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Merkel's Right, Greece Should Act Like Bulgaria

By Ilian Scarlatov - Jul 23, 2012

Earlier this month, German Chancellor Angela Merkel cited Bulgaria as an exemplar of fiscal virtue in its response to the financial crisis.

It isn't every day that Bulgaria, still the poorest country in the European Union, is held up as a role model. The only way to understand Merkel's praise was as a parable for her belief that countries that spend more than they earn have to go through a period of harsh austerity if they are to grow sustainably.

To Bulgarians, if not their Greek neighbors, whom Merkel presumably had in mind as Bulgaria's pupils, the thinking makes sense.

Greeks and Bulgarians had a lot in common until relatively recently. Both spent centuries under Ottoman rule; both fought for their independence and became poor backwaters of Europe. Their paths began to diverge only after World War II, when Bulgaria was folded into the Soviet bloc and Greece remained part of Western Europe. Once Greece joined the EU -- then called the European Economic Community -- in 1981, it was showered with money, as the communists next door stagnated.

Then, in 1989, the Soviet bloc collapsed. A new Bulgarian democracy was born, but with no money in the state treasury to pay for it. The nation's savings were insignificant, shops were empty, unemployment was high and infrastructure was rudimentary. Austerity was just a fact of life.

Wiped Out

After seven years of delayed reforms, booming private businesses and an almost complete lack of regulation, hyperinflation came to Bulgaria in 1996 and again wiped out the nation's savings, forcing the closure of a third of the country's banks. As a result, the lev -- Bulgaria's currency -- was pegged to the deutsche mark (later to the euro), and the central bank was banned from lending to commercial banks, a precaution that remains in place today. The International Monetary Fund requires that all Bulgarian currency in circulation should be fully matched by foreign-exchange reserves.

The decade of 1989-1999 was harsh, but it turned Bulgaria into a disciplined nation of savers -- even after the country joined the EU in 2007. The banking sector is financed by these savings accounts, which provide a healthy Tier 1 capital- adequacy ratio of 15.8 percent. Credit-card penetration is extremely low -- Bulgarians prefer cash.

Being poor is no fun, of course. Public-sector employees are badly paid and retired people struggle to survive with their low pensions. Not a single motorway has been completed to link one end of Bulgaria with another and only parts of the subway in the capital, Sofia, work. This is the price to pay for not spending money that isn't yours to improve your lot, at the level of the state and of the individual consumer.

But today Bulgaria has positive economic growth and the second-lowest state debt in the EU (after Estonia) at 16 percent of gross domestic product. It also has a manageable budget deficit of about 2 percent of GDP, despite levying a flat corporate and personal income tax of just 10 percent. Foreign-exchange reserves amount to 6 percent of GDP. In short, the country has a future.

Greeks, by contrast, have been spending more than they earn for the last 20 years. Once an employee entered the public sector, he couldn't be laid off; he received 40 days' vacation per year; and he was paid 14 months out of 12, with guaranteed annual raises. Greeks are richer as a result, but that lifestyle is not sustainable. Debt to GDP is 165 percent and the budget deficit is an unmanageable 9.1 percent.

Overpriced Pies

After the euro was adopted in 2001, the Greek government failed to control retail prices, which tripled. A traditional "tiropita," or cheese pie, used to cost 30 euro cents in Athens back in 2001 -- by 2006, it cost 3 euros. How could this be possible? In how many places on the planet did a commodity rise in value by 10 times in this period? Rather than attempt to control prices, though, the government focused on trying to boost salaries -- and that meant increased borrowing.

Excessive leverage was also used for infrastructure projects. Greece's highways are impeccable; its ports and the Athens subway are state of the art -- better than Germany's. Athens was transformed for the Olympic Games in 2004. Estimates of the overall cost of that event range from 6 billion euros ($7.2 billion) to 27 billion euros. It's obvious to any macroeconomist that infrastructure on such a grand scale does not square with Greece's roughly $300 billion GDP. Most of the money was borrowed and, as Merkel knows, payday always comes in the end.

Bulgaria's example is the only way forward for Greece. It does mean becoming poorer for now, but unlike Bulgaria in the 1990s, Greece has infrastructure and savings -- an estimated 600 billion euros stashed abroad alone -- to make the process easier. Austerity should make the Greek government and the nation more disciplined in their spending habits.

Europe may have mishandled the financial crisis, but for the past three years Greeks have tried to blame others for the state of their own economy. Unless they recognize the mistakes they made on their own, their future path of development will never be sustainable.

Either those tasty cheese pies need to sell for 30 cents again on the streets of Athens, or the country will have to leave the euro area.

(Ilian Scarlatov is the founder and general manager of KBC Securities in Bulgaria. The opinions expressed are his own.)

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