

## Bulgaria's Fiscal Expansion: Navigating Through Stormy Waters

By Georgy Ganev

When the global economic crisis wreaked havoc across the world, most governments responded with a dramatic increase in spending. Their reactions had two main goals in mind: first, to bailout failing financial systems and second, to substitute the decline in private demand with a boost in aggregate public spending. For Bulgaria, fiscal stimulus programs proved to present their own unique set of challenges.

### The Merits of Fiscal Stimulus

Many people, subscribing to the standard logic of Keynesian economic policy, will argue that it is precisely this swift action on the part of several governments that is the sole reason for why the world avoided slipping into a depression at least as deep and long as the Great Depression. Some prominent economists, including Nobel laureates Paul Krugman<sup>1</sup> and Joseph Stiglitz<sup>2</sup> continue to defend the proposition that now that the trough of the crisis seems to be behind us, any attempt to curb deficits and consolidate public finances will inevitably cause a double dip recession.

This proposition rests on two related, but not equivalent, claims. The first is that fiscal stimuli help to avoid depressions and shorten recessions. The second is that fiscal consolidation, or austerity, causes recessions. In economic parlance, the claim is that the fiscal multiplier is large in both directions.

One can easily imagine the theory behind this claim, but the infinitely more important question is the one surrounding its empirical validity, especially its validity under various contexts and idiosyncratic circumstances.

<sup>1</sup> See comments in his blog <http://krugman.blogs.nytimes.com>

<sup>2</sup> See <http://www.bloomberg.com/news/2010-08-24/stiglitz-says-government-cuts-set-to-push-europe-into-double-dip-recession.html>

### Bulgarian Response

The case of Bulgaria during the last business cycle offers a very peculiar set of circumstances. Specifically, they can help shed light on the first part of the claim: that fiscal stimuli can help avoid depressions and shorten recessions. Bulgaria's economic circumstances at the beginning of the 21<sup>st</sup> century are indeed peculiar. First and foremost, it operates under a currency board regime, which means that there is a highly institutionalized fixed exchange rate to the Euro as well as an almost complete lack of autonomous domestic monetary policy. Today, the central bank has no control over the monetary base and is not allowed to hold any form of Bulgarian debt, including government paper and loans to Bulgarian banks. For this reason the stability of the monetary regime requires fiscal prudence. In fact, the country has actually recorded a decade of fiscal surpluses, which have been piled up into the government's fiscal reserves.

At the same time Bulgaria is a small, open, and converging member of the European Union (EU). These characteristics are quite relevant. For example, as a small economy, Bulgaria's size is negligible relative to world capital flows. Its openness implies that exchanges with the rest of the world are large relative to its domestic size. Finally, as its economy seeks to converge with wealthier EU member states, its domestic rates of return are relatively high, so that in normal economic times it is highly attractive to capital. As an EU member Bulgaria's current and financial accounts are completely open.

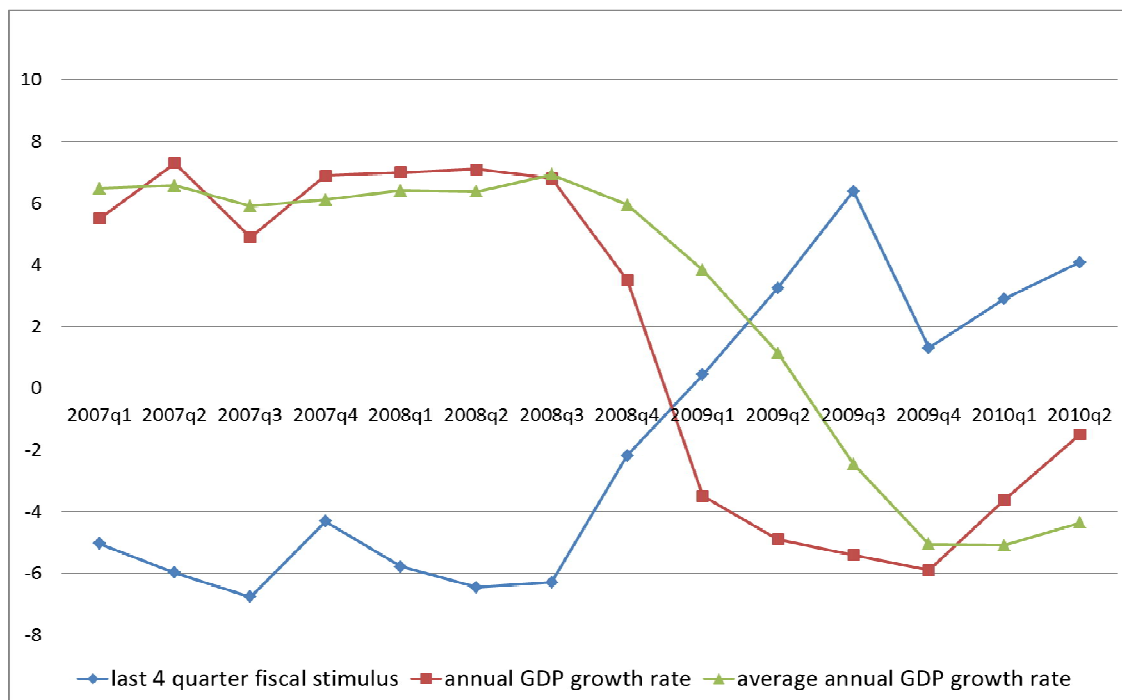
This means that when the global crisis knocked on Bulgaria's door in late 2008, the country had ample reserves, as large as 20% of annual GDP, stacked in a highly liquid form and ready for spending. Bulgaria did

not need to issue new debt or raise concerns among the private sector over expectations about the future servicing of its debt, a problem which presently plagues many countries across the world. Bulgaria had ample fiscal reserves and cold cash stashed abroad. More importantly, it was ready to spend its reserves without crowding out anyone's access or desire for credit.

### Fiscal Expansion Unable to Avoid Recession

And Bulgaria did spend it. At present the size of the fiscal reserve is less than half of its size in October 2008. Measured through change in the government's net debt position, the Bulgarian government has stimulated the economy in each of the last six quarters, in some cases by as much as 4 to 6% of current GDP. One would imagine that, given such support, the Bulgarian economy should have avoided a recession altogether, or at least seen a very mild one. The facts, as illustrated in Figure 1, are a bit different.

**FIGURE 1: BULGARIA: FISCAL STIMULUS (% OF GDP) AND GDP GROWTH RATES (%)**



SOURCE: MINISTRY OF FINANCE, NATIONAL STATISTICAL INSTITUTE, OWN CALCULATIONS

In each of six fiscally stimulated quarters the Bulgarian economy contracted, in some cases between 5 and 6% annually. To put things in comparative perspective, the 2009 Bulgarian recession was a bit deeper than the overall EU-27 recession. In short, during the period from late 2008 to mid-2010, Bulgaria saw half of its sizable

fiscal reserves diminished and with nothing to show for it. No multiplier effect seems to be visible, and the Bulgarian experience puts a serious empirical obstacle to the claim that fiscal stimuli soften recessions.

Of course, this development can be explained in the specific features of the Bulgarian economy- it is small, open, and converging in a large market of freely moving capital. In addition, this explanation is centered on the fact that under these circumstances capital flows into the country during good times and out of the country in bad times (dwarfing the otherwise large changes in the fiscal position). To illustrate this, Figure 2 demonstrates the exact same data set as the one used to illustrate the fiscal stimulus, only inverted to now show the change in government net debt position.

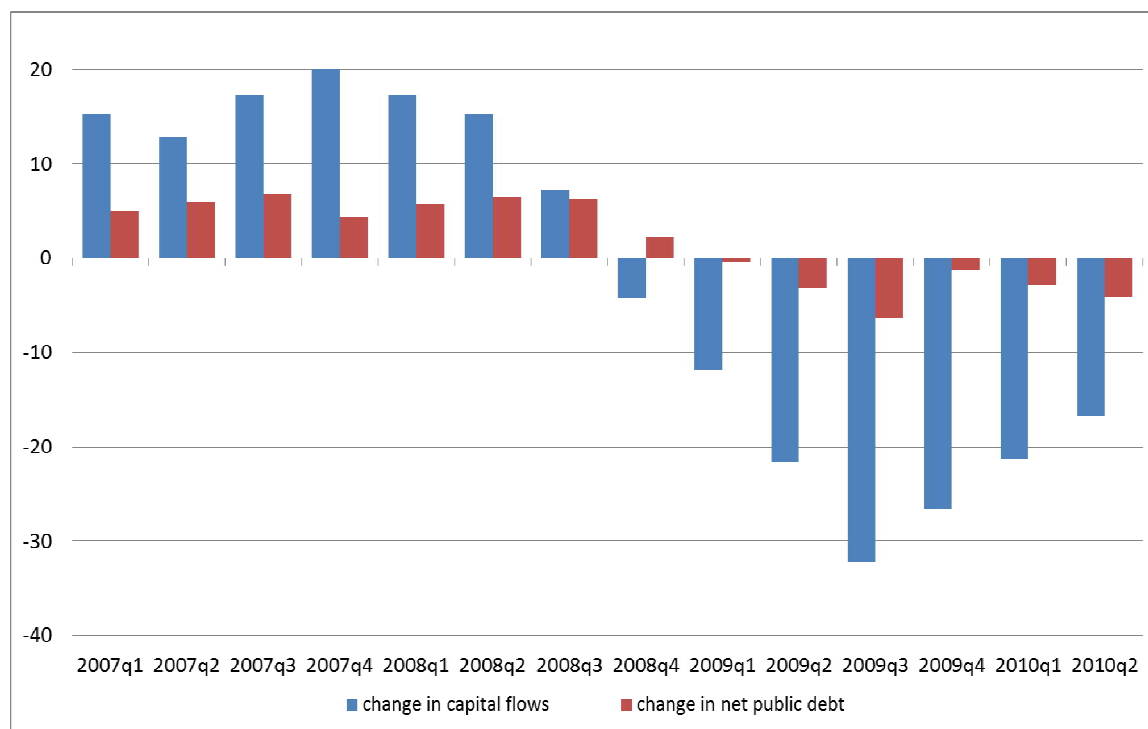
The stark changes in fiscal position demonstrate the fate of a small, open, converging EU economy. The fiscal movements of its government were almost always smaller than the relevant capital flows. During

sound economic times these flows create domestic demand. During bad times they depress domestic demand. There is nothing, beyond a trifle, that the government of this small economy can do to substitute for these flows during a downturn. More importantly, under the EU it is legally forbidden to block capital flows during boom times. That is why Prof. Paul Seabright's<sup>3</sup> metaphor is spot on:

"Politicians are in charge of the modern nomy in much the same way as a sailor is in charge of a small boat in a storm...[T]heir influence over the course of events is tiny in comparison with that of the storm around them".

<sup>3</sup> From "Company of Strangers", p.25, quoted by Greg Mankiw: <http://gregmankiw.blogspot.com/2010/08/wise-passage.html>

FIGURE 2: ANNUAL CHANGES IN FISCAL POSITION RELATIVE TO CHANGES IN CAPITAL FLOWS IN BULGARIA (IN % OF GDP)



SOURCE: MINISTRY OF FINANCE, BULGARIAN NATIONAL BANK, OWN CALCULATIONS

## Conclusion

This is certainly what is happening to Bulgaria at the moment. And, if we extend the metaphor, the best strategy to navigate a small boat through a big storm is to pay attention to the storm as well as the severity of its waves. In the case of Bulgaria this would not require managing domestic demand, by trying to substitute government spending for it, but to actively manage the way in which the enormous international capital flows affect a particular country. Under such a strategy the fiscal reserve, this fruit of reasonable fiscal austerity, still has a crucial role to play, but in a dramatically different way. Rather than being spent in order to substitute the un-substitutable, it may serve as an anchor for international capital flows and makes them a bit more willing to enter and a bit less quick to exit. This strategy can hardly ever be much more than a hope, but what else is there for a small boat caught up in the middle of a treacherous and unpredictable storm?

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