Monetary Regimes, Economic Stability, and EU Accession: Comparing Bulgaria and Romania

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Keywords: Post-Communist transition; monetary regimes; EU accession; moral hazard; interwar monetary history

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Abstract

This paper traces the origins of the different monetary regimes adopted in Bulgaria and Romania in 1996-97 and examines their performance during the EU accession. The findings indicate that the constraints of the currency board in Bulgaria shifted economic activity towards the private sector, while the discretionary policies in Romania turned public finances into both a contributor and a response mechanism to economic imbalances. While the prospects of EU accession initially enhanced the performance of the monetary anchors, the implicit insurance of EU membership increased moral hazard and led to a rapid rise in private (more pronounced in Bulgaria) and public debt (more pronounced in Romania). We propose also some historical parallels between our sample period 1997-2009 and the years 1925-1940 and identify similar differences between the monetary regimes of Bulgaria and Romania. This historical comparative analysis provides a fertile ground for reflection on the cyclical recurrence of certain patterns in the choice of monetary regimes and preferences for specific economic policies.

Keywords: Post-Communist transition; monetary regimes; EU accession; moral hazard; interwar monetary history

As neighboring countries, Bulgaria and Romania have shared many experiences over the centuries, from the time of the Ottoman Empire to their joint entry into the European Union (EU) in 2007. Accordingly, they have always been rivals despite differences in the size and structure of their economies. Following the Balkans Wars 1912-1913 and Bucharest Treaty in 1913 when Bulgaria was punished territorially and economically, Bulgaria and Romania fought as enemies during the First World War. The two countries were allies during the Second World War, and shared a common ideology as Soviet satellites for over 40 years. Even though both nations were members of the Communist bloc, Romania distanced itself from the Soviet Union by adopting more independent economic policies while Bulgaria faithfully followed Soviet policies. After the breakdown of the Communist regimes at the end of the 1980s, the competition between the two countries turned to the goal of making a speedy transition to a market economy and democracy. Since the mid-1990s, Bulgaria and Romania have vied with each other for the integration into the EU by trying to implement the necessary institutional reforms.[1] In the process of EU accession, Bulgaria and Romania were also treated as a group separate from the frontrunners in Central Europe and the laggards in the Western Balkans. The two countries signed association agreements with the EU, the first step of the negotiation process, in 1993, about two years later than Poland, Hungary, and Czechoslovakia. Similarly, Bulgaria and Romania joined the EU in 2007, more than two years later than the Central European and Baltic economies. Following the official start of membership negotiations in 2000, the race between Bulgaria and Romania gained momentum as comparisons of their performance in the areas of economic and institutional reforms became regular practice. After becoming EU members, the aspiration to gain more influence within the EU and obtain more financial aid has fueled their rivalry. Moreover, the two

Balkan neighbors were eager to fulfill the convergence criteria in order to gain admission to the euro area. In the wake of the recent global economic crisis, the issue in question is which of the two economies would be more severely affected and which one would adopt the more successful policies to deal with the recession.

The goal of this paper is to conduct a comparative analysis of the economic development in Bulgaria and Romania over the past decade, with a particular focus on the effect of the different monetary regimes that these countries adopted. Despite many similarities during the transition to a market economy, Bulgaria and Romania experienced an economic crisis in 1996-97, which marked the adoption of *very* different monetary regimes. In Romania, where the crisis was less severe, the government continued to pursue and enhance its discretionary monetary policy, even introducing inflation targeting in 2005. In contrast, Bulgaria, faced with a deep financial and economic crisis, took more radical measures by adopting a currency board. This arrangement represents an extremely orthodox monetary regime similar to the gold-exchange standard, which, in principle, corresponds to the negation of monetary policy. Besides their impact on economic policies, the two radically opposed monetary regimes shaped the views of policy makers, academics, and the general public to such an extent that even after more than a decade it is next to impossible to find Romanians who would object to active monetary policy or Bulgarians who would denounce the currency board.

A large number of studies on Central and Eastern Europe include Bulgaria and Romania as part of their analysis, but only a handful of papers have focused solely on the two economies, exploring various topics such as the role of emigrants' remittances (Blouchoutzi & Nikas, 2010), foreign direct investment (FDI) (Kalotay, 2008), enterprise restructuring (Calacean & Aligica, 2004), exports (Dritsakis, 2004), nominal and real convergence (Figuet & Nenovsky, 2006), and inflation and monetary regime (Pelinescu & Caraiani, 2006). Our study differs from previous research in its focus on the impact of the different monetary regimes that Bulgaria and Romania endorsed.

We examine at first the reasons for adopting these monetary arrangements by analyzing the initial economic conditions from the time of the planned economies in the 1980s to the early transitional period of the 1990s and identify macroeconomic vulnerabilities that have contributed to the choice of a specific monetary regime in 1997. Next, we study the different implications of the two monetary regimes on the economic development of Bulgaria and Romania in the late 1990s and 2000s. In particular, we use an insurance game model (Dooley, 1997, 2000) to explain the dichotomous relationship between the monetary anchor and the process of EU accession. The implications of this relationship allow us to compare and analyze the performance of the two monetary regimes in the aftermath of the global economic crisis.

Lastly, we explore the historical parallels between our sample period 1997-2009 and the years 1925-1940 and identify similar differences between the monetary regimes of Bulgaria and Romania. This historical comparative analysis provides a fertile ground for reflection on the cyclical recurrence of certain patterns in the choice of monetary regimes and preferences for specific economic policies.

The paper is structured as follows. In the next section we provide an overview of the divergence of monetary regimes between Bulgaria and Romania after 1997. Section 3 analyzes the origins and implications of the different monetary regimes in the two countries. In Section 4, we compare the performance of the monetary regimes in the 1990s and 2000s with the situation in the 1920s and 1930s. Section 5 concludes.

The battle of monetary regimes: Currency board versus monetary policy

Post-communist countries can be generally divided into two groups according to the type of monetary regime they operated at the onset of transition. The first group started the transition with fixed exchange rates and strict monetary policies and subsequently moved to a floating exchange rate (e.g., Central Europe) or preserved the peg (e.g., the Baltic countries). This model was very successful because the fixed exchange rate regime provided more opportunities for overcoming the cronyism prevalent in the early years of transition and indicated willingness for integration into the EU, which became the new geostrategic choice. The second group, which was much less successful and included Romania and Bulgaria, started the transition with a floating exchange rate, but its fluctuations proved fertile ground for various manipulations and embezzlement schemes.

In 1996-97, Bulgaria experienced a severe economic, financial, and political crisis, which led to the introduction of a currency board that was profoundly different from the active discretionary monetary policies employed in the years 1990-1996. The International Monetary Fund (IMF) and Bulgaria's major creditors wanted a stable and credible monetary regime which would enable the country to service its external debt. Accordingly, they provided loans for the creation of initial foreign reserves for the currency board. The new arrangement also concurred with the expectations of low-income and middle-class Bulgarians who had lost their purchasing power due to hyperinflation and their savings as a result of bank failures. From a macroeconomic and institutional perspective, Bulgaria needed a break from the extensive criminal activity during the early period of transition, which included the monetization of losses through the banking system and the unfair and illegal redistribution of assets and liabilities.[2] The Bulgarian economy had been in a non-cooperative game equilibrium, similar to the prisoner's dilemma (Ialnazov & Nenovsky, 2011).

It is well-known that a currency board is an extremely restrictive monetary system that eliminates monetary policy with the exception of statutory reserve management and the regulation of the banking system. The exchange rate is fixed by law, and the monetary base is fully covered by highly liquid foreign assets, which are disclosed in a weekly release of the currency board's balance sheet. The Bulgarian National Bank (BNB)'s function as a lender of last resort is limited to specific situations of systemic risk, which depends on the condition of the payment system and the surplus of foreign reserves over liabilities. More importantly, on the asset side of the currency board's balance sheet, there are no domestic assets, securities of the Bulgarian government, or claims on the banking sector. This makes discretionary monetary policy (e.g., open market operations) impossible (Gulde et al., 2008; Nenovsky & Hristov, 2002). The currency board is in many aspects similar to the gold-exchange standard, relying on the principles of credibility and discipline (Desquilbert & Nenovsky, 2005; Raybaut & Torre, 2005).

Since the currency board was introduced after a severe economic crisis, the general population and the elites alike readily accepted the new system, which quickly became a major *cognitive* model that shaped the conceptualization of the role of money in the economy. Moreover, the Bulgarian currency board, which subsequently survived the Russian and East Asian financial crises as well as the collapse of the currency board in Argentina, became the leading anchor.[3] This anchor helped Bulgaria break out of a critical stalemate in which corruption and criminal activity had flourished, and steered the economy towards a decade of prosperity and a successful EU accession. Despite some initial doubts regarding the economic and legal compatibility of the currency board with Bulgaria's EU membership, the EU decided in favor under the condition that the board remains a unilateral responsibility of the country operating it. Although the benefits of the currency board in Bulgaria during the current economic crisis are debatable, the general public continues to regard the board as a major institutionally-proven anchor, despite the fact that the social memory of the 1996-97 crisis has been fading with time (Mudd et al., 2010).

Unlike Bulgaria, Romania has never given up its discretionary monetary policy, and its central bank has always held the full range of traditional policy tools. Even after currency boards became popular and Bulgaria adopted one, Romania never hesitated to continue its path of active monetary policy and exchange rate management. Romania too experienced an economic crisis in 1996, which, although not as severe as the one in Bulgaria, also brought reformist center-right parties to power (as was the case in Bulgaria in June 1997). In 2005, Romania joined the group of countries from Central Europe (Poland, the Czech Republic and Hungary) by introducing flexible inflation targeting (Isarescu, 2003). Inflation targeting implies a floating exchange rate because it is difficult for a central bank to simultaneously employ two anchors, in this case a nominal exchange rate and an inflation target. However, the National Bank of Romania (NBR) initially did not abandon exchange rate management after introducing the new monetary regime, as evidenced by foreign exchange market interventions (Frommel & Shobert, 2006). Governor Mugur Isarescu even speaks of cultural conditions for the adoption of inflation targeting. After it became clear that Romania would not be bypassed by the latest economic crisis, NBR started reducing interest rates (a 4% cumulative reduction since the beginning of 2009) and the statutory reserves, pursuing a policy of monetary easing (IMF, 2010). The decision to increase the value-added tax by 5 % (despite a 25% reduction in public sector wages and a 15% reduction of social transfers) led to an automatic surge in inflation in mid-2010, reaching 7-8% by the end of the year. As a result, the inflation target, which had been set at 3.5% $\pm$ 1, was breached, compelling NBR to halt the monetary easing (IMF, 2010).

The active monetary and exchange rate policies played a major role not only as a policy tool of NBR, but also in the research of Romanian economists (Dimitru, 2003; Pelinescu & Cariani, 2006; Dumiter, 2009; Zaman & Georgescu, 2010). Besides the research conducted at NBR, which for institutional reasons supports and promotes the benefits of discretionary monetary policy and inflation targeting, there is a quasi-monopoly of theoretical and empirical publications in Romania which eulogize this type of policy. The criticism is saved for particular decisions or technical details of conducting the policy. The opponents of discretionary monetary policy are a small minority. Whenever a currency board arrangement is mentioned, it is strongly criticized and often ridiculed as a primitive system employed in underdeveloped nations incapable of managing their own affairs.[4]

Thus, both in Romania and in Bulgaria, two dominating models of conducting monetary policy and of conceptualizing money and money management emerged. In Bulgaria, this philosophy has been passive, extremely conservative, and externally delegated. In Romania, it has been active, discretionary, and empirical, relying on a range of statistically derived policy targets. The publications of Bulgarian and Romanian economists also have their focus on different areas. While most Bulgarian economists shy away from employing complex models in their research, their Romanian counterparts have published numerous studies on the complex and multiple relations involved in active monetary policy.

Origins and implications of the monetary regimes

The different paths that Bulgaria and Romania took after 1997 call for an investigation of the origins of the two monetary regimes as well as their economic performance, particularly in the context of EU accession and the recent global economic crisis.

The immediate trigger for the adoption of a currency board in Bulgaria was the deep financial and economic crisis of 1996-97, while a less severe crisis in Romania did not alter the discretionary monetary policy of the country. However, in order to gain a better understanding, we need to investigate the economic conditions in the years leading up to the breakdown of the Communist regimes in the late 1980s and the initial period of transition to a market economy in the early 1990s because these conditions also contributed to the diverging policy choices of the two countries (for extensive discussion see Petrovic, 2008). In the 1980s, the two Balkan neighbors had centrally administered economies managed by Communist parties. Once the two regimes fell in late 1989, a painful transition began which saw a dramatic drop in output and hyperinflation in the early 1990s. But these general trends mask important differences between Bulgaria and Romania.

The major macroeconomic variables in Table 1 show that Romania's economy is more than three times larger than Bulgaria's. Gross domestic product (GDP) per capita was higher in Romania, but it was already on the decline during the second half of the 1980s and continued to fall in the 1990s, converging towards the level of its neighbor. Bulgaria's GDP per capita increased in the late 1980s, but, by 1995, it had fallen to its level in 1985. Similarly, economic growth in Romania was negative since the mid1980s and recovered only in the mid 1990s. In contrast, Bulgaria's economy recorded positive growth until the start of the transition in 1990, followed by several years of dramatic decline. Inflation was relatively low in Bulgaria and Romania when prices were still fixed by the government, but, after the price liberalization in

1990, both countries saw inflation reach more than 200%. In the wake of the 1996 crisis, Bulgaria's inflation was much higher than Romania's. Furthermore, trade, especially within the Council for Mutual Economic Assistance (COMECON), played a much more significant role in Bulgaria as compared to Romania's relatively closed economy (see for more Slim, 1997). Lastly, in the early 1990s Romania proved considerably more attractive for FDI than its neighbor.

Another crucial difference between the two countries was the accumulation of foreign debt. Bulgaria's foreign debt has been increasing since 1985 and had almost tripled by the start of the transition (Figure 1a). The current account deficit in 1985 was close to 80% of GDP as the Communist regime was borrowing heavily abroad to finance domestic consumption. The upward trend of foreign debt accumulation was reversed only in 1994. The Communist regime in Romania adopted a very different strategy. In 1972, Romania became the first country from the Communist bloc to join the IMF (Bulgaria followed suit only in 1990). Consequently, Romania borrowed extensively in the West, causing its foreign debt to triple in the late 1970s. In 1982, Romania's Communist leader, Nicolae Ceausescu, vowed to repay the foreign debt in order to eliminate the dependence on the IMF. For this purpose, severe austerity measures were introduced, restricting consumption, imposing food rationing, and reducing imports, which were largely responsible for the negative growth rate and the negative income elasticity of imports during the 1980s (see Table 1). While these policies created hardships and contributed to Ceausescu's downfall, they also allowed Romania to begin the transitional period with almost no foreign debt at a time when Bulgaria's debt level was almost $12 billion and rising. The Romanian governments of the early transitional period began accumulating foreign debt but, by the start of the crisis in 1996, it was still significantly lower than Bulgaria's, especially if one takes into account the larger size of Romania's economy (Figure 1a).

The high level of foreign debt imposed a heavy financial burden on Bulgaria. The government teetered on the verge of default as external debt service increased from 3% of GDP in 1993 to more than 14% in 1996 (Figure 1b). As a result, foreign reserves declined rapidly, the exchange rate experienced a dramatic depreciation, and inflation soared to levels exceeding 1000% in 1997 (Figures 1c-1e). Romania's external debt service spiked in 1996, but its foreign reserves rose, while in Bulgaria they were declining. Neither the increase in inflation nor the depreciation of the exchange rate was nearly as dramatic as in Bulgaria. Accordingly, the economic crisis in Bulgaria, which was coupled with a collapse of the banking system and triggered a political crisis, called for radical change to restore macroeconomic stability, while the Romanian government did not see any immediate need to change its existing monetary regime and discretionary monetary policy.

The adoption of the currency board arrangement led to fundamental changes in Bulgaria's economy, redefined the role of government policies, and shifted economic activity as well as the risks associated with it in a different direction than in Romania. As a discipline-inducing and conservative mechanism, the currency board not only fixed the exchange rate and imposed drastic restrictions on monetary policy but also curtailed deficit spending that could destabilize the new arrangement. Since 1997, the government budget has been mostly in surplus until the global economic crisis hit Bulgaria in 2009 (Figure 2a).

The constraints imposed on public finances and monetary policy in Bulgaria had a profound effect on the private sector, which expanded as state-owned enterprises were privatized or shut down in the late 1990s and early 2000s. At the same time, the currency board forced the private sector to adjust to the hard budget constraint and restructure in order for it to remain competitive in an open economy. As a result, increases in hourly labor costs have been relatively moderate (Figure 2b). More importantly, the restrictions on public finances led to a shift from public to private debt. While the government was running budget surpluses and was paying off its external debt, private borrowing soared, leading to a rapid increase in private external debt, especially over the 2000s (Figure 2c and 2e). The currency board reduced the foreign exchange risk and the sovereign risk and lowered the interest rates levels to those abroad, allowing the private sector to borrow at low cost but also exposing the economy to external shocks.

In Romania, the economic situation was the *opposite* of the Bulgarian case. Public finances were not subject to any formal institutional restrictions, and NBR was free to use discretionary monetary policy. Accordingly, the government was running permanent budget deficits, which became unsustainable during the global economic crisis and forced Romania to seek help from the IMF (Figure 2a). The lack of fiscal discipline, coupled with the fact that Romania's economy is less open than Bulgaria's, led to a rapid increase in hourly labor costs (Figure 2b). Furthermore, as borrowing was concentrated in the public sector, credit to the private sector and private external debt were only a fraction of the corresponding levels in Bulgaria (Figure 2c and 2f).

In addition to the monetary regimes, the EU accession provided a second anchor for the two Balkan economies. However, while EU membership offered numerous advantages, it also had a dichotomous interaction with the monetary regimes. This led to a completely new situation of institutional interaction between the two anchors to determine their complementarity or not. This relationship between the two anchors can be analyzed within the theoretical framework of an insurance game model (Dooley, 1997, 2000) or simply as moral hazard dynamics.[5] In particular, the years after the divergence of monetary regimes in Bulgaria and Romania can be divided into two periods.

The first period started in the late 1990s with the opening of accession negotiations with the EU. At this point in time, it became clear that the two countries would be joining the EU in the future after fulfilling certain conditions. The prospects of EU membership, which required the implementation of crucial economic and institutional reforms, boosted the fiscal discipline and monetary stability maintained by the monetary regimes in Bulgaria and Romania. All efforts of policy makers, with the support of the general public, were focused on complying with the requirements for EU accession. As a result, in the late 1990s and especially the early 2000s, government debt in both countries decreased rapidly (Figures 3a, b), while the budget deficit in Romania was slashed from more than 4% of GDP to almost 1% (Figure 2a).

During this initial period, the disciplining effect of the monetary regime (especially the currency board in Bulgaria) was enhanced by the credibility effect from the prospects of EU accession. A major reason for this complementarity between the two anchors was the fact that, at that time the EU had not yet provided any financial guarantees or committed any major funds to the two candidate countries. This changed profoundly in 2004 when Bulgaria and Romania completed the negotiations and were promised full EU membership by 2007. Moreover, in 2004 the EU pledged funding in the amount of 15 billion euro for both countries in the years 2007-2009 in addition to pre-accession funds that have been provided since 1999 (Vincelette & Vassileva, 2006).

The onset of this second period of the insurance game coincided with the fact that, in 2004, the foreign reserves of the Bulgarian and Romanian governments exceeded their foreign liabilities for the first time since the start of the transition (Figures 3a,b). The positive difference between reserves and liabilities could be viewed as collateral, offering free insurance for private sector liabilities (Dooley, 2000). This led to large capital inflows and an increase in the banking sector liabilities. At this point, the EU anchor, which had been enhancing the monetary anchor in the first period, began to weaken and contradict the disciplining effect of the monetary regime. EU membership and financial commitments to Bulgaria and Romania were perceived as an implicit guarantee against sovereign risk (dubbed the "EU halo effect"), evidenced by the decline in the yields on sovereign bonds to levels unwarranted by fundamentals and global liquidity conditions (Luengnaruemitchai & Schadler, 2007). The credibility effect provided initially by the EU anchor now turned into a perceived soft budget constraint that contradicted the goals of fiscal discipline and monetary stability and increased macroeconomic vulnerabilities in Bulgaria and Romania.

Given the constraints on fiscal and monetary policy imposed by a currency board, the large capital inflows in Bulgaria translated into a rapid and dramatic rise in external private liabilities (Figure 2c) and since 2008 in non-performing loans (Figure 2d). In response, BNB raised the reserve requirements for banks and imposed restrictions on lending in 2005. While private sector debt and non-performing loans in Romania increased as well (Figures 2c,d,f), the weakening of the monetary anchor became especially evident in the area of public finances due to the discretionary monetary regime. The government budget deficit, which had been decreasing for several consecutive years, reversed its course in 2005 (Figure 2a). In the same year, NBR introduced inflation targeting in an attempt to prevent the overheating of the economy and slow down capital inflows.

When the global financial crisis hit the Balkan economies in late 2008 and early 2009, the differences between the two monetary regimes became apparent again. In Romania, the worsening condition of public finances forced the country to seek financial support from the IMF in an attempt to provide a fiscal stimulus during the downturn. In contrast, Bulgaria implemented drastic austerity measures to safeguard the currency board arrangement but incurred budget deficits that were larger than usual. Moreover, the fact that the banking sector in Bulgaria was almost entirely controlled by large banks from EU countries ensured that the growing share of non-performing loans was absorbed without destabilizing the financial system.[6]

Historical parallels (1925-1940)

A comparative analysis of the economic and financial policies in Bulgaria and Romania in the 1920s and 1930s reveals striking similarities with the diverging monetary regimes that the two countries adopted in the late 1990s. More importantly, even though they may be coincidental, these historical parallels could also indicate a recurring pattern of preferences for specific monetary policies in the two countries (for extensive discussion and statistical information consult Pasvolsky, 1928, 1930 and Royal Institute for International Affairs, 1936).

For political and geostrategic reasons, Bulgaria and Romania found themselves on opposite sides in World War I, which had important implications for their choice of economic and financial policies. Being on the losing side of the war, Bulgaria was forced to make large reparation payments and cede parts of its territory. Romania annexed part of Northeastern Bulgaria and claimed about 10% of the total reparation liabilities of its neighbor. As a result, Bulgaria's foreign reserves were quickly depleted, and the country was confronted with large budget deficits and an onerous external debt, which was denominated in gold-backed Bulgarian leva and was mostly owed to non-devaluing countries. Even before reparation payments began in 1923, foreign debt service had reached the amount of 112 million gold francs between 1918 and 1922, which represented about 16% of budgetary spending. The additional reparations imposed by the Treaty of Neuilly amounted to 2.3 billion gold francs at an annual interest of 5% over 37 years, without counting the occupation expenses. This was equivalent to a quarter of Bulgaria's national wealth at the time.

Following the general trend of a return to the pre-war gold standard, Bulgaria carried out financial and monetary stabilization in 1924 (de jure in 1926/28). In particular, a new fixed exchange rate between the Bulgarian lev and the US dollar was established, whereby loans provided under the auspices of the newly established League of Nations supplied the foreign reserves needed to cover the currency in circulation. The government balanced the budget through spending cuts, while BNB conducted deflationary policies via increases in the discount rate.

Overall, these measures did not differ in principle or in practice from the ones that other countries adopted. The distinctive feature of Bulgaria's economic and financial policies was the orthodox adherence to the principles of the gold standard, which involved fiscal discipline and a strict and almost self-sacrificial servicing of the large external obligations. Despite the incessant complaints by political leaders and economists about the unfairly high level of reparation liabilities, the country continued to service its external debt, becoming in the words of then prime minister Andrey Lyapchev an "exemplary payer of its foreign creditors" (Nenovsky, 2010a).

Due to Bulgaria's political isolation after World War I, however, the diligent debt repayment was not rewarded, and the country had to shoulder its liabilities with almost no relief (Ivanov, 2001). A sharp drop of up to 70% in the prices of agricultural products on world markets made matters worse as Bulgaria was a major agricultural producer and exporter (Bonnet, 1933). The Stresa Conference in 1932 discussed possible assistance to Central and Eastern

European countries, which formed the so-called “Agrarian Bloc,” but the proposal to use revenue from the sale of agricultural products to service foreign debt was rejected by Western creditors. Although the heavy burden of servicing the debt called for new loan agreements and led to frequent political crises, Bulgaria was among the few countries that never defaulted on its obligations.

Moreover, Bulgaria is a rare example of a country that never abandoned (formally) the fixed exchange rate associated with the gold standard. By maintaining the currency on a gold basis, the government tried to avoid increases in the cost of foreign debt service (Royal Institute of International Affairs, 1936, p. 129). In fact, the devaluation of the British sterling in the 1930s offered some relief for Bulgaria, as part of the external debt was denominated in sterling. Furthermore, Bulgaria, like most other countries at the time, introduced exchange controls in 1931, but, unlike other nations, it never devalued its currency because it would have certainly increased its debt burden.[7] It is often argued that exchange controls are a de facto abandoning of one of the basic principles of the gold standard, namely the free movement of gold and foreign currency (Wandschneider, 2008). However, this measure could also be interpreted as a temporary safeguard of the gold standard in response to the devaluation of the British pound and of the other currencies that followed suit. The controls protected Bulgaria’s gold reserves and facilitated the servicing of the external debt. In addition, exchange controls served as defense against restrictions introduced by Bulgaria’s trading partners. For instance, Germany, France, and neighboring Turkey imposed protectionist measures on agricultural goods, which constituted a major part of Bulgarian exports (Raupach, 1969). After neighboring Greece devalued its currency in 1932, Bulgarian exporters lost their competitive advantage on the Greek market.

Being on the winning side of the war, Romania received reparation payments from Bulgaria and was, thus, initially not burdened by large external debt obligations. As a result, its monetary and financial stabilization was implemented at a much slower pace and with greater difficulties than in Bulgaria. In particular, Romanian economists were more indecisive in their support for monetary stabilization and much more inclined to use foreign loans to stimulate domestic development and demand rather than to service their external obligations (Madgearu, 1939; Muresan & Muresan, 2003; Blejan et al., 2008, 2009, 2010).

The Romanian leu was fixed to the US dollar only in 1929, but already in 1932 the government imposed foreign exchange controls, leaving the fixed exchange rate as the only legacy of the gold standard. In contrast to Bulgaria, the exchange controls in Romania soon led to fluctuations of the exchange rate within a band of between 5% and 15% and a black market emerged. Following the devaluation of the French franc in 1936, the Romanian government de facto devalued the leu by revaluing the gold reserves, as virtually all foreign reserves were in gold. As a result, the leu lost between 28% (League of Nations, 1938, p. 51) and 38% (Blejan et al., 2009) of its value.

French economists and bankers played an important role in promoting monetary stability by retaining the fixed exchange rate. For instance, amid tough negotiations, Christian Rist, head of the monetary mission to Bucharest, insisted that the Romanian government should use a loan obtained in 1931 and carrying an annual interest rate of 7.5% for stabilization purposes. Romanian economists were planning to use the loan to fund government spending, including the extension of the railway network (Costache et al., 2009). This case illustrates how Romanian economists and policy makers were primarily concerned with the development of industry and the real economy and were not convinced of the necessity and efficacy of monetary stability or of the need to service foreign loans. This is further supported by the fact that Romania defaulted on its debt in 1933.

Moreover, Romanian economists, in contrast to their Bulgarian colleagues, focused their attention to a greater degree on corporatist and protectionist theories. For instance, Mihail Manoilescu (1891-1950), a prominent economist and NBR governor for a brief time, formulated an original protectionist theory which favored industrialization in developing agrarian societies combined with protectionist measures and reliance on domestic demand rather than exports (Bobulescu, 2003). First published in French in 1929, Manoilescu’s book was quickly translated into several languages. Although Manoilescu became renowned in Bulgaria and visited the country in 1933, Bulgarian economists were slow in embracing his views that were critical of the classical political economy. Bulgarian economic community remains relatively more close to classical principle of domestic policy and international trade that Romanian one (Nenovsky, 2010a).

The unconditional belief in the currency board arrangement, the obsession with balanced budgets, and the severe restrictions on monetary policy in Bulgaria of the late 1990s and 2000s are strikingly similar to the orthodox and sometime even fanatical adherence to the gold standard, the strict fiscal discipline, the diligent servicing of the foreign debt, and the aversion towards protectionism and active money management in Bulgaria of the 1920s and 1930s. In contrast, Romania’s discretionary monetary policy, flexible exchange rate, and budget deficits in the last decade are reminiscent of the slow monetary stabilization, the tendency to use foreign loans to stimulate domestic industrialization, and the devaluation in the late 1920s and 1930s.

Conclusion

At first glance, the economies of Bulgaria and Romania have followed similar patterns of development with only minor deviations. This paper argues that, in reality, fundamental differences between the two economies have emerged over the last 10 to 15 years as a result of a strategic choice of institutional arrangements in the late 1990s.

In particular, we focus on the choice of monetary regimes in the aftermath of the 1996-97 economic crises, which set Bulgaria and Romania on completely different trajectories. Bulgaria opted for a currency board arrangement that effectively eliminated the country's monetary autonomy, while Romania chose discretionary monetary policy and inflation targeting. This difference was determined by the initial conditions of the two economies, particularly with regard to their external debt. Bulgaria accumulated a large debt in the late 1980s and early 1990s whereas Romania began the transition with virtually no external liabilities. Furthermore, our paper shows that the monetary regimes had profound implications for the entire economic system and policies of the two countries. With its monetary and fiscal policies restricted, Bulgaria's economic activity shifted towards the private sector, making it the focal point of economic shocks and response mechanisms. In contrast, the discretionary policies in Romania turned the government and public finances into both a contributing factor and a response mechanism to imbalances. Accession to the EU, coupled with global excess liquidity in the late 2000s, amplified these differences by channeling moral hazard into the private sector in Bulgaria and the public sector in Romania. Accordingly, when the recent global economic crisis reached the Balkans, Bulgaria exhibited strong growth in private debt while Romania was compelled to seek financial help from the IMF as public finances deteriorated rapidly.

The differing monetary regimes also shaped the perceptions of economists and politicians in the two countries. In Bulgaria, the eulogy of static monetary regimes of the past prevailed and any form of activism was denied whereas in Romania economists vied with each other in designing economic models and describing the complex mechanisms of inflation targeting and monetary policy. Lastly, we show that institutional and policy differences between the two countries have a historical dimension as well. In the 1920s and 1930s, Bulgaria adhered strictly to the gold standard while the monetary and exchange rate stabilization was significantly more protracted in Romania.

Notes

1. In fact, the EU enlargement was based on the idea that accession candidates would compete with each other in fulfilling the membership criteria, thereby creating incentives for development, discipline, and reforms.

2. For details, see Dobrinsky (2000), Nenovsky and Rizopoulos (2003), Berlemann and Nenovsky (2004), and Vucheva (2005). For the period after the introduction of the currency board, see Minea and Rault (2009).

3. An anchor has a range of functionalities, the main one being that it makes it possible to coordinate the expectations in a given direction and improves predictability and cooperation as a whole (Ialnazov, 2003).

4. One of the authors of this paper worked at the central bank over a longer period of time (1996-2008), and remembers well the contrasting views held by Bulgarian and Romanian economists. Bulgarian economists argued that under a currency board everything was simple and automatic eliminating the need for any intervention, while their Romanian colleagues used elaborate graphs to show the complexity of relations between variables, adding that these were nevertheless controllable and manageable.

5. The insurance model of Dooley (1997, 2000) has been applied to the East Asian and Latin American financial crises (Chinn et al., 1999). Nenovsky (2010) expanded the model to explain the effect of EU enlargement on monetary regimes in Eastern Europe.

6. The European Bank Coordination Initiative of 2009 also contributed to financial stability by ensuring that EU-based parent banks with subsidiaries in Central and Eastern Europe committed to keep their capital exposure in the region constant at the 2008 levels.

7. As of 1938, Bulgaria was the only Balkan country that did not formally devalue its currency. The other countries that imposed exchange controls without devaluation were Germany, Poland, and Hungary (League of Nations, 1938).

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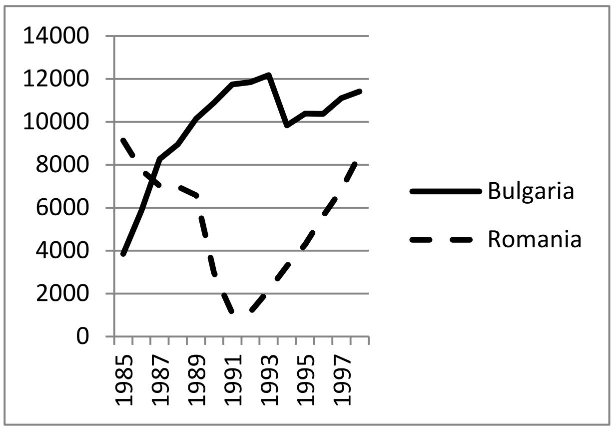
Table 1: Economic indicators for Bulgaria and Romania before the 1996-97 crisis

	Bulgaria			Romania		
	1985	1990	1995	1985	1990	1995
GDP (in billion constant 2000 US$)	13.5	14.6	12.8	48.2	44.0	39.5
GDP per capita (constant 2000 US$)	1512	1671	1519	2120	1896	1742
GDP growth rate (%)	2.68	-9.12	2.86	-0.10	-5.60	7.16
Inflation (%)	0.23	26.18	62.38	0.27	13.60	35.25
Trade (% of GDP)	539	125	84	-	35	43
FDI (% of GDP)	-	0.02	0.69	-	0.00	1.18
Income elasticity of imports[a]						
COMECON	1.94	2.61	-7.86	-10.66	1.00	3.56
Developed countries	3.47	-1.78	-0.19	-	-5.83	5.57

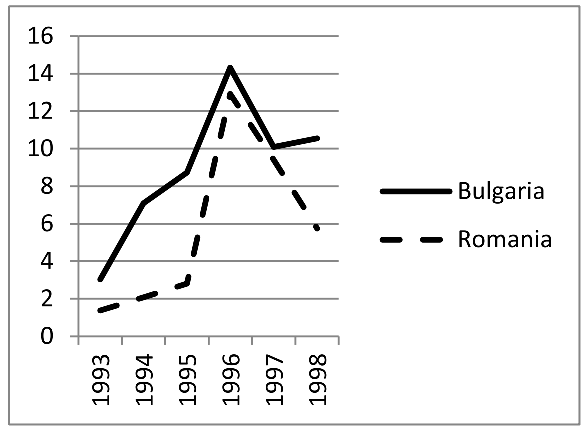
Source: World Development Indicators. [a] as reported in Slim (1997) for the periods 1984-86, 1990-92, and 1993-95, respectively.

Figure 1: Origins of the monetary regimes in Bulgaria and Romania (1985-1998)

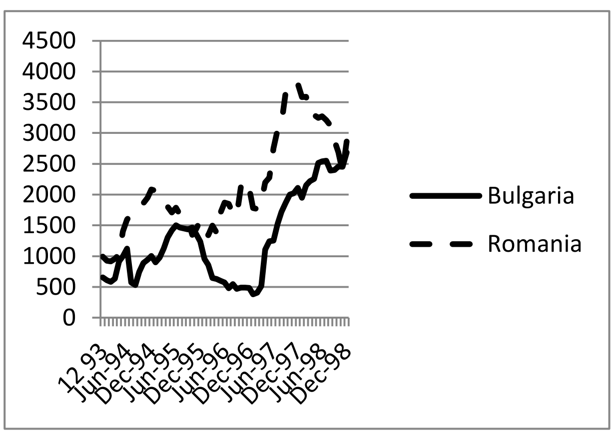
(a) External debt (in millions of current US$)



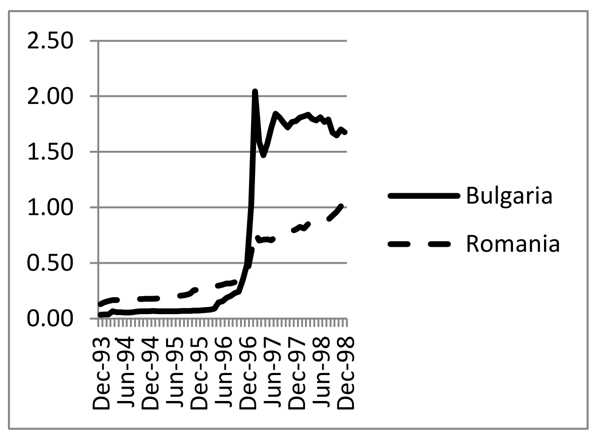
(b) Debt service on external debt (% of GDP)



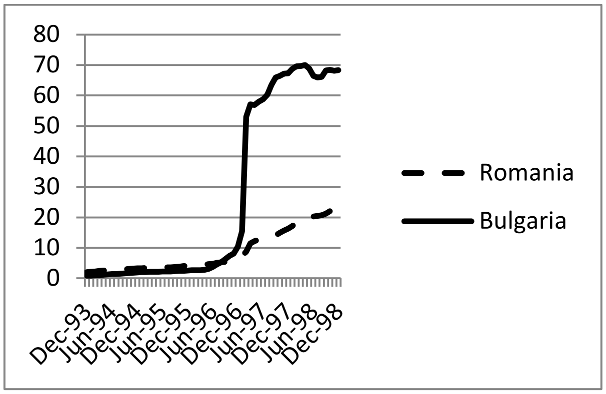
(c) Foreign reserves (in millions of current US$)



(d) Exchange rate (currency units per US$)



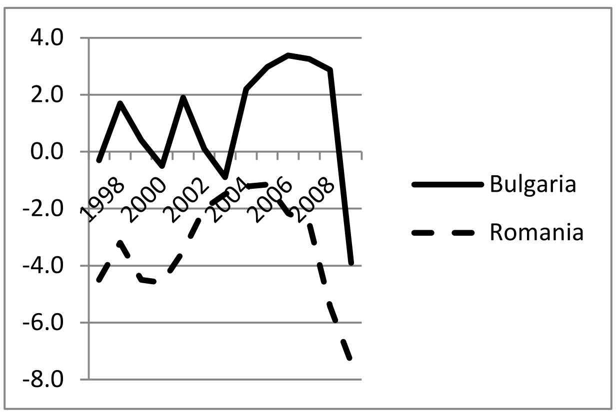
(e) Consumer Price Index (2005=100)



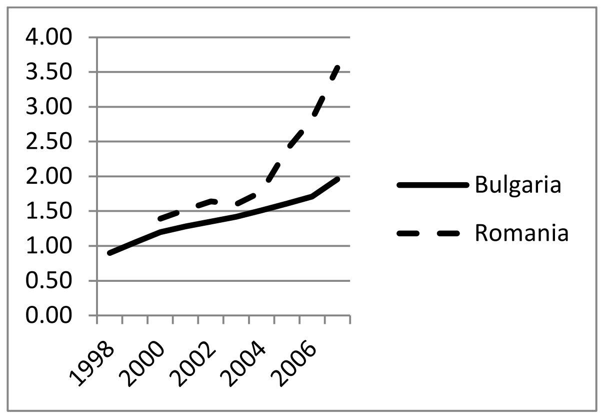
Source: International Financial Statistics; World Development Indicators

Figure 2: Impact of the monetary regimes after 1997

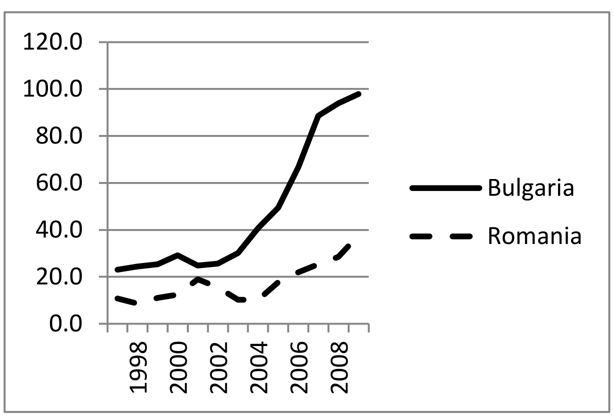
(a) Government budget balance (% of GDP)



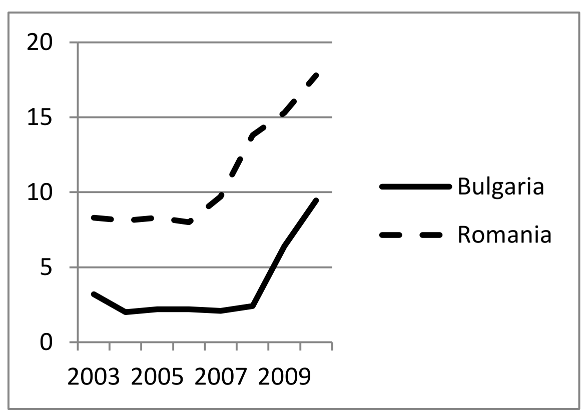
(b) Hourly labor costs (in euros)



(c) External private debt (% of GDP)

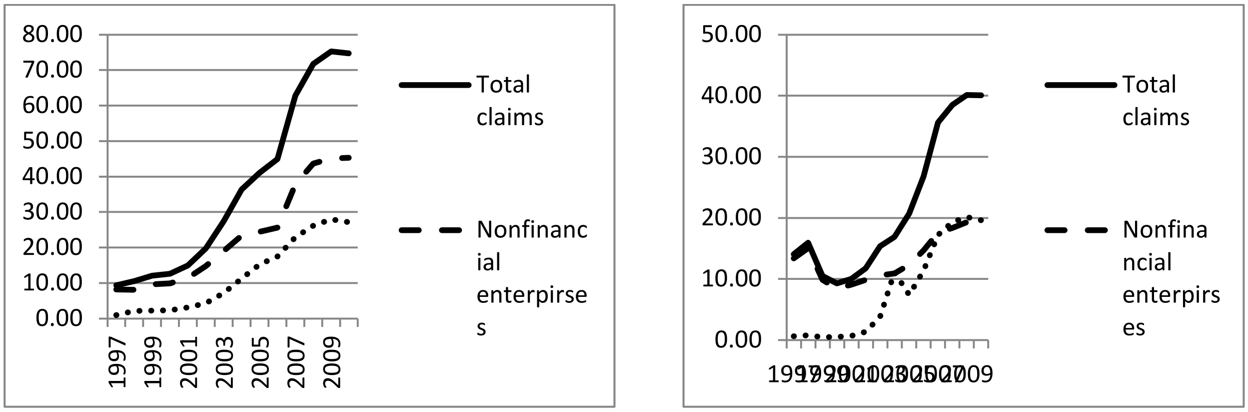


(d) Non-performing loans (% of total gross loans)



(e) Domestic credit to private sector in Bulgaria (% of GDP)

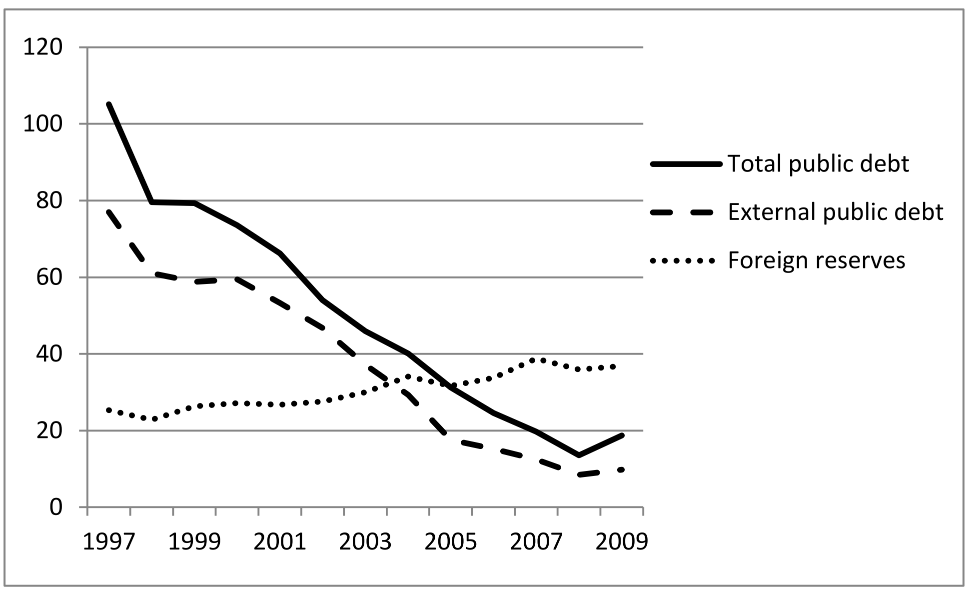
(f) Domestic credit to private sector in Romania (% of GDP)



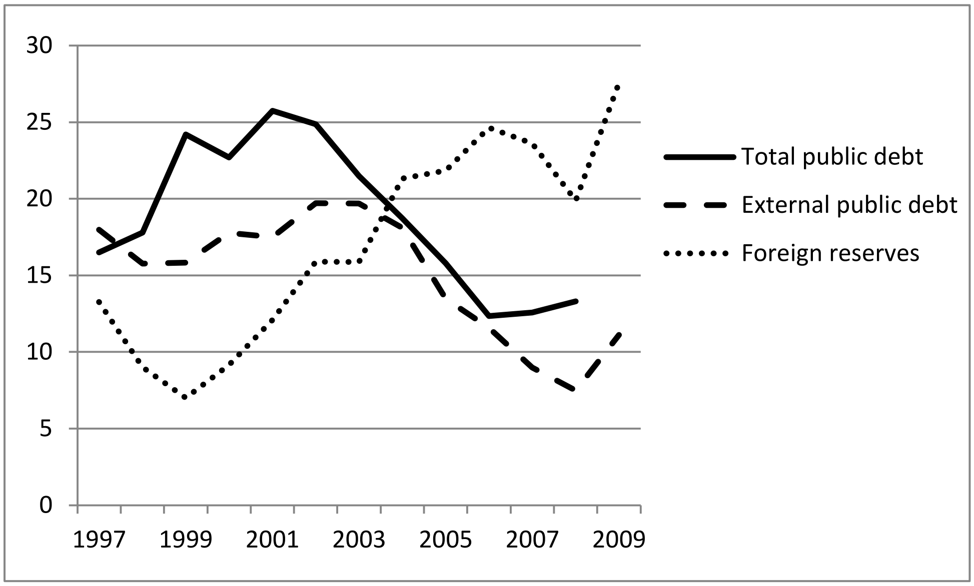
Source: Bulgarian National Bank; National Bank of Romania

Figure 3: Public debt and foreign reserves (% of GDP)

(a) Bulgaria



(b) Romania



Source: International Financial Statistics