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Debates over Crises: A Special Focus on Bulgaria[1]

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Abstract: The explanation and the economic policy proposals that address the present crisis are compared with those that were considered during the Great Depression. Through two simplified theoretical models, this work shows that there has been very little change both in terms of crisis explanation and economic policy proposals. The 'market failure model' explanation and the 'forward to the state model' explanation were winners at the time of the Great Depression and have again emerged as the winner at present. Why is this so? This work sheds some light from the perspective of Bulgarian history and the present experience.

Keywords: global crisis, Bulgaria

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1. Introduction: The historical context—then and now

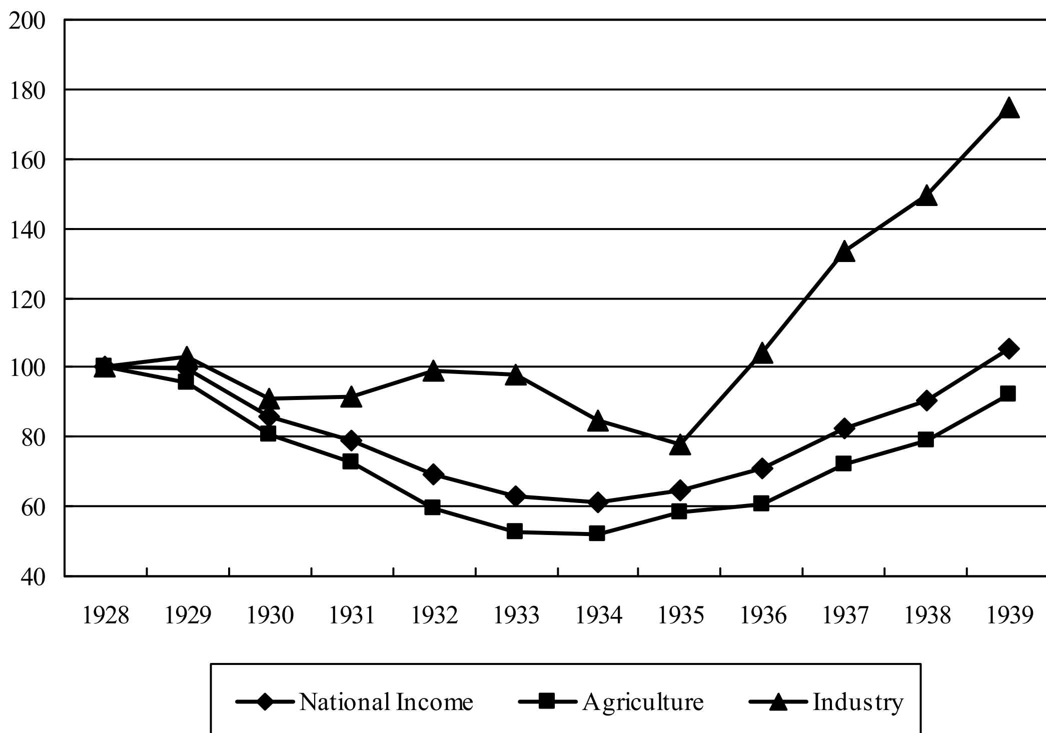
A careful reading of past discussions, especially, from the era of the Great Depression as well as that concerning present day disputes, indicates that very little has changed both in terms of crisis explanation and economic policy proposals.

First and foremost, theoretical discussions need to be placed in a historical context. After WWI, Europe was divided both economically and politically. A fact that illustrates this is the increase in national currencies from 13 to 27. An attempt was made to restore the pre-war gold standard and its automatism; a number of monetary conferences were held, and the League of Nations was established. World centres were rearranged and disputes over external markets and colonies grew fierce. The economic power shifted to the USA, which became a major creditor, while Europe and Asia became debtors. The war brought a number of new social groups to the fore and democratized economic life, with women coming to play an important role in society.

Bulgaria suffered losses both in terms of population and territory and began paying onerous sums as reparations. Despite the difficulties, aided by two stabilization loans, the gold lev was reinstated in 1928. The depression, which suddenly aggravated, had a severe impact on the country, with agricultural prices declining (by almost 50%) and many banks failing, while the debts increased in real terms. For political reasons, a number of laws were adopted to protect and relieve the debtors' burdens, which in my view had disastrous consequences for the country's

public finances and morale in general. The crisis hit rock bottom in 1932–1934. Subsequently, the economic growth was partially restored by means of customs restrictions, exchange rate control, compensation trades, and clearing arrangements. A set of banking regulations were introduced, and deposit protection schemes and the so-called Bankers' Council (*Bankerski Savet*) were established. Unlike Greece, Hungary, and Romania, Bulgaria regularly serviced its external debt and did not devaluate its currency. Over time, the country became increasingly influenced by Germany and became involved in its preparations for a new war[2].

Chart 1 The Bulgarian economy (1928–1940)



Unlike the Great Depression, the present crisis was preceded by a period of nationalism, rather than globalization. Europe is united, at least formally, and the euro has been in existence for 10 years. Once again, we are witnessing geopolitical dislocations—the centre of economic power has shifted to Asia, which has become a major creditor, while the USA is already a debtor. Savings and investments diverge significantly across centres. The dollar, however, is still at the core of the world's monetary system, which impedes global monetary reform (it should be recalled here that between the wars, the world's money—namely, gold—had transcended the

system). Today, Bulgaria is under a currency board arrangement and is part of the European Union[3]. It has limited scope for autonomous decision making.

2. Simplified explanations of the big crises—then and now

Of course, theories pertaining to the crises are many and varied. However, these can be reduced to two basic models—Model 1 which holds the market responsible, and Model 2 which finds the state accountable. As will be discussed below, patterns repeat themselves.

Model 1: In the past, the main factor that is considered to have triggered the crisis was the gold standard with its 'chains' which caused a spill over of the crisis from one country to another and prevented the world money supply from growing[4]. Alternatively, each period that saw an increase in money supply only made any subsequent contraction extremely painful. The drop in prices and the consequent debt deflation led to diminished consumption. In this model, the preferences of economic agents have proven to be unstable. As for the situation today, explanations have shifted slightly to the risk side of financial markets and the market in general has been brought to the fore. Financial markets are seen as 'short-sighted', inherently unstable, and lacking in efficiency (see, for example, the numerous speeches of the ECB governor Jean-Claude Trichet). Furthermore, the lack of regulations, mark-to-market accounting, etc. have also been criticised. Global imbalances are discussed, but these are also seen as being market related. In Bulgaria's case, what inevitably comes to mind is the accusation that the currency board, just like the gold standard, is a restrictive and harmful mechanism which is artificially enforced from the outside and limits our sovereign monetary policy, thereby leading to suppressed real incomes and, hence, reduced consumption of the population.

Model 2: Model 2 argues that the state (in the past, 'the war as a factor' was often brought up) is the main reason for the destroyed heaven of pre-war global economy. The war led to a sharp increase in money supply, the collapse of public finances, and huge physical and moral losses. The post-war inflation quickly (and unnaturally) destroyed the connection between savings and investments, as part of the savings were replaced by unbacked and 'false' money (through low interest rates, well below their natural levels). This led to over-investment and 'poor,' inefficient projects, which deformed the structure of production. Theoretically, the explanation offered is concerned with the harm that comes from the initial monetary shock, which undermines preferences and leads to structural deformities. Sooner or later, it would lead to a reversal of conjuncture, contraction, and deflation. At present, little can be done to extend this model (except for considering the low interest rates in the USA and the suppressed domestic consumption in China). As supporting elements, some arguments from the asymmetry of information and moral hazard are often advanced, relating for instance with the explicit and implicit guarantees undertaken by the state with regard to certain financial

institutions—guarantees that induce these institutions to take unwarranted high risks. With regard to Bulgaria, I would also like add to this paradigm, the adverse impact of the European bureaucracy and European funds, which are 'potential' sources of behavioural instability and social conflicts.

However, both then and now, *Model 1* provides the answer for both the past and present situations. This is the model of 'insufficient demand and consumption' and 'market instability'. Model 1 predicts the suppression of the market and liberal thinking. However, Model 2 has also been represented well enough, especially in theoretical discussions (see the Austrian School representatives; also see, for example, the Italian economist Luigi Einaudi and the French economist Jacques Rueff).

3. Proposed solutions—then and now

In this section as well, two models are considered, one of which unfortunately is completely monopolistic. The premise of the monopolistic model, denoted as *Model 1*, is captured in the expression 'forward to the state'. The state should encourage demand (investments and consumption) by pursuing an expansionist monetary and fiscal policy (in addition to the active policy of protecting and boosting the national industry). As is well known, in the early 1930s, the possible solutions to the depression came down to three alternatives (devaluation, deflation, or exchange rate control), and the choice that was made determined the three blocks into which the world economy has disintegrated. Bulgaria chose to keep the gold lev and made weak attempts to reduce public spending, but mainly the exchange rate control and restriction of capital flows prevailed. At the present period**,** the philosophy behind Model 1 is the same, save for an emphasis on the variety of technical tools, which the central bank and the fiscal policy can employ. On closer examination, it is apparent that, in technical terms, no novelties exist (I mention this also in relation to the latest fashion in monetary techniques called 'quantitative easing'). There any also no innovations in the measures taken with regard to banks (sustaining banks' balance sheets, their consolidation, nationalization, etc.). It was believed then, just as it is today, that confidence in the money market is crucial and can only be restored by the state and state guarantees. Today, discussions revolve around the need for greater regulations and control with regard to financial markets and rating agencies, the need for an early-warning system, the study of systemic risks, etc. A new international monetary order or world money is rarely discussed, although there have been some proposals by China and Russia. Overall, decisions are made within the framework of acceptable change, which is no change at all.

Sadly, but quite logically from the sociological perspective, *Model 2* has been completely eliminated. Without getting into details, I would only mention that according to Model 2, the solution lies in the process of self-equilibrium and restoring the preferences that have been

distorted by monetary shocks. This model asserts that savings, rather than consumption, should be the focus of economic policy. Unlike the first model where GDP growth is the overarching objective, this model is different: the important thing is the sustainability of economic growth and that it 'has a place' in the preferences of economic agents. Model 2 supports minimum interference by the state and stresses the detrimental effect of fiscal and monetary policies. According to this model, the outcome of the crisis is *a priori* uncertain and an open-ended process. In other words, we do not know what will occur in the aftermath of a crisis. For understandable reasons, politicians find this hard to accept. Things are complicated by the fact that politicians and their subservient economists consistently uphold the assertions that Model 2 is naïve and foolish.

The consensus with regard to Model 1 can be stated in the following words 'the state will pull us out of the crisis'.

How can we explain such single-mindedness? Why is Keynes being revived, and why in his most primitive interpretations? How is it possible that theory has produced *absolutely* nothing new for almost a century now? No new theory, no new technical solutions? Why have countless economists—theoreticians and practicians—received salaries and for what?

The problem is fictitious; rather the answer is almost clear.

We know this intuitively, unpleasant though it may seem. In short, 'the market's failures' are only an excuse and a pretext of the state (government). It is *the state's excuse* for the economy's deplorable condition. It is a *pretext* because the state looks for excuses to embark on new tasks, new functions, and the redistribution of wealth and incomes. With such a great deal of manipulation, the market becomes the scapegoat. It cannot defend itself; it is not loud or argumentative as the state, which has on its side numerous white-collar workers and academics working in state and 'private' universities. Every situation is marked by criticising something while calling it by a different name. What is referred to as the market is actually the *market distorted by the state* (or, the state disguised as the market); then, this market is blamed for the crisis.

Of course, within the framework of Model 1 ('forward to the state'), various interests and forces are at play, or as the then Prime Minister Prof. Alexander Tsankov said in 1932, the resolution of the crisis is a matter of a 'balance of forces, not of ideas'. I would like to reiterate that the economic system, which is largely an *open-ended* one, and the constant manipulations of the actors or interests, ingenious as these may be, would *all the same, lead to unpredictable outcomes* (very much in the vein of films with surprise endings). To those of us who are frightened by the monopoly of Model 1, this is the only solace—namely, that the audience enjoys films with surprise endings, usually serving to evoke reactions of amazement.

There are those that might question: 'What is to be done then? How come nothing is being prosposed?'

To which, we (who live in Bulgaria) would answer that the only things that can be done are as follows: minimum interference, minimum discretionary policies, and respect for the principles of reasonableness—stable currency, sound public finances, a small and concise bureaucracy, and an efficient judicial system. Most importantly, there is a need for everybody's initiative.

The worst consequence from the current crisis, as I see it, would be the *loss of trust in the market,* and the loss of free initiative and personal responsibility. This is especially disastrous for the young and potentially enterprising Bulgarians.

Notes

[1] This paper is an extract from the speech delivered at the 'Crises in a historical perspective' forum, organized by the Bulgarian Ministry of Finance, 20 May 2009.
[2] For more details, see Nenovsky and Dimitrova (2007).
[3] See Ialnazov and Nenovsky (2001), pp. 31–48.
[4] See, for example, Eichengreen (1992).

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