

MONEY MATTERS: THE POWER OF BANKING STRUCTURES AND CREDIT IN ECONOMIC GROWTH



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List of Abbreviations

ABS – Asset-backed securities
BAS – Bulgarian Academy of Sciences
BBB – British Business Bank
BCC – Bank Consolidation Company
BDB – Bulgarian Development Bank
BNB – Bulgarian National Bank
CEE – Central and Eastern European
COMECON - Council for Mutual Economic Assistance
DSGE – Dynamic Stochastic General Equilibrium
EBA – European Banking Authority
EC – European Commission
ECB – European Central Bank
EU – European Union
FGN – Finance – growth nexus
GFC – Global Financial Crisis
HQs - Headquarters
ICFC – Industrial and Commercial Finance Corporation
IMF – International Monetary Fund
KfW - Kreditanstalt für Wiederaufbau
LCB – Local community banks
MBBG – Major British Banking Groups
MENA – Middle East and North Africa
MSME – Micro-, small-, and medium-sized enterprises
PDB – Public development banks
QE – Quantitative Easing
QT – Quantitative Tightening
QTC – Quantity Theory of Credit
QTDC – Quantity Theory of Disaggregated Credit
QTM – Quantity Theory of Money
RCB – Rural commercial banks
SB – Saving's banks
SHVB – Shareholder Value Banks
SMB – small- and medium businesses
SOE – State-Owned Enterprises
TBTF – Too-big-to-fail
TBTF – Too-big-to-fail
UBB – United Bulgarian Bank
UK – United Kingdom
USA - United States of America
VC – Vicker's Commission
WB – World Bank

To my son Ivan Alexander and all children of Bulgaria and beyond for a happier, safer,
healthier society in which they can grow and develop as humans.

Book Introduction & Reviews by Colleagues

The finance-economic growth nexus (FGN) explores the dynamic relationship between financial development and economic performance, a subject that has long fascinated economists and policymakers. This work aims to deepen the understanding of this nexus by examining how different banking structures - public, private, and local - impact credit allocation and economic growth. By focussing on the distinct financial systems of Britain, Germany, and Bulgaria, the work highlights how institutional diversity shapes the flow of credit, especially to micro, small, and medium-sized enterprises (MSMEs) - the critical drivers of innovation, competition, and job creation. The richness of the comparative analysis enriches existing theoretical debates by integrating the often-overlooked role of development finance and localised banking institutions within broader economic growth frameworks.

The work thoroughly investigates the structural and institutional characteristics of national banking systems and their impact on economic development, particularly in the context of financial deepening, the diversity of banking ecosystems, and the spatial proximity between creditors and borrowers. When comparing the centralised banking models of the United Kingdom and Bulgaria with the decentralised, stakeholder-oriented model of Germany, the research helps identifying how banking system architecture affects credit creation, support for MSMEs, and broader macroeconomic outcomes. For economists, this work offers a rigorous yet accessible exploration of how banking systems influence capital accumulation, technological innovation, and risk management, thereby affecting economic outcomes.

Fundamentally, the work also contributes to empirical and historical perspectives on the critical role of public and community banks, emphasising their potential to push sustainable growth by channeling credit toward productive investments rather than speculative activities. For general readers interested in economics, the use of real-world examples from advanced and emerging European economies illustrates the practical implications of banking policies on national prosperity and economic stability. Therefore, to a great extent, this work underscores the necessity of tailoring financial systems and credit practices to local contexts to support inclusive and resilient economic development.

Readers will benefit from the study highlighting the risks posed by misdirected credit - such as speculative lending and consumption-driven financing; these can lead to asset bubbles, inflation, and systemic financial instability, as seen in historical and contemporary crises. By revisiting lessons from diverse banking traditions and economic experiences, the research provides valuable policy insights into how banks and regulators can better align lending practices with long-term productive growth. This focus on sustainable finance is especially relevant in today's global economy, where balancing innovation, stability, and inclusion remains a central challenge. With a reader-friendly approach that blends theory, empirical evidence, and practical examples, the work offers a timely contribution to ongoing discussions on financial system reform and economic development strategy.

Dr Rick Boidurjo, Senior Lecturer and MBA Director, Middlesex University, London, United Kingdom.

“This is a powerful work of monetary scholarship and applied political economy. With clarity and empirical depth, Dr Ivanov shows that who creates credit, for what purpose, and at what scale determines growth, stability, and regional prosperity. He moves beyond abstractions to compare concrete banking architectures in Bulgaria, Germany, and the United Kingdom, illuminating why decentralized community banks and development finance lift micro, small, and medium enterprises and raise living standards. Rooted in the Quantity Theory of Disaggregated Credit, the analysis is rigorous, practical, and humane. A landmark contribution that equips policymakers and citizens to rebuild finance in the public interest.”

Prof. Richard A Werner, Professor in Banking, Finance and Economics; Inventor of Quantitative Easing (“QE”).

"The system is broken. Years and decades of bad policies based on bad theories have taken their tolls on workers and on our economies. We need new ideas that are based on the real world, and specifically on how it works. We need to understand how institutions operate if we want to have a better society. In this book, the author tells us what is needed and how to move forward. If our political leaders had the courage to read this book, then there is hope. A wonderful book that must be read by everyone ... now."

Prof. Louis-Philippe Rochon, Full Professor of Economics, Laurentian University, Canada

“This volume explains the structural and institutional characteristics of contemporary banking systems in different countries and points out their impacts on economic development with regard to financial deepening, the diversity of banking ecosystems, and the spatial proximity between creditors and borrowers. It offers an in-depth analysis of banks’ roles in supporting economic growth, critically comparing a bank-based financial system with a market-based financial system.”

Prof. Sergio Rossi, Full Professor of Macroeconomics and Monetary Economics, University of Fribourg, Switzerland.

“This book is an invaluable resource for scholars in the field of monetary economics. It delivers a rigorous critique of mainstream theory while presenting a compelling alternative within the post-Keynesian tradition. The theoretical framework is then applied to an insightful analysis of the banking systems in Bulgaria, Germany, and the United Kingdom. A must-read for anyone engaged in the study of banking structures and contemporary monetary economics.”

Prof. Sylvio Kappes, Professor of Macroeconomics, Federal University of Alagoas, Brazil.

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Dr Plamen Ivanov

A handwritten signature in dark ink, appearing to read 'Plamen Ivanov', with a stylized, cursive script.

Sofia, Bulgaria
February 18th, 2025

Abstract

This book takes on a question that lies at the centre of modern political economy: not merely how much credit an economy generates, but who creates it, for what uses, and with what institutional guardrails. The argument is simple yet profound. Credit is not neutral. When the financial system directs lending toward speculative asset purchases rather than productive investment, the result is slower growth, greater volatility, and wider inequality. Conversely, when institutions channel finance toward small and medium enterprises, local infrastructure, and capability building, economies learn more, innovate more, and share prosperity more broadly.

Drawing on the Quantity Theory of Disaggregated Credit, the analysis distinguishes between credit that expands productive capacity and credit that fuels asset price inflation. That conceptual clarity is matched by careful comparative evidence across banking architectures. Systems with dense networks of community, cooperative, and public development banks are better at solving information asymmetries, cultivating long relationships, and underwriting place-based knowledge that large, arms-length lenders usually overlook. The result is more resilient regions, deeper supply chains, and higher employment multipliers.

The book's contribution is not just theoretical or empirical. It is programmatic. It shows how bulwarks of patient finance — local banks with public purpose, development banks with clear mandates, and supervisory regimes that track the composition of credit — can rebalance incentives without sacrificing efficiency. Indeed, efficiency properly understood includes the social costs of instability and the externalities of underinvestment in people and productive capacity.

The policy proposals are pragmatic and immediately actionable. They include rebuilding community banking where it has withered, modernizing development finance to crowd in private investment, and redesigning macroprudential policy to target credit flowing into asset markets that do not add to GDP. The message is neither nostalgic nor technocratic. It is a call to align financial structure with the economy we claim to want: innovative, inclusive, and stable. In showing how institutional design of credit creation shapes growth paths and distributional outcomes, this book provides a blueprint for economies seeking to escape the low investment, high inequality trap and to place finance once again in the service of the real economy.

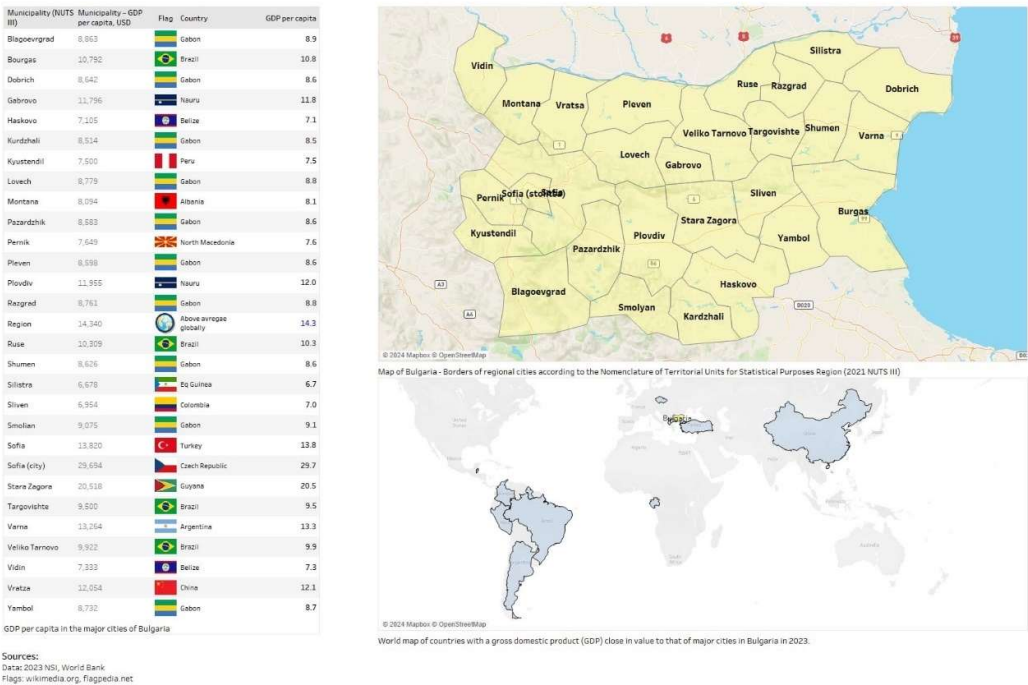
Preface

This book is dedicated to exploring how localized public financial institutions, similar to the savings banks (in German: *Sparkassen*) in urban areas and cooperative banks (in German: *Genossenschaften*) in rural Germany, can be harnessed to transform economies, particularly by empowering micro, small, and medium-sized enterprises (MSMEs) and thereby elevating the standard of living for ordinary citizens in Bulgaria and other economically less successful emerging, post-Communist economies (Mear and Werner, 2020; Duan et al. 2024, 2025; Mkhaiber and Werner, 2021).

Bulgaria’s politico-economic landscape underwent a seismic shift from a single-party, centrally planned economy to a multi-party, free-market economy some 35 years ago (Kostov, 2019). Guided by the advice of Washington-, London- and Brussels-based institutions, the country liberalized its markets and removed barriers to foreign investment (Mihov, 1999; Bobeva, 2022; Weber, 2021; World Bank, 2023). Despite these efforts towards freeing private entrepreneurship from the shackles of communist planning techniques, a glance at the regional GDP per capita reveals a stark regional disparity. The country’s political, and financial, capital, Sofia, boasts economic figures comparable to well-developed Central European countries like Czechia (circa USD \$30,000). On the other hand, the Bulgaria’s poorest regions (e.g. Shumen, Yambol, Lovech, Kyustendil) languish with GDP per capita (circa USD\$8,000 – \$9,000) akin to less developed nations in Africa and Latin America such as Gabon and Peru, respectively. Regrettably, most regions in Bulgaria fall into the latter category, as illustrated in Figure 1 below. This structural transformation has been labelled by some observers as the “the third worldization” of a “second world” nation, as empirics beyond GDP show (Vassilev, 2003).

Figure 1: Regional Development in Bulgaria contextualised against other national economies

Bulgaria’s regional economic development compared to national economies around the world: where are we?



Source: National Statistical Institute, the World Bank and own calculations

The early restructuring period came with promises of prosperity as Bulgaria moved away from its Communist past (Kostov, 2024). However, rather than delivering on these high hopes, the country now faces a wide array of socio-economic issues, similar to those seen in liberal market economies - regional disparities and income inequality, deindustrialization, loss of trust in government and its institutions, eroding quality standards in (higher) education, fiscal unsustainability, depopulation among many others (Ivanov, 2018; Djankov et al., 2008; Karaangova, 2022b; Hristov, 2022; Chupetlovski, 2021a, 2021b).¹

The initial wave of economic restructuring led to the privatization of numerous state-owned enterprises (SOEs), resulting in urban deindustrialization and growing income inequality. This was exacerbated by the weakening of trade unions in the early post-Communist period, diminishing workers' bargaining power (Grigorova, 2023). The plight of millions of working poor, relying on meager wages and resorting to extortionate payday loans to cover basic needs like emergency healthcare bills, highlights the severity of this issue. Redevelopment efforts to establish industrial zones, such as in Plovdiv and Varna (Ministry of the Economy, 2024), have only recently started showing some positive economic results but still key components, such as a developed, deep banking and financial system, for the founding of a healthy, business ecosystem are amiss, as we shall establish in this manuscript (King and Levine, 1993a, 1993b; Levine, 1997; Mehl et al. 2005).

The early constitutional changes to protect private property rights, intended to foster a free reign of private entrepreneurship leading to a competitive market economy, have also failed in their bid to provide a solid institutional basis for a healthy, market-led economy (Djankov et al., 2008; North and Weingast, 1989). As a result, only a handful of domestic enterprises have successfully expanded both nationally and internationally, as revealed by the yearly rankings of Bulgaria's largest enterprises compiled by the leading financial newspaper Capital (2024). Instead, a system of small-scale abuses of power by local and central government officials has emerged, exploiting an outdated legislative framework for personal gain (Velchev, 2019, 2024; North, 1991; Acemoglu and Robinson, 2012, 2023; Acemoglu and Johnson, 2023).

This leads to low public trust in government institutions (Open Society, 2022), contributing to weak tax receipts and the growth of the grey economy.² This undermines fiscal stability, particularly during crises, as today. Corruption in public procurement is widespread (Bosio et al., 2022), from poorly constructed infrastructure projects—such as highways, energy and waterworks—to petty bureaucratic abuses designed to supplement low salaries (Ivanov, 2018). Conflicts of interest and corruption in publicly-funded higher education institutions (HEIs), where vice-chancellors earn disproportionate salaries despite poor results, are only one of the

¹ In many ways, the end of Communism also marked the decline of capitalism's "Golden Era," which began unravelling in the 1990s (Milanovic, 2019).

² More frequently than not, economists (Bosio et al., 2022) and analysts will highlight the role of culture as a driving factor behind arrested development. Whilst this explanatory variable can play some role in determining economic growth, it fails to account that countries can experience rapid growth without changing its culture (e.g. work ethics, religion, etc). An easy example is China, that experienced massive poverty and general socio-economic backwardness but yet, in the space of 40 years has transformed itself from the poorest nation in the world to a leading industrial powerhouse challenging for the premier seat in the international order without undergoing fundamental changes to key cultural factors (e.g. religion). The Japanese also have similar experience in the last 100 years from a very poor country at the beginning of the 20th century to a industrial powerhouse in the late 20th century to a stagnant economy from the 1990s onwards without fundamentally changing their overall cultural and belief systems. Thus, culture alone is unable to explain macroeconomic performance (opposite to Bosio et al., 2022).

many other examples that can be used to illustrate how public trust is gradually eroding away and discouraging tax compliance at all levels (Karaangova, 2019, 2022a, 2022b, 2022c).³

This combination of inefficient public spending and low tax receipts worsens the government's ability to provide essential services such as sustainable and affordable water and energy supply (Iliev, 2024), national security (Radev, 2024), and high-quality education (Karaangova, 2019, 2022a; Karaangova and Ivanov, 2025), which are indispensable, core components of the social contract (Locke, 1690).⁴

Nonetheless, the Knightian-style uncertainty regarding the local economy's health during the early transition period led to a significant and unfortunate consequence: a dramatic decline in fertility rates (Angelov, 2016). Faced with prospects of unemployment due to deindustrialization, soaring living costs as inflation picked up due to diminished industrial output (Mihov, 1999), translated into a banking and subsequently a currency crisis (Nenovsky and Hristov, 1998), which ultimately led to a monetary experiment of fixed exchange rates against the Deutsche Mark (and its proto-successor, the Euro) as the local currency significantly weakened (Hanke, 1998, 2024).⁵ This was a direct result of a widespread mistrust in the government's ability to run a fiat monetary system in the nascent stages of Bulgarian capitalist framework, when a myriad of newly-found "pocket banks" failed due to mismanagement and shady lending practices in the context of poorly regulated banking environment (Vincellette, 2001; Avramov, 1999; Yotzov et al., 1998).

This general financial and economic instability urged the population in reproduction age to hesitate in expanding their families. This demographic challenge was exacerbated by a mass exodus of working-age Bulgarians seeking seasonal employment abroad, whether in tourist destinations like Greece, Spain, and Cyprus, as farmhands in Germany, the Netherlands and the United Kingdom (UK), or as construction workers, healthcare professionals (e.g. nurses, medical doctors), engineers and housemaids across mainland Europe & the United States of America (USA).

Over the past 35 years, these twin forces, declining fertility rates and mass outward migration, have driven a dramatic population decline, shrinking the nation from nearly 9 million on track to be under 6.5 million inhabitants by 2030 —a stark loss of over one-quarter of its population.⁶

³ A number of scandals outbroke in the last few years, including the ballooning government contract for a new building at the a leading Bulgarian university from several million euros to quadruple the public investment with reports that redirected tax funds to be used by a former vice-chancellor to complete his own overseas business projects. Such a corruption trend is identified week in, week out by news media with reports of abuse of the public purse in the fields of culture, transport, public works & finances, healthcare and so on.

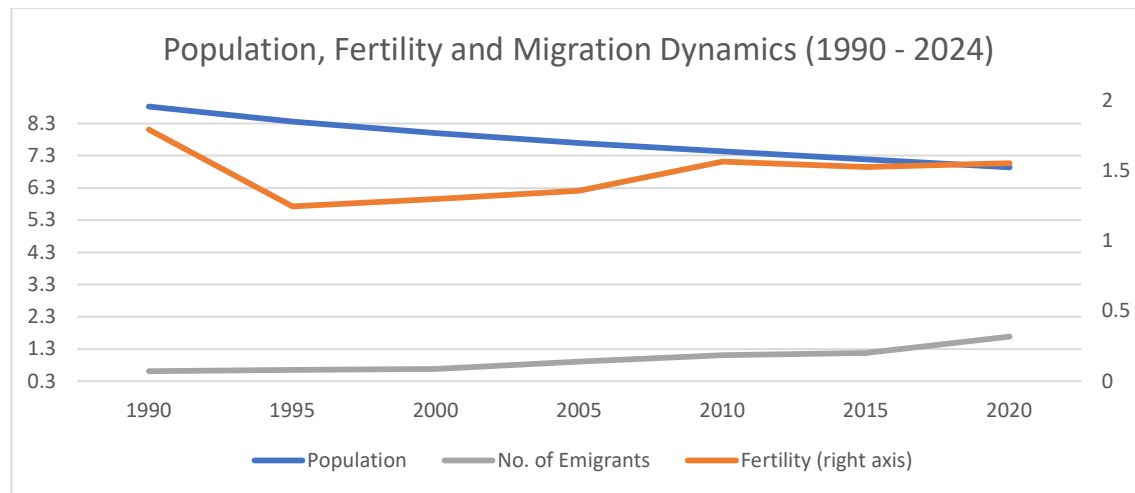
⁴ The social contract is a philosophical concept, originally articulated by Enlightenment thinkers John Locke (1698) and Jean-Jacques Rousseau (1701), that defines the implicit agreement between citizens and their government. In exchange for protection of rights and the provision of public goods, citizens agree to follow laws and contribute to society, particularly through taxation. The social contract concept is recognized by the United Nations via the Sustainable Development Goals, which advance end of poverty, provisioning of secure and clean water and energy supply amongst other public benefits (e.g. strong institutions, high quality education, etc).

⁵ In short, a banking crisis by mismanagement of both state and privately-run banks turned into a currency crisis (Hanke, 1998; Mihov, 1999).

⁶ Concurrently, there is anecdotal evidence about the changing distribution of population shares among the three major ethnic groups – Bulgarians, Turks and Roma – that exerts pressure on a number of socio-economic realms including but not limited to participation in labour markets, types of employment (grey economy vs official market economy), pressure on social welfare payments and utilities, educational attainment and many others.

This demographic collapse, which can be classified as Bulgaria's "third national catastrophe," rivals the scale of earlier historical calamities in its profound socio-economic consequences.

Figure 2: Population Dynamics (1957 - 2023)



Source: Our World in Data.

The acute labour shortage resulting from this demographic implosion has left businesses across all public and private sectors grappling with a dwindling local workforce. To address this critical gap, many enterprises have increasingly turned to importing foreign workers, a practice that reflects the sheer urgency of the situation. A recent survey by the Bulgarian Industrial Association (2024) unveils that Bulgaria-based businesses consider labour shortage as the biggest threat to their survival, ahead of lack of financing options for local firms. As Bulgaria continues to navigate these demographic challenges, the combined effects of its aging population and emigration-driven labour deficits underscore the need for bold policy interventions to stabilize its workforce and economic future, as a former economy minister highlights with his proposal for a fiscally-funded “baby bonus” (Vasilev, 2024).⁷

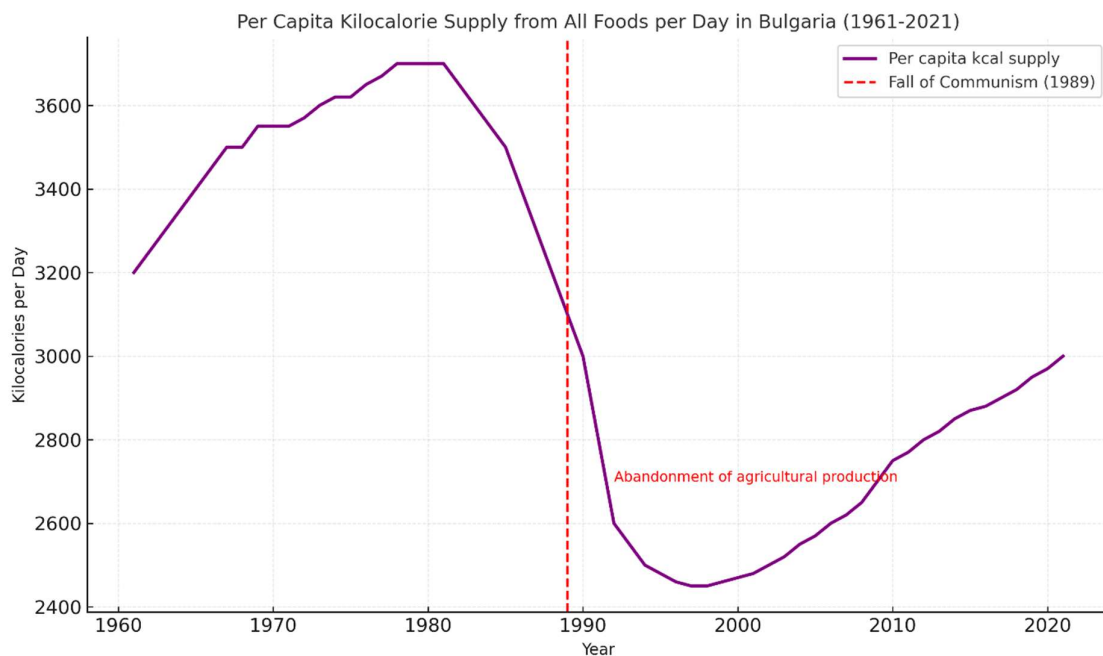
Simultaneously, the mass outward migration from about 5% of total population in the early 1990s to nearly 25% by 2020 (see Figure 2) triggered a concerning spillover effect, capturing the attention of social scientists, the media, and the public: regional depopulation. A recent report by the Bulgarian Academy of Sciences highlights the severity of this issue, warning that hundreds of villages, and regions, are on the brink of extinction within the next decade, in addition to the already abandoned 550 villages (Ivanov, 2018). This is particularly true across all of Northern Bulgaria, with a former finance minister suggesting creating a special government ministry, dedicated to resolving regional underdevelopment (Djankov, 2017). Alarmingly, this trend is now evident even in Bulgaria's most fertile land areas, such as Dobrich and the wider Ludogorie (i.e. Northeast Bulgaria). The absence of a working-age population in these distant parts of the country has led to ecological disasters (ESG News, 2022). The chief commander of the Bulgarian firefighter unit in a recent interview highlighted that as economic agents withdraw from agricultural activities and livestock farming declines in rural areas,

⁷ To this end, Bulgaria must analyse in greater detail the good and bad demographic policies and experiments in other post-Communist countries, including but not limited to Hungary, Russia, and China, as well as to consider the wider lifecycle of a person satisfying Maslow's hierarchy of needs including high quality education, food & water supply, security, personal and professional development, leisure and long-term family prosperity (Chomsky, 1998; Saxonberg and Sirovatka, 2006; Maslow, 1943), given that currently circa 33% (or just over 400,000) of her children live in the risk of poverty and social exclusion.

leading to unchecked vegetation growth that has resulted in uncontrollable wildfires that ravage the countryside and border regions (Djartov, 2024).⁸

The "death" of the Bulgarian village, once a cornerstone of local society and food production (see Figure 3), has set the stage for increased reliance on foreign agricultural imports. This dependency makes market prices vulnerable to fluctuations in overseas monetary policies and changes in the cost of money and debt owed by foreign agri-food corporations to their creditors (e.g. banks, bondholders, venture capitalists). The poorly conceived quantitative easing (QE) policies by non-resident central banks (i.e. European Central Bank, the Bank of England, the Federal Reserve) implemented in response to the COVID-19 crisis have exacerbated this issue, leading to record-breaking inflation in everyday foodstuffs, both domestically and internationally, culminating in the so-called cost of living crisis (so familiar to Bulgarians from the early transition period when a currency board was first installed, which led to the sterilization of autonomous monetary policy) (Werner, 1997, 2003, 2005; Miller, 1999; Yotzov et al., 1998; Hanke and Schuler, 1994). Moreover, this integration in the global supply chain subjects prices to speculation on international commodity markets, where produce is sold hundreds, if not thousands, of times even before it arrives on the supermarket shelves (Martin and Clapp, 2015).

Figure 3: Food Supply, Bulgaria (1961 - 2021)



(Source: Our World in Data, 2024)

In contrast to the credit rationing experienced by micro-, small-, and medium-sized enterprises (MSMEs) (Stiglitz and Weiss, 1981, 1992; Mkhairber and Werner, 2021) in all industrial sectors (including agriculture), as we shall establish in Chapter 5.4., the credit institutions operating in Bulgaria have prioritized mortgage lending over the last half a decade (Bogdanov, 2024; Forbes 2024). Despite stern warning statements from the Bulgarian National Bank (BNB, 2024), the

⁸ He partially discredited the hypothesis that it is climate change alone that drives environmental disasters but rather it is the detachment of humans from their natural environment and habitat that leads to turning Black Swan events into regularities.

country's central bank, to the foreign-dominated commercial banking sector to restrain credit growth in this economic sector, a property bubble continues to inflate as banks continue to underwrite this favourable asset class from a capital weight perspective.⁹ This situation underscores the impotence of regulatory power, and framework, in pecuniary matters and the (un)willingness of the “domestic” bank sector to cooperate with the central bank's instructions, particularly when monetary policy power is constrained by a currency board (Rochon, 2022; Duan et al., 2025; Ivanov, 2025; Mihov, 1999; Mishkin, 2022).¹⁰

Yet, the largest players in the domestic banking market are systematically important entities (UniCredit, KBC, OTP, EuroBank) with European and global reach with headquarters' beyond Bulgarian borders. Their emphasis on mortgage lending over supporting the development of domestic businesses reflects a misalignment of financial priorities that stifles broader economic growth, including in the Occident economies, and worsens existing economic disparities. Such misalignment is why prominent figures such as Prof. Charles Goodhart (2017), a Professor of Economics at London School of Economics and former Chief Economist at the Bank of England (BoE), alongside his colleague at the Bank, another former economist turned BoE governor Sir Mervyn King (2016), have urged the economics and finance professions to reconsider the fundamental principles of banking and its societal impact:

Without reform of the financial system, a new crisis will be inevitable, and the failure... to address the disequilibrium in the global economy makes it likely that it will occur sooner rather than later.

Sir Mervyn King, 2016

Some experts even advocate for the introduction of a Banking Oath, akin to the Hippocratic Oath for doctors, to ensure that bankers prioritize the well-being of clients and the wider society in their work (Llewellyn, 2014) next to protecting the planet (Hickel, 2019, 2021) over the Friedmannian (1968) shareholder profit-maximisation paradigm taught to business and economics graduates around the globe from the same translated textbooks, written at top-tier business schools in the USA (Raworth, 2018).¹¹

From the perspective of the average Bulgarian voter, the inability of political actors, including uprising political stars with educational credentials from such higher education institutions (HEIs), to aptly address the escalating socio-economic crises has led to a succession of snap elections over the past four years, generating a net expenditure of circa EUR0.5b (Nova, 2024). Numerous experimental, short-lived political alliances have been tried and tested with little to no success in resolving the ongoing structural issues but instead have accumulated record high-levels of public debt, with the 2025 fiscal budget estimated to be 18 billion leva in the red.

⁹ Basel regulations prescribe only a 35% risk weight to mortgage lending as opposed to 75% (or about 56% when discount is applied) risk weight to MSME lending. In addition, the increase of minimum reserves to be held by commercial banks, imposed by the central bank, in early 2023 failed to slow the credit expansion as the assumptive framework behind the fractional reserve banking fails to recognize the true role of the private banking sector as the producers of money in the economy, including on the mortgage market (Bofinger et al., 2024; Werner, 2014; King, 2016). For more details see Chapter 3.

¹⁰ The ECB (2020) already started the direct supervision of the largest 4 foreign-owned banks in Bulgaria under the Single Supervision Mechanism, showcasing the decreasing relevance of the Bulgarian supervisory body – the Bulgarian National Bank.

¹¹ In consonance with the latter understanding, the current governor of the Bulgarian National Bank Mr Dimitar Radev claims that excessive profits generated by the private banking sector must not be subjected to one-off, extraordinary tax to help with the fiscal deficit as this will backfire against the financial stability and the wider economic activity in Bulgaria, as the private banks will have less funds to advance to clients.

Thus, rather than stabilizing the political landscape, the latest changes to the constitutional and judicial systems — once seen as the root of all evil in the Bulgarian institutional framework (Ivanov, 2017, 2022) — have contributed to further disintegration of political parties. In fact, ample empirical evidence emerges about improper corruption practices before, during and in the immediate aftermath of the latest 8th round of snap elections in October 2024 (BNT, 2024). This political instability reflects some deep-seated frustrations and fragmentation in society and the widespread lack of credit in the current institutional framework, and thereby its ability to deliver eloquent solutions to the country's pressing, increasing socio-economic challenges.

This endless cycle of crises begs the question: Are these issues inherent to the current institutional order in the so-called Bulgarian-style capitalism? Or is capitalism perpetually in crisis, as one can see with the strings of similar negative socio-economic challenges faced by developed liberal and social democracies such as the United States of America, United Kingdom, France, Germany and Austria, triggering the rise of extreme political views there, too?

Based on my research, I argue that Bulgaria's core challenges stem from its failure to build a strong financial system that effectively supports entrepreneurial activities across regions and over time, particularly local MSMEs, which account for 99.8% of all enterprises (Enev, 2023). This book advocates for a comprehensive overhaul of her financial sector, emphasizing the creation of decentralized savings banks in urban areas and cooperative banks in rural regions to procure lending for the entrepreneurial-driven investments in the real economy (Guannine, 2001, 2002; Lehmann – Hesemeyer and Wahl, 2021). Such structural reforms, alongside high-quality higher education for senior managers and owners of local MSMEs (Karaangova and Ivanov, 2025), could foster growth, competitiveness, and internationalization of the local enterprises, resolving many of the socio-economic issues in our country. Analogous strategies proved successful in mid-19th century Germany, despite political fragmentation, technological shifts, and demographic changes, similar to the array of broad macroeconomic trends observed in Bulgaria nowadays (Schmidt et al., 2015). Their founding, driven by both accommodative government policy and entrepreneurial self-organization, allowed for the installation of an institutional framework that had the ability to promote productivity through technology advancement and shared prosperity due to the highly decentralized nature of the banking system, and by extension in the real economy (Audretsch, 2018).

Though this lays beyond the merits of the present manuscript, the policy toolkit available to the architects of Bulgaria's capitalist framework can be enhanced with more appropriate measures, such as managing the currency exchange rate, developing an industrial policy fit for the 21st century (Mazzucato, 2021, 2022; Weber, 2021; Nozharov, 2024), and implementing a national strategy to improve living conditions and repopulate the countryside (i.e., "QE for babies") (Werner, 2018; Vasilev, 2024). Furthermore, a national strategy for primary and higher education should be devised, focusing on cooperation and coordination with business demands, while training top-quality public managers and bureaucrats as the role of the state in a market economy ought to be reconsidered (Duan et al., 2024, 2025; Mazzucatto, 2021, 2023; Karaangova, 2022a, 2022b, 2022c; Karaangova and Ivanov, 2025; Offer, 2022).

The path to economic freedom will be long and challenging, but it is vital for the future of our communities. As Sir Mervyn King (2016) highlighted, a profound shift in how we think about banks, and the wider financial system, and their role in society is essential to improve the well-being of businesses, families, and the state (Goodhart, 2017; Raworth, 2018). This book seeks to set some sparks into that revolution of economic thought by showing that sustainable development can only be achieved by building and mastering our own banking, and thereby credit,

system, empowering local communities with the apt institutional tools, localized community banks (LCBs), to engage in sustainable production and consumption leading to higher standard of life, as was in advanced social democracies as Germany.

Die Bundesrepublik, once a model for this approach, has seen its economic progress stall, a direct result of the consolidation of its community banking sector under the heavy hand of the European Central Bank (ECB). With the ECB's view that Europe is "overbanked" (Dombert, 2017), thousands of strong, LCBs in Germany, as well as Italy, Spain, Sweden, and other social democracies, were forced to close or merge (Ferri et al., 2019). Years of regulatory pressure and zero-interest-rate policies have crippled these vital credit institutions, contributing to their country's present-day economic stagnation. Learning from both the successes and failures of Germany's past monetary policies, including the structure and organization of its banking sector, is crucial if we are to avoid repeating the same mistakes as them over the last 25 years (Werner, 2018, Duan et al., 2023, 2024; Ivanov, forthcoming).

Chapter 1: Introduction

1.1. Research Rationale

The finance-economic growth nexus (FGN hereafter) refers to the relationship between financial development and economic growth (King and Levine, 1993a, 1993b). This concept examines how various aspects of a country's financial system influence its economic performance and vice versa. In this context, the FGN has been extensively studied in economic literature, and several key points have emerged, as shall be discussed in greater length in Chapter 2:

1. Financial Development and Economic Growth:

- **Positive Impact:** Well-developed financial systems facilitate economic growth by efficiently allocating resources, reducing transaction costs, and providing a platform for risk management (King and Levine, 1993, Levine, 2007). Access to finance helps businesses expand, invest in new technologies, and improve productivity (Schumpeter, 1911; Keynes, 1930).
- **Channels of Influence:** Financial development affects economic growth through several channels, including savings mobilization (Bagehot, 1873; Harrod, 1957; Domar, 1961), investment facilitation (Duan et al., 2024, 2025; Mkhairber and Werner, 2021), innovation promotion (Mear and Werner, 2021), and improved allocation of scarce resources.

2. Mechanisms of the Finance-Growth Relationship:

- **Capital Accumulation:** Financial institutions mobilize savings and direct them towards productive investments, leading to capital formation and economic growth (Schumpeter, 1911 [1934]; Keynes, 1930).
- **Technological Innovation:** Financial markets and institutions support innovation by providing the necessary funding for research and development (Mazzucato and Collington, 2024; Ryan-Collins et al., 2023).
- **Risk Management:** Financial systems offer instruments for risk diversification, helping businesses manage uncertainties and invest in growth opportunities.

3. Empirical Evidence:

- **Cross-Country Studies:** Many studies have found a positive correlation between financial development and economic growth across different countries and time periods though there is a widespread consensus about the non-linearity of this interrelationship and the possible inverted U-curve with (over)financialisation of (developed) economies (King and Levine, 1993a, 1993b; Levine 1997; Mehl et al., 2005; Ivanov, 2024; Karwowski, 2019; Epstein, 2005).
- **Endogeneity Concerns:** There is ongoing debate about the direction of causality. While financial development can drive economic growth, growing economies also tend to develop more sophisticated financial systems (see Bofinger et al., 2024).

Over the past three decades, the debates surrounding the FGN have been highly contentious, both empirically and theoretically (Bofinger et al., 2024). In this manuscript, I aim to contribute to this ongoing discourse by offering a concise review of the theoretical developments within the FGN and examining the current debates surrounding these theories.

Furthermore, I extend this theoretical discussion to encompass development finance within the broader framework of the FGN discourse. A key emerging trend is the recognition that most

contemporary theories addressing the FGN have been predominantly focused on standard finance mechanisms e.g. financial intermediation ratio and monetisation ratio as originally defined by King and Levine (1993) (see Mehl et al., 2005), often neglecting the crucial role of the structure of the banking sector, including the role of public development finance (Rochon and Marshall, 2019; Griffith-Jones et al., 2023; Marois, 2022, 2024; Marois and McDonald, 2023). This study delves into the historical perspective to examine the positive impact that decentralized, publicly-owned financial systems can have on catalyzing economic growth in the most advanced European economy (Smith, 1776; Bagehot, 1876; Audretsch, 2018; Guinnine, 2001; Lehmann-Hesemayer and Wahl, 2021). Interestingly, it is only in recent years that some heterodox scholars, particularly those from a post-Keynesian tradition (Rochon and Marshall, 2022; Griffith-Jones, 2023; Rochon et al., 2022; Duan et al., 2024, 2025; Marois, 2021, 2023), have begun to revive and emphasize the importance of public banks in guiding the capitalist processes of production and consumption. Yet, these advances of economic thought also neglect the impact of localized community banks (LCBs) in Germanic speaking countries due to the lack of such credit institutions in the Anglophone-speaking world (Marshall and Rochon, 2019, 2022).

In this context, access to external finance is a critical driver of economic growth, particularly for micro, small and medium-sized enterprises (MSMEs), which rely heavily on banking sector financing, particularly crisis times (Mihov, 1999; Beck et al., 2004). Economic growth stems from improvements in the quality and quantity of labor, capital, and TFP, which reflects how efficiently capital and labor are utilized. With MSMEs playing a pivotal role in this process by spurring innovation (Mazzucato, 2022), fostering competition, and driving productive churn in national economies (Keynes, 1930), as a recent EU report states “[MSMEs] create more jobs than large enterprises. If data are corrected for the ... population effect this statement is even better substantiated” (De Kok et al., 2011: 6), then organizing a financial system that caters for their financing needs is of first order. Further, empirical evidence highlights that real economy sectors, which are dependent on external finance (particularly true for MSMEs), experience increased firm entry and post-entry growth, emphasizing the importance of an accessible and efficient financial system (Aghion et al., 2007). This access to political resources (i.e. money) enables superior MSMEs to thrive, while underperforming firms are phased out or remain small in their scale, contributing to a more dynamic and efficient economy but also higher standards of life (Mkhaiber and Werner, 2021; Mkhaiber, 2018).

The role of the banking sector in facilitating MSME financing is crucial, as bank structure directly influences the allocation of capital across national economies (Duan et al., 2024, 2025). Well-developed financial systems widen distribution of credit supply, driving faster growth among high-performing firms while enabling underperforming businesses to contract more efficiently (Galbraith, 2015, 2025; Mkhaiber and Werner, 2021; Werner, 2005; Voutsinas and Werner, 2011). MSMEs, particularly those driven by opportunistic entrepreneurship, are strongly associated with higher economic growth (Erken et al., 2009; Acs and Szerb, 2007). However, disruptions such as impaired credit supply during economic downturns can hinder productivity, as evidenced during the credit crunch in the post-2008 Global Financial Crisis (GFC) period (Cable, 2016; Goodhart, 2017; King, 2016). Ensuring that viable MSMEs have access to external financing allows them to invest in capital improvements, enhancing TFP, and contribute to a stable macroeconomic performance (Beck et al., 2004). The interplay between MSME financing and banking sector development underscores its importance as a mechanism for sustainable growth and productivity advancement in modern economies.

This work contributes a critical dimension to this ongoing, lively academic debate by underscoring the pivotal role of public & local bank credit, especially its application as elucidated in the Disaggregated Quantity Theory of Credit (Werner, 1997, 2005, 2014, 2020). Werner's theory is groundbreaking in its distinction between credit used for productive investment (i.e. capital formation and improvement & increased labour skills), which fosters economic growth, and credit used for speculative activities, which can lead to economic instability as conjectured by John Maynard Keynes (1930) in the English language tradition as well as the equally great Joseph Alois Schumpeter (1911, 1934) from the (Youngest) German Historical School. This innovative theoretical framework, which successfully integrates and formalizes various strands of some post-Keynesian and Schumpeterian economic thought (Lavoie, 2014; Rochon, 2024; Minsky, 1981; Keen, 2024; Bofinger et al., 2024), is explored in greater detail in Chapter 3.

To ensure sustainable economic growth, banks—regardless of their ownership structure—must prioritize lending that supports the real economy (Ivanov and Werner, 2022). This means directing credit toward activities that generate new production, such as manufacturing, innovative services, and overall additional economic output (Schumpeter [1911] 1934; Keynes, 1930; Werner, 2005; Karaangova and Ivanov, 2025; Duan et al., 2024, 2025). Conversely, allocating bank credit to speculative activities, such as purchasing existing housing stock, or to fund consumption, such as buying already available goods and services, introduces significant risks to macroeconomic and financial stability. These practices merely inject additional liquidity into a fixed supply of goods and services, resulting in asset price inflation (e.g., rising house prices), as during the 2008 GFC, or consumer price inflation (e.g., higher prices for everyday goods), as in the post-2020 COVID-19 pandemic (Werner, 2020; Bezemer, Gradyki and Zhang, 2018; Ryan-Collins, 2016; Duan et al., 2018, 2019).

This exploratory study underscores the need to integrate the role of development finance into the theoretical framework of the FGN, including the role of MSMEs and LCBs in local economies. It emphasizes that LCBs can play a vital role in driving economic growth, particularly in less developed countries with weak institutional settings such as Bulgaria, the poorest member state of the EU. By fostering direct connections with local communities, these institutions are better equipped to channel funds into productive investments that stimulate economic progress. However, the paper highlights the limitations of conventional FGN models, which often underestimate the true potential of finance to catalyse economic development (King and Levine, 1993a, 1993b; Duan et al., 2024, 2025, Ivanov et al., 2025), especially in underdeveloped regions.

Beyond advocating for small-scale, publicly owned financial institutions, the study stresses the necessity of sound credit underwriting practices (Avramov, 1997, 1999; Yotzov et al., 1998; Bobeva, 2022; Mihov, 1999; Kyoseva, 2015). When banks extend credit for purposes that deviate from productive investments, several harmful consequences can ensue. These include inflation in asset and consumer markets, a surge in non-performing loans, and, ultimately, the destabilization or even collapse of the banking system. Worse still, such practices can lead to a loss of trust in the local currency, undermining the broader financial system, leading to arrested and uneven economic development. Historical examples, including that of early post-Communist Bulgaria, when “pocket banks” mushroomed, engaging in connected lending to credit officers (a structural issue unaddressed by supervisory bodies) illustrate this point vividly (Mihov, 1999; Miller, 1999).

Back then, poor lending practices and systemic bank mismanagement resulted in economic disarray, leading to the installation of a currency board (Bobeva, 2022; Hanke, 1997, 1999).

Similarly, in 18th century France, the speculative schemes associated with John Law's Banque Royale printing promissory notes well-above the gold reserve, and investing this paper credit in the Mississippi Company, led to a spectacular collapse of the newly-found bank after the inability of the private commercial enterprise to realise any income or profit (Hyde, 1948). The failure of his paper credit system designed to fund the company's operations in the new colonies (today's Louisiana) not only destabilized the French financial system but also caused the public to lose faith in paper money (the innovative financial product of 17th / 18th century European banking sector) for more than a century. This mistrust significantly hampered France's capacity to build an empire on par with England's during the 18th – 19th century, as it lacked the cheap political resources and funding enjoyed by its Continental rival via the Bank of England to expand the British Empire (Velde, 1989). The current, long-standing loss of public trust in the Bulgarian currency and the ability of the central bank to preside over the wider banking system in Bulgaria, with the ultimate proof of almost 30-year old currency board in continual operation as well as the desire to join the common European currency, the euro (Hristov, 1999), is analogous to the 18th century French case. Through this historical prism of a social scarring with the unwieldy, exponential growth of the banking sector, and poor lending practice, in early post-Communist Bulgaria, we could potentially seek as an explanatory variable as to why the FGN has not taken firm hold in policy discussions about the past, present and future economic development in the country.¹²

Ultimately, the findings suggest that a more nuanced understanding of the FGN requires acknowledging the importance of development-oriented finance. Banks must adopt principles that prioritize productive investments over speculative or consumption-driven credit allocation (Werner, 1997, 2003, 2005). Only by doing so can the banking system avoid the pitfalls of inflationary pressures, economic instability, and long-term damage to public trust in financial institutions and local currencies (Hanke, 1995; Kelton, 2020).

1.2. Research Aim:

This study aims to investigate the structural and institutional characteristics of national banking systems and their impact on economic development, particularly in the context of financial deepening, the diversity of banking ecosystems, and the spatial proximity between creditors and borrowers. By comparing the centralized banking models of the United Kingdom and Bulgaria with the decentralized, stakeholder-oriented model of Germany, the research seeks to identify how banking system architecture affects credit creation, support for micro-, small-, and medium-sized enterprises (MSMEs), and broader macroeconomic outcomes.

¹² The currency question is best abridged by Prof. Katarina Pistor (2017), a legal scholar at Columbia University, in a seminal article that in the present-day institutional system, the ultimate criterion for freedom is not political independence but monetary independence with no survival constraint in terms of pecuniary matters: “State sovereignty is closely intertwined with, but not limited to, control over territory and people. It has long been recognized that control over monetary affairs is a critical part of genuine sovereignty. In this Article, I go a step further and argue that the relevance and importance of territorial versus monetary sovereignty has shifted in favor of the latter. This shift goes hand in hand with the rise of credit-based financial systems. Such systems depend, in the last instance, on backstopping by an entity with control over its own money supply and no binding survival constraints.”

1.3. Research Objectives

- To compile and present a comprehensive and critical literature review on the FGN, including the role of public development banks, examining both theoretical and empirical perspectives across developed and developing economies.
- To critically compare and analyze the financial systems of a market-based financial system, exemplified by the United Kingdom (UK), and a bank-based financial system, exemplified by Germany.
- To critically examine the institutional design of the leading national development banks in addressing market failures, including the access to finance by the micro-, small- and medium-sized enterprises (MSMEs) in the real economy.
- To investigate the link between financial architecture, bank business models including the broad composition of credit aggregates and economic growth in these three distinct economies.
- To provide an in-depth analysis of the adequacy of the banking structures in Bulgaria, Germany and the UK in promoting economic growth, along with policy recommendations for improvements (e.g. credit guidance).

1.4. Hypotheses:

H1: Financial deepening, defined as an increase in credit-to-GDP and monetization ratios, contributes positively to economic growth when credit is allocated to productive sectors of the real economy.

H2: A diverse and decentralized banking ecosystem—particularly one that includes cooperative and savings banks—provides better credit access to MSMEs, resulting in higher levels of regional economic development and aggregate growth.

H3: Geographical proximity between banks' decision-making centers and borrowers enhances the acquisition of soft, non-quantitative information about credit counterparties. This leads to improved credit underwriting for information-opaque MSMEs and higher levels of productive credit creation.

1.5. Methods:

The study employs a mixed-methods approach. First, a comparative institutional analysis is conducted to evaluate the banking architectures of Bulgaria, the UK, and Germany, drawing on both historical evolution and current banking models. Quantitative data from central banks, development banks (e.g., BDB, KfW, and British Business Bank), and national statistical associations are used to assess financial depth, credit allocation patterns, and MSME lending outcomes. Spatial analysis is employed to map out the geographical distribution of headquarters of banks, linking it to MSME credit access, based on “transactional vs relationship” banking style lending patterns. On top, case studies of public development banks — including the supplementary German Sparkassen and Genossenschaften banking networks together with the German Development Bank (KfW), the British Business Bank, and the Bulgarian Development Bank — are used to analyze the practical implications of credit centralization of private credit versus decentralization of public credit. The theoretical framework is grounded

in the innovative Disaggregated Quantity Theory of Credit, enabling a distinction between credit for GDP and non-GDP transactions, and critically assessing its predictive validity in light of empirical findings.

1.6. Original Contributions of the Study

This section outlines the original contributions of this manuscript, which aim to deepen our understanding of the FGN, particularly in the context of development finance. Through a critical analysis of existing literature, the research emphasizes the often-overlooked role of urban savings and rural cooperative banks, or what I collectively label as localized community banks (LCBs) in driving economic growth. Additionally, a comparative study of banking systems in Bulgaria, Germany, and the United Kingdom offers insights into the implications of different financial structures towards economic development. The section also integrates an analysis of government-owned development banks, assessing their impact on local MSMEs and broader macroeconomic outcomes, depending on the sub-structures of the broader banking sector and channels of distribution of funding to MSMEs.

- A critical examination of the academic literature on the FGN, highlighting the often-overlooked role of development finance, specifically savings and cooperative banks, in fostering economic growth.
- A spatial analysis comparing the banking systems of Bulgaria, Germany, and the United Kingdom, with a focus on their structural differences and regional impacts.
- A comparative study of bank-based financial systems (Germany) versus market-based financial systems (UK), exploring their implications for Bulgaria's long-term sustainable economic development.
- An integrated analysis of the microeconomic role and functions of three government-owned development banks—Bulgarian Development Bank (BDB) in Bulgaria, Kreditanstalt für Wiederaufbau (KfW) in Germany, and British Business Bank (BBB) in the United Kingdom—alongside their macroeconomic effects on local MSMEs and broader economic growth.

1.7. Structure of the Study

Chapter 2 provides a comprehensive overview of the emergence and growth of the economic literature on the FGN, viewed through theoretical, empirical, and historical lenses (King and Levine, 1993a, 1993b; Werner, 2003; Ivanov, 2018; Mkhaiber and Werner, 2021; Mear and Werner, 2021; Duan et al., 2023, 2024).

In Chapter 3, I also delve into some of the present day challenges in macroeconomic theory (Stiglitz, 2018; Nakamura and Steinson, 2018), and its corollary macroeconometrics (Hendry, 2020, 2024) that has left the economics profession unable to answer some of the most pressing questions about how modern-day societies operate with gaping holes in the academic knowledge about what makes monetary and fiscal policy work and what are the determining factors triggering economic growth. Based on an in-depth analysis of some fundamental issues with modelling techniques adopted by conventional economics, the chapter then offers an introduction to an alternative macroeconomic paradigm, which is rooted in the economic reality of the world (such as credit rationing, market imperfections, endogenous money supply and purpose of credit creation) (Werner, 1997, 2003, 2005; Rochon, 1999; Borio, 2014; King, 2016; Goodhart, 2017), rather than the complex, abstract and highly-unrealistic assumptive

models advanced in standard macroeconomics (such as money neutrality, perfect information, perfect markets, exogenous money supply). This new macroeconomic paradigm, the quantity theory of disaggregated credit (QTDC) (Werner, 1992, 1995, 2006; Ivanov and Werner, 2020), then serves as the missing link in the FGN, particularly linking the structure of the banking systems, the broad composition of the credit aggregates and the wider economic development of the three case studies.

Chapter 4 outlines the research methodology and data collection process for the three studied countries – Bulgaria, Germany and the United Kingdom. The purposive sampling technique has been employed to leverage insights from two distinct, advanced forms of capitalism: the United Kingdom and Germany. The UK represents the Anglo-American, securities-based style of capitalism, characterized by its stock and bond markets (Mishkin, 2022; Apostolov, 2021, Draghi, 2024). Germany, on the other hand, is recognized for its bank-based capitalist system, which has, historically, produced widespread wealth across the nation (Werner, 2005; Ivanov, 2018). It further offers in-sights into the data collection, processing and visualization as well as the analytical framework, based on the QTDC. In section 4.5, I disclose the broad structure of the analytical chapters to ensure consistency and comparability between the three case studies. The chapter also offers some thoughts as to how this study can be further refined and developed to provide more insight into the FGN such as the inclusion of more detailed microeconomic-based research (e.g. the inclusion of ProCredit Bank in the analysis of the Bulgarian banking mechanism; more comprehensive analysis of the evolution of bank distribution of the UK, in particular country and provincial banks; and so on). The chapter then discusses some dimension of the ethical considerations of the research process: yet, it must be highlighted that the present manuscript is based entirely on secondary, publicly available data.

Chapter 5 offers an in-depth analysis of the financial architecture of the three countries, with a particular focus on the development, or lack thereof, of their respective banking systems, using the prism of QTDC, explaining how the creation and allocation of new purchasing power in the economy, as envisioned by Schumpeter in 1911 and later adopted by John Maynard Keynes in 1930, can drive economic growth. Both economists concur that productive investments lead to economic growth, and when private banking sectors fail to provide adequate business lending, state intervention is necessary to correct these market failures – a sentiment now echoed by the International Monetary Fund’s Managing Director Kristalina Georgieva (2024).

This train of thought is precisely what drove the UK government to launch and establish the British Business Bank (BBB) in 2012, possibly one of the last industrialised countries to do so. Yet, similar to the Bulgarian Development Bank (BDB), its success is highly limited as both institutions operate in a banking environment that lacks the breadth and depth of a banking sub-structure that operates on more-than-profit principles such community-centred credit institutions – namely urban-based savings banks (SBs) and rural-based cooperative banks (RCBs) – all of which aim advance the economic well-being of their local public. The existence and close cooperation of such publicly spirited LCBs with the German development bank - Kreditanstalt für Wiederaufbau (KfW) - is a major driving factor as to why Germany boasts the most advanced economy in Europe. However, ongoing economic restructuring along laissez-faire lines, driven by the Frankfurt- and Brussels-based institutions, is rapidly changing the economic landscape in the paragon of social democracy, *die Bundesrepublik* (IMF, 2024). This shift has resulted in the closure and merger of hundreds of banks, particularly LCBs, reducing credit availability for small-scale entrepreneurs and family businesses, which in turn stifles output, employment, and economic growth. This is what I now label as the finance – degrowth nexus (Hickel, 2019, 2021; Kallis, 2021).

Chapter 6 presents a comparative analysis of banking structures in Bulgaria, the United Kingdom, and Germany, offering policy recommendations aimed at correcting structural inefficiencies in the former two countries while cautioning against the ongoing centralization of financial power within the latter. It argues that the decentralization of banking mechanisms, akin to Germany's stakeholder-driven local community banking model, is imperative for fostering regional economic resilience in both Bulgaria and the UK. At the same time, it warns against Germany's own trend toward banking consolidation, which risks concentrating financial capital within a single financial center, as has already occurred in the City of London, leading to the deindustrialization of peripheral regions.

The UK and Bulgaria share a highly centralized financial architecture, wherein public development banking is concentrated in a single institution, namely the BBB and the BDB, respectively. These institutions, despite their nominal national mandates, are structurally and operationally incapable of addressing regional economic disparities due to their sheer lack of localized financial expertise and physical presence in the regions they are meant to serve. The chapter advocates for a shift toward a decentralized banking system, modeled after Germany's Sparkassen (savings banks) and Genossenschaftsbanken (cooperative banks), which maintain a close relationship between borrowers and lenders, thereby facilitating better risk assessment and credit allocation tailored to regional economic needs.

This decentralized approach is not merely a theoretical preference but has been empirically demonstrated to enhance access to credit for MSMEs, stimulate local entrepreneurship, and reduce financial exclusion. By embedding financial institutions within their respective economic environments, regional banks develop a nuanced understanding of local industry dynamics, allowing them to channel capital where it is most effective—a crucial factor absent in both the Bulgarian and British financial landscapes.

While Bulgaria and the UK must decentralize their financial systems, Germany must resist the pressures of banking consolidation, which risks replicating the Anglo-American model of centralized finance. Over the past two decades, German banking authorities have pursued policies that have reduced the number of regional banks, pushing for greater financial integration within larger banking entities. The chapter cautions that this process threatens to erode the competitive advantages of Germany's historically decentralized financial architecture, which has been instrumental in sustaining industrial production and regional economic stability.

The lesson from the UK is instructive: the over-concentration of financial services in London has hollowed out regional economies, leading to a situation where the rest of the country exists as a deindustrialized hinterland dependent on decisions made in a single financial hub. If Germany continues down this path, it risks replicating London's dominance over the UK economy, where the allocation of credit serves the interests of the financial sector rather than the real economy. The decentralization of banking ensures a broader, more equitable distribution of financial capital, thereby reducing the risk of systemic imbalances and regional economic decline.

A core concern addressed in this chapter is the misuse of credit creation, particularly when financial institutions fail to ensure that new credit results in tangible economic output. While the Disaggregated Quantity Theory of Credit (DQTC) offers a compelling framework for understanding the role of credit in economic expansion, scholars must remain cognizant of the risks posed by misallocated credit flows (Werner, 2014). The historical case study presented

in this manuscript demonstrates that when credit is created without a corresponding increase in productive capacity, the result is not sustainable growth, but rather financial instability, inflationary pressures, and a loss of confidence in the domestic currency.

In the Bulgarian context, this misallocation has historically facilitated financial crises and necessitated the outsourcing of monetary policy—first through the introduction of a currency board, which effectively transferred monetary control outside the country, and later through the overreliance on foreign credit institutions, which dominate Bulgaria’s commercial banking sector. The result has been a gradual erosion of domestic financial sovereignty, whereby Bulgarian policymakers have limited tools to influence economic development through domestic credit policies.

A similar phenomenon, albeit in different form, can be observed in the UK, where financial capital is predominantly directed toward speculative activities in the housing market and financial assets, rather than productive investment in industry and innovation. As a consequence, credit serves short-term profit-seeking mechanisms rather than fostering long-term economic sustainability—a distortion that reinforces regional inequalities and undermines industrial competitiveness.

The final policy recommendation of this chapter is the shortening of the distance between borrowers and creditors as a fundamental mechanism for promoting regional economic development. This is not simply a logistical matter but a structural necessity—one that can only be achieved through the decentralization of banking infrastructure. By ensuring that credit flows to where it is most needed, regional banking models allow for greater financial stability, improved risk assessment, and more sustainable economic development.

However, decentralization alone is not sufficient. The process must be accompanied by rigorous oversight to ensure that credit creation is aligned with real economic output. The failure to do so—whether through reckless lending practices, speculative credit bubbles, or external financial dependency—risks repeating the mistakes of past financial crises. Therefore, scholars and policymakers alike must remain vigilant in assessing the true economic impact of credit creation, ensuring that financial institutions serve the interests of productive enterprise rather than speculative gain.