reserve (about a third of it) with a view to provide favorable opportunities for the business to survive and grow. This can explain to some extent the fall in the growth of the reserve assets with the BNB, i.e. this act can be considered controlled. The gradual decrease in the reserve assets of the BNB observed over the following years, however, was an uncontrollable outcome of the processes taking place in the country and the special features of its macroeconomic management.

The last part of the BoP contains other two items – "*IMF credit (net)*" and "*Exceptional financing transactions (net)*". Figure 16 shows the impact of these two items on the changes in the reserve assets of the BNB. By 2007 Bulgaria

[8] The capital account is subject to much less correction as far as its components can be more accurately determined.

had settled completely its financial and credit relationships with the IMF and ceased to use extraordinary financing to support the BoP, so since 2008 the size of change in the reserve assets with the BNB coincided/overlapped with the total balance of the BoP.

Figure 17



BNB's reserve assets did not decrease steadily but with fluctuations (Figure 17). Those changes were obviously linked to fluctuating estimates of investors, all economic agents and the people. For the two years and a half since 2008, EUR 1.6 billion (net) had left the country. This is a classical case of unsteady BoP which stirs up tensions and necessitates regulating macroeconomic policies.

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In an increasingly globalizing world the BoP is one of the most important and substantial indicators and at the same time instrument of macroeconomic management which incorporates in itself almost all that happens (or not) in the national economy. The items and structures of the BoP reflect the estimates of the external markets on the condition and development of the economy and signals are formed about emerging macroeconomic strains.

The critical reading of the structure and dynamics of the foreign payment relationships leads to the following conclusions:

1. The general condition and dynamics of the foreign payment structures of the country since the mid-2008 has been unsatisfactory and goes on worsening. From the third quarter of 2008 till the second quarter of 2011 more than EUR 3.6 billion (net) had left the country, i.e. by about EUR 1.1 billion on an annual average. During the first half of 2011 there was recorded a cross border leakage of EUR 573 million. Such a situation is not steady and directly attacks the foundations of the CBA. It is necessary to take efficient measures on time in order to prevent resorting to the radical measure – rejection of the CBA and devaluation of the national currency.

2. The financial and credit relationships with the EU are of key importance for recovering economic development and the steadiness of the foreign payment structures. Since the country's accession into the EU till today the government administration has managed to really absorb only about a quater of the EU funds aimed at assisting the national economy. Bulgaria could have added other 3-5 percentage points on its annual growth in GDP provided the EU financial assistance had been applied in a satisfactory way. Respectively, Bulgaria lost 3-5 percentage points from the underuse of the financial support provided by the EU. This is the cost of the lack of skills, corruption and incompetence of the government administration.

The meaning of the efficient application of the financial support given by the EU outweighs the size of the resources directly used. The financial-lending behaviour of the EU is contagious for foreign investors. Theory stated and practice confirmed it that the financial-lending message of official investors on the one hand, and of private investors on the other, was similar, with that of official investors being the leading behaviour. It is impossible to expect a great flow of foreign investment if EU clearly showed investment reservations.

3. The structure of the exports of goods, in its present shape, does not presume dominance of its positive dynamics in forming the rates of growth in GDP (as it is for the period of the first quarter of 2010 till the second quarter of 2011). The leading position of „*raw materials*" in the structure and dynamics of exports of goods implies a gradual depletion of reserves, the more so that it is also the outcome of varying characteristics of the international conjuncture. The national sources of feeding this position are poor. Theory states and practice confirmed it that a steady growth in exports can only be provided in case of overtaking realization of consumer and investment goods on the external markets. Provided the dynamics of the export of goods broke, this would have a negative impact on the trade balance, respectively on the current account.

4. The reserves for further improvement of the current account of the BoP are related most of all to the creation of opportunities for greater absorption of the current transfers by the EU. Experience has shown that the current transfers effected by local emigrants abroad are not to be neglected. One of the possibilities for keeping this financial channel open is through a purposeful and active pro-Bulgarian policy within emigrant circles, keeping their Bulgarian self-awareness and letting them stay close to their roots of origin. The example of the Jewish Diaspora should definitely be viewed positively in this respect.

5. Since the end of 2008 a disastrous fall in FDI was recorded in the country. Experience showed that for a developing economy, such as the Bulgarian, domestic investment is not enough to provide the necessary social and economic prosperity. FDI are the holders of know-how both in technology and management. FDI return is of key importance for updating the domestic production structures.

Life has shown that the primitive thinking for attracting FDI (as well as the intensification of investment process in general) through fiscal relief (low flat tax rate) does not lead to the expected positive result. It is very elementary to think that investors are only interested in passing financial prerequisites. These (the financial prerequisites) can prove decisive given that "*all else being equal*", where actually is the key to attractiveness.

Fiscal and financial reliefs do not help where the institutional environment is of poor quality. So, improving and rationalizing the institutional environment most generally has the priority in increasing the country's investment appeal.

6.Who exports capital from Bulgaria? The immediate and prevailing primitive answer is: Foreigners! Usually followed by: Foreigners and globalization are to be blamed about everything bad that happens in Bulgaria!

Truth is quite different. For two years and a half (January 2008 – June 2011, i.e. 30 months of "*crisis*") residents took out of the country a capital of EUR 2.5 billion,[9] i.e. by about a billion EUR on an annual average! This amount was invested for example equally in foreign debt securities (portfolio investment) and deposits with foreign commercial banks. For the same period non-residents brought into the country capital (net) of EUR 3.2 billion.[10] There is also withdrawal of portfolio investment and deposits from Bulgarian commercial banks with them but of a lesser degree (a total of about EUR 850 million, which is made up for by a considerable surplus from the FDI inflow).

The natural conclusion is that residents are afraid much more of what happens in the country and its financial and economic consequences than non-residents.

The final summary of the figures in the BoP and what lies behind them leads to the conclusion that what has taken place in Bulgaria over the last few years should be described as a Bulgarian financial and economic crisis rather than an element and outcome of the global financial and economic crisis. Respectively, the explanation and solution of the problems are to be sought in the field of domestic economic policies rather than on the global arena.

1.XII.2011

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[9] Assets in the financial account of the BoP.

[10] Liabilities in the financial account of the BoP.