Issue 1 January – February 2010

expat compass

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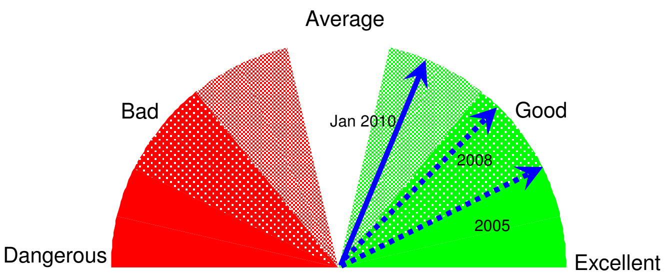
EXPAT CURRENCY BOARD WATCH



OUTLOOK: GOOD BUT WORSENING

We present our proprietary indicator, the **Expat Currency Board Watch** (see page 2), which summarizes in one chart our views about the lev/euro exchange rate. It would be useful to observe this indicator dynamically, as not only the level, but also the direction of change is important. For the time being, **we are optimistic about the currency board and see no immediate danger of devaluation.**

LACHEZAR BOGDANOV:

THE ECONOMY IS FLEXIBLE IN TIMES OF OVERWHELMING EXTERNAL SHOCKS

Despite its record levels in 2007 and 2008, the current account deficit shrank significantly in 2009. Moreover, imports fell faster than exports. Employment figures imply remarkable adjustability of the labour market.

Page 11

WELCOME TO THE EXPAT COMPASS

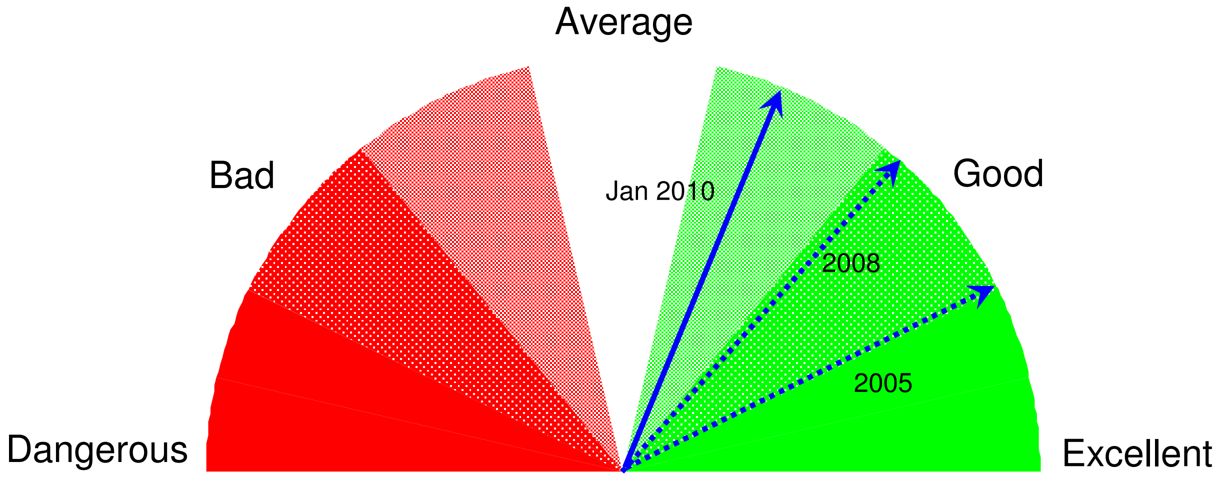
We would like to welcome you to our new economic research product, the **Expat Compass.** It is produced by **Expat Capital,** a financial services company based in Sofia, Bulgaria. For more information about **Expat Capital,** our mutual funds and real estate investment trusts, please see page 12 or visit our website, www.expat.bg.

The product will be published bi-monthly in Bulgarian and English in electronic form. It is distributed free of charge. In order to subscribe or make comments, please write to us at compass@expat.bg.

The Expat Compass is intended for investors, economists, businesspeople, and policy-makers. It will provide comments on the health of the Bulgarian economy with special attention to the stability of the currency board, i.e. the fixed exchange rate of the lev (BGN) to the euro. Why the currency board? Because we think that whether the fixed exchange rate will survive is the single most important and most discussed issue in the realm of Bulgarian economic policy. If the currency board stays stable, and Bulgaria soon joins the ERM II and later the Eurozone at the current rate of EUR 1 = BGN 1.95583, we would consider that to be a major economic success for the country.

We present our proprietary indicator, the **Expat Currency Board Watch** (page 2). We then present a list of 16 economic and political indicators which we deem important, as well as our evaluation thereof. For this issue of the **Expat Compass,** we have selected 7 out of these 16 indicators (pages 3-10) and have offered our comments in charts and words. **Expat Compass** also includes a special *Guest Comment* on the Bulgarian economy. In this first issue our guest is one of the most prominent Bulgarian economists, Mr. Lachezar Bogdanov, Managing Partner at Industry Watch.

OUTLOOK: GOOD BUT WORSENING



Over the last year, the only question consistently asked at all economic discussions and business meetings is whether the currency board will hold, i.e. whether the lev exchange rate against the euro is stable. Before we cast any doubts, let us start with our positive conclusion.

We are optimistic about the currency board and see no immediate danger of devaluation.

In the future months and years, we intend to constantly monitor the development of relevant economic indicators in order to assess the health of the currency board and to potentially predict any negative events, should they ever happen.

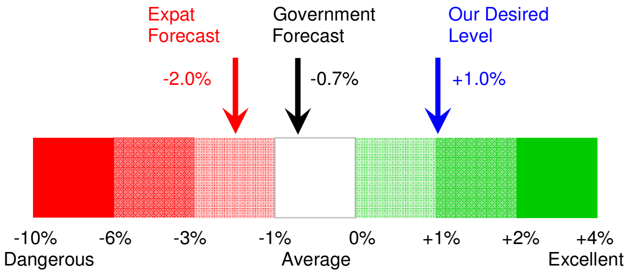
How to assess the stability of the currency board and to predict any danger of devaluation? We suggest the following check-list of 16 questions and provide our answers:

ISSUE	OUR COMMENTS	
I. Political issues		
1. Does the government support the currency board?	++	Yes
2. Does the Central Bank support the currency board?	+++	Yes, absolutely
3. Do the European institutions (EC, ECB) support Bulgaria in joining the ERM II and the Eurozone?	-	Not much
II. Budget and debt		
4. Budget balance	-	Small deficit, rising
5. Budget spending	--	Excessive and rising
6. Government debt	+++	Very low
7. Foreign liabilities of the private sector	--	High
8. Fiscal reserves	++	High and stable
III. Economic cycle related issues		
9. GDP growth	--	Recession
10. Inflation	+++	Low
11. Unemployment	-	Average, rising
12. Strength of the banking system	+	Good but worsening
IV. External balances		
13. Current account deficit, trade deficit	--	Very high but falling
14. Foreign direct investment	+	High but falling
15. Revenues from international tourism	+	Moderately high, falling
16. Foreign exchange reserves	++	High

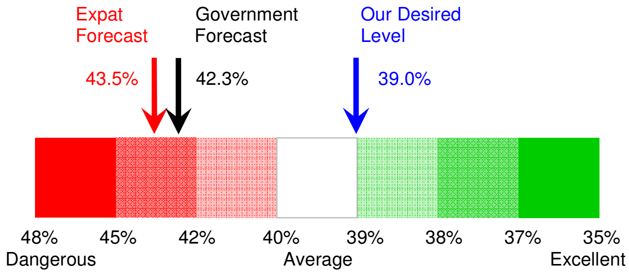
Legend: Good (green) Bad (red)

INDICATORS

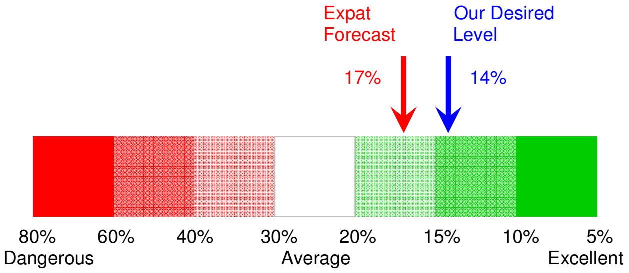
I) Budget Surplus/Deficit, % GDP, 2010



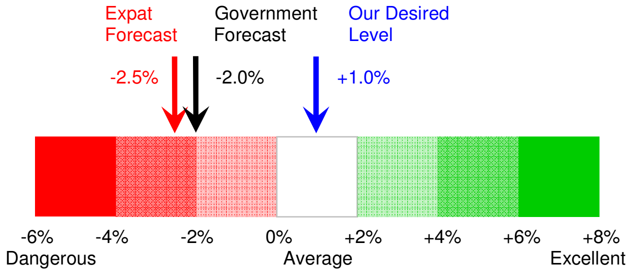
II) Budget Spending, % GDP, 2010



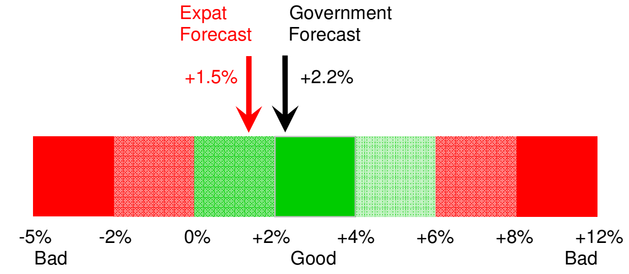
III) Government Debt, % GDP, 2010, Year-End



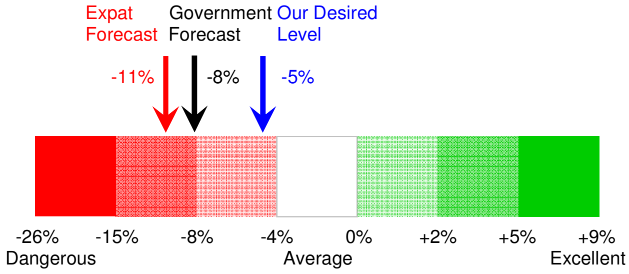
IV) Real GDP Growth, %, 2010



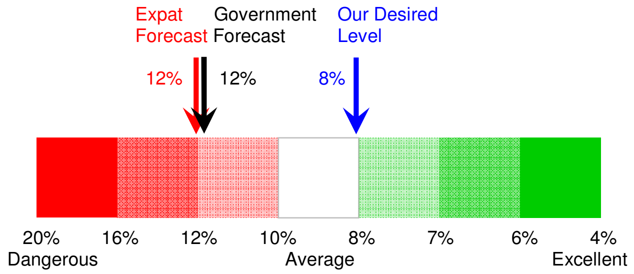
V) Inflation, %, 2010, Year-End



VI) Current Account Deficit, % GDP, 2010

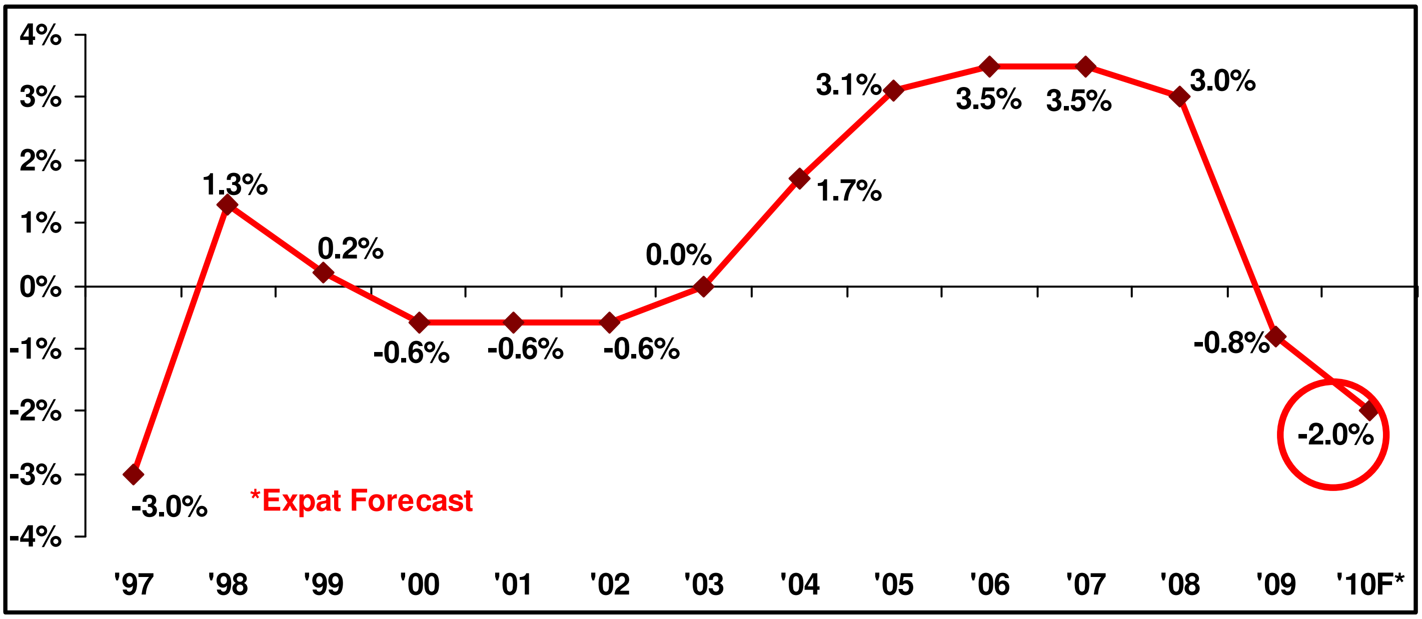


VII) Unemployment, %, 2010, Year-End



I) BUDGET SURPLUS/DEFICIT

Chart 1. Budget Surplus (+)/Deficit (-), % GDP



Source: Ministry of Finance, Bulgarian National Bank, Expat Capital

The budget: sliding from huge surpluses to deficits

The news about the budget is mixed, in our view. On the positive side, Bulgaria has achieved the lowest budget deficit in the EU for 2009 – only 0.8% of GDP. If Bulgaria has to be criticized for running a small deficit, what should we say about the rest of Europe? What is more, this deficit of c. BGN 500 mln was accumulated in July alone, just before the new government came to power. Thus, the new reformist finance minister deserves recognition for effectively balancing the budget for Aug-Dec 2009 through successful spending restrictions. The comments that public spending was in a non-thrifty pre-election mode between Sept 2008 and July 2009 are justified, we would agree.

On the other hand, critics can say the country could have achieved a bit more. Deeper public sector reforms, including health care and the pension system, are being discussed but have not started yet. The balanced budget rhetoric (which we strongly support) does not resonate with the fact that Bulgaria has turned into a deficit after 6 years of record surpluses. The government has delayed expenses of between BGN 1 and 2 bn – mostly for existing public procurement contracts – thus worsening the severe liquidity crisis in the economy and the increasing inter-company indebtedness. On an accrual basis, i.e. not on an actual cash basis, the true 2009 budget deficit should be 2-3%. Also, the 2009 budget was amended in December to allow for a deficit. The Bulgarian parliament had not amended any budgets for the past 12 years.

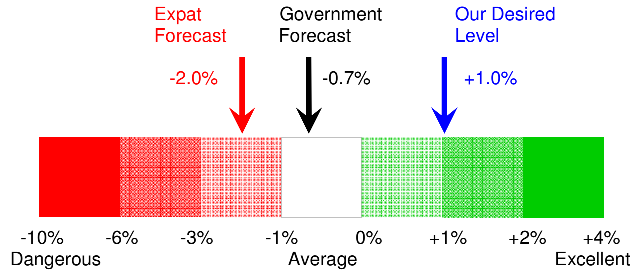
We are also disappointed that the 2010 budget envisions a deficit of 0.7% of GDP for the first time since, probably, 2003. Let us remind that Bulgaria has traditionally run high current account deficits which reached dangerous levels of over 25% of GDP in 2007-08. Thus, budget surpluses seem prudent for a country with a currency board, with high external imbalances, and for a country which defaulted on its foreign debt service in 1990 and experienced high inflation and hyperinflation in 1990-97.

To summarize, Bulgaria's budget deficit situation is better than all EU countries, but is worse than Bulgaria's achievements during the whole period between 1998 and 2008. We are also worried that populist pressures for more spending might make things worse and not better in 2010-13. As the chart shows, we actually expect the deficit to reach 2% in 2010, while our desired level is a surplus of +1% of GDP.

Diagnosis: from "dark green" (i.e. positive), we are entering the "red" (i.e. negative) zone

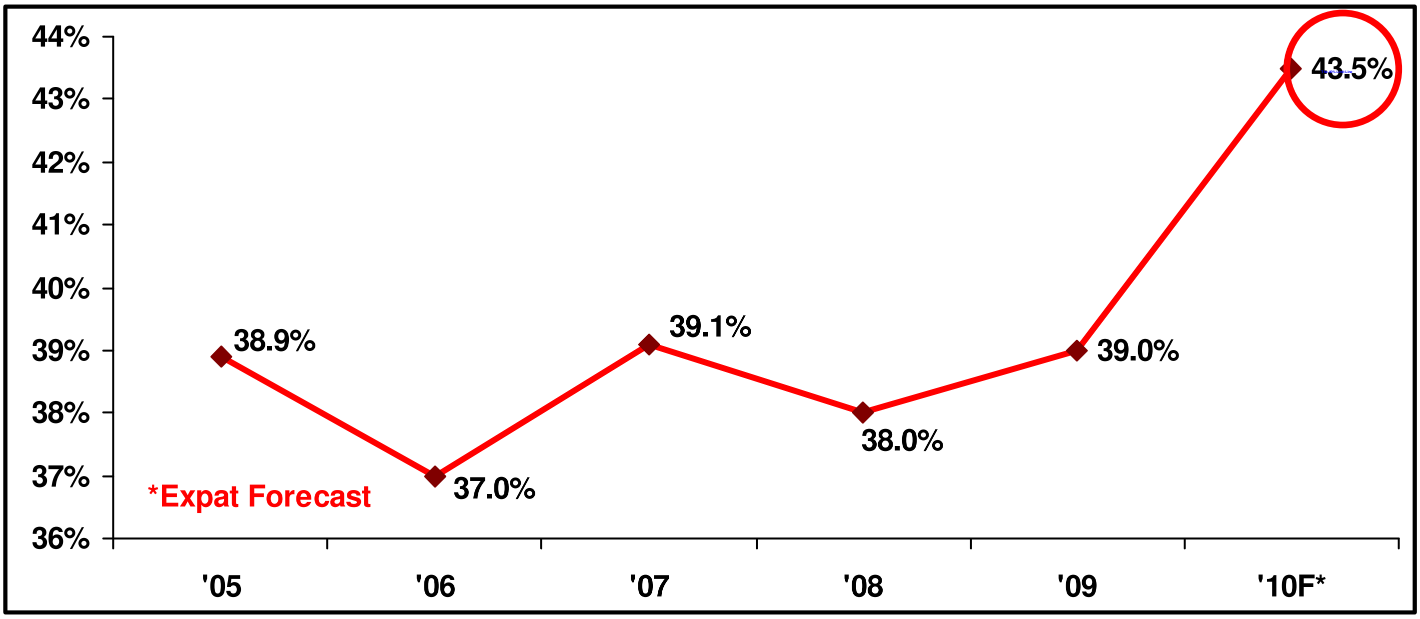
Implications for the currency board: positive but worsening

Budget Surplus/Deficit, % GDP, 2010



II) BUDGET SPENDING

Chart 2. Public Spending, % GDP



Source: Ministry of Finance, Bulgarian National Bank, Expat Capital

Public spending: the 2010 budget is not small but excessively generous, especially to pensioners

Many observers depict the 2010 budget as small in size. We disagree. In our view, the 2010 budget as % of GDP is too large, by far the largest for the last two decades. Bulgaria used to plan budget expenditures below or around 40% of GDP for many years. Even in 2005-09 Bulgaria spent only 38-40% due to the restrictions enforced by some of the coalition partners in the government. Moving far from its originally declared intentions of keeping public spending within 30-35% of GDP, the present government has increased it to 42.3% for 2010, with promises for additional money for several sectors such as agriculture, health care, and internal affairs. We think spending may get closer to 43.5%, while our recommended level is as low as 39%.

The government has publicly outlined six priority areas in the 2010 budget: the social sector, education, health care, environment, road infrastructure, internal affairs. However, most of these sectors will receive significantly less money than initially planned for 2009. With one notable exception which is not among the priorities: **pensions.** In fact, the Bulgarian pensioners are the only segment of the population which has not suffered from the crisis. In 2007, pensions were as low as 8.3% of GDP. In 2010, they will be over 11.3% – and this does not include any possible mid-year increases (not budgeted, but possible) and year-end bonuses. For 3 years, pension spending has increased by over BGN 2.5 bn, or by 54%, while nominal GDP has only risen by 12%. Our expectation is that the actual pension spending might reach 12% of GDP in 2010, while our recommended level is below 9%. With worsening demographics, a radical pension reform would be necessary, which should include freezing or even reducing pensions and raising the retirement age.

Unless the government wants to raise taxes and social security contributions or run chronic budget deficits. Or, even worse, reduce the pensions in real terms through currency devaluation.

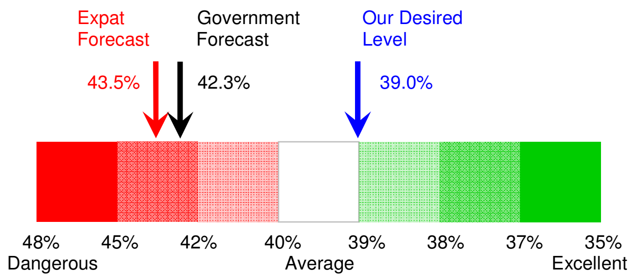
Here is our check-list for desired developments. On all these fronts, our current expectations are not optimistic:

- health care reform, including, inter alia, the closure of a hundred or so hospitals
- changes in the pension model in order to reduce public pension spending as % of GDP
- continuing reforms in education, as well as restructuring of the Academy of Sciences
- additional optimization in the public administration (the number of civil service employees was reduced by 17 thousand in 2005-09, the new government has promised more)
- privatization and concession deals, public-private partnerships, which should help substitute public investment in infrastructure with private funds

Diagnosis: from "green" (i.e. positive), we are entering the "red" (i.e. negative) zone

Implications for the currency board: average but worsening

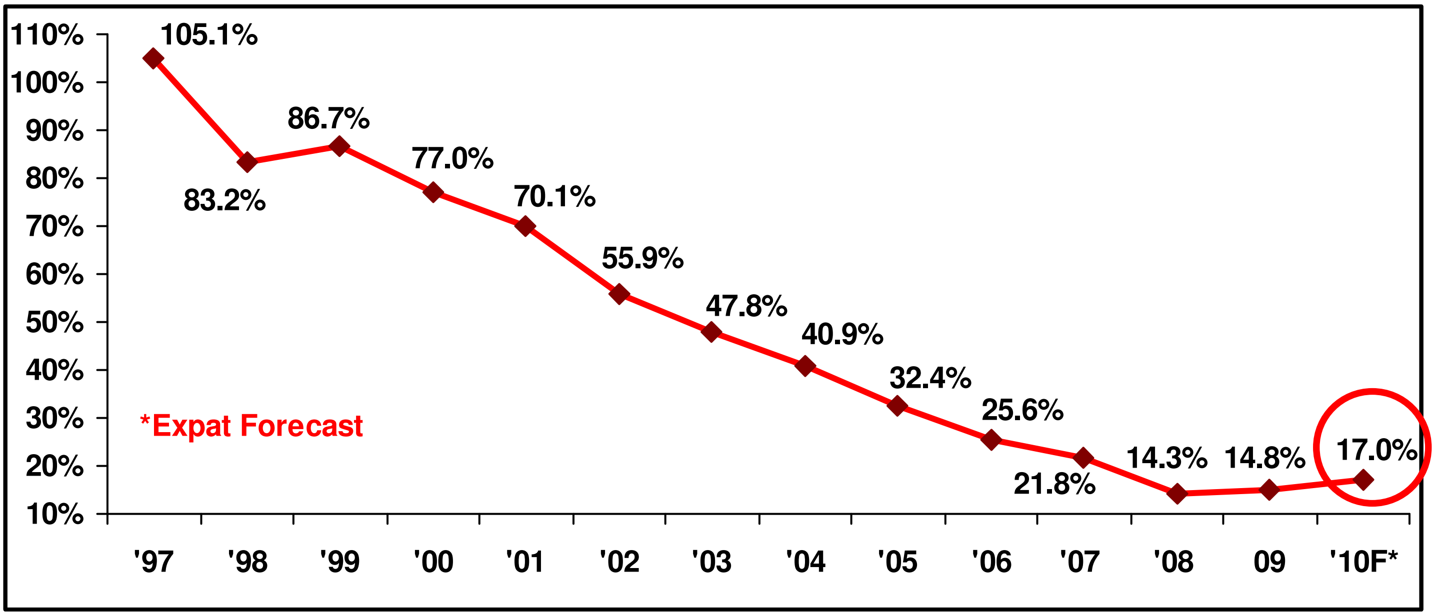
Budget Spending, % GDP, 2010



ANALYSIS

III) GOVERNMENT DEBT

Chart 3. Public Debt, % GDP, Year-End



Source: Ministry of Finance, Expat Capital

Bulgaria is a low-public-debt country, but the private sector's foreign liabilities are large

When we evaluate the indebtedness of a country, we should have in mind where it started from. Bulgaria defaulted on its foreign debt in 1990 and restructured it in 1994. Back then, the government debt was over 130% of GDP. Bulgaria was a very highly indebted country. Or rather, nominal GDP was very low in dollar terms. Through very prudent fiscal policies from 1998 to 2008 and due to the strong GDP growth, the country managed to reduce its indebtedness to below 15% of GDP. Furthermore, the foreign exchange reserves of EUR 12 bn are much larger than the total government debt of EUR 5 bn. Thus, Bulgaria has actually no net public debt, domestic or foreign, i.e. Bulgaria would be able to repay all its public debt with reserves. If this is the case, it would be interesting to think about why the country's credit rating (BBB by S&P) is lower than that of Greece (BBB+) and many other countries with sharply deteriorating public finances and soaring debt levels.

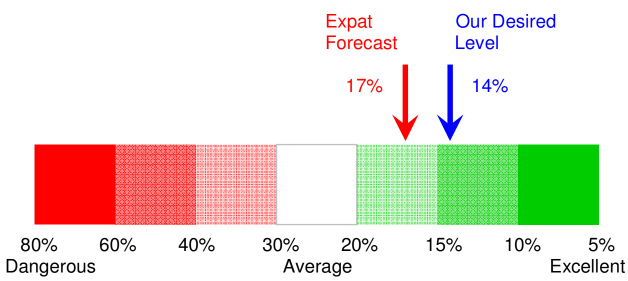
The government's programme says the level of public debt should be kept below 25% of GDP. We would welcome not an increase, but an additional decrease in the indebtedness as a result of running budget surpluses. However, the positive trend has been reversed.

The picture in the **private sector** is quite different. During the economic boom in the last several years, the local companies managed to accumulate large amounts of foreign liabilities comparable to the size of the country's GDP. Some of this debt is to the foreign parent companies, including parent banks. We are afraid there might be many entities experiencing financial distress in 2010-11. We should watch closely the amount of bad loans in the banking system, as well as the number of bankruptcies, especially among large companies.

Diagnosis: "green"

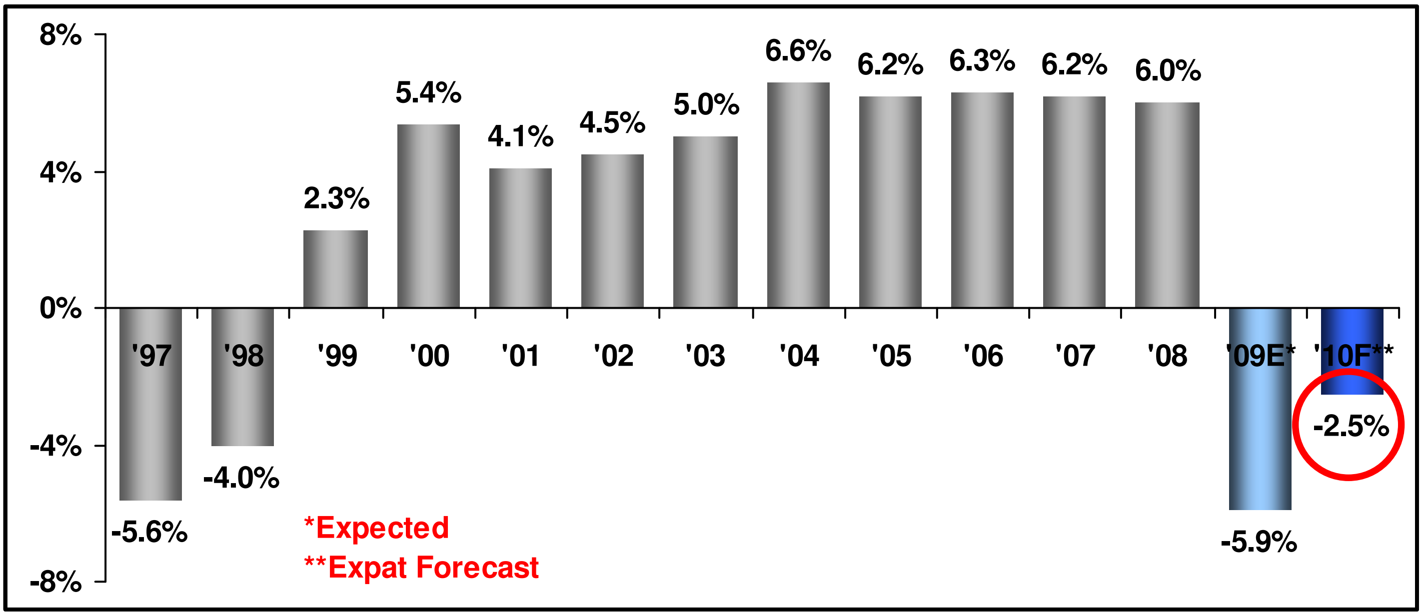
Implications for the currency board: public sector – very positive; private sector – negative

Government Debt, % GDP, 2010, Year-End



IV) REAL GDP GROWTH

Chart 4. Real GDP Growth, %



Source: Bulgarian National Bank, National Statistics Institute, Eurostat, Expat Capital

Will the recession end in 2010? We are not sure

Similarly to most of the rest of the world, Bulgaria enjoyed 10 years of strong growth which in 2004-08 was above 6%. We can argue that Bulgaria entered the crisis in a better shape than most of the other countries, but it has suffered nevertheless. In 2009, GDP might have contracted by around -5%, the numbers are expected in March 2010. Industrial production has fallen more sharply. The construction and real estate sectors, which were flourishing till the summer of 2008, have been hit the most.

The **banking sector** in Bulgaria entered the crisis in a good shape. No distress situations; the highest capital adequacy ratios in the EU of some 17%; very few non-performing loans before 2009, although rising strongly since mid-2009. Interest rates have increased sharply with bank BGN deposit rates above 9% per year and credit rates in double digits. This has attracted more deposits to the banks, but the business sector has experienced a credit crunch and high interest expenses. The large and rising inter-company indebtedness and the lack of financing seem to be a major problem for the economy at the moment. The banking sector reported record profits of BGN 1.4 bn in 2008, and another BGN 700 mln in 2009. We hope to see bank profits for the sector as a whole also in 2010, but we are not very optimistic about the level.

No high-profile bankruptcies in the industrial sector so far, except the steel giant Kremikovtsi, but the latter was probably not due to the crisis. The shutdown of Kremikovtsi has additionally hurt the railways and the ports due to the reduced cargo volumes.

When will this recession end? Well, this is the million-dollar question. Our view is that H1 2010 should be worse:

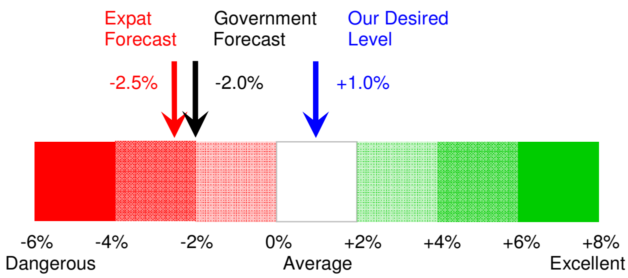
- rising bad loans and massive write-offs at the banks
- bankruptcies of industrial companies and SMEs
- continuing lack of liquidity
- stagnation in the construction sector, and real estate prices falling further
- shaky stock market

The turning point might then happen in H2 2010, as long as the EU has positive growth of at least 1% in 2010.

Diagnosis: “red” territory – recession

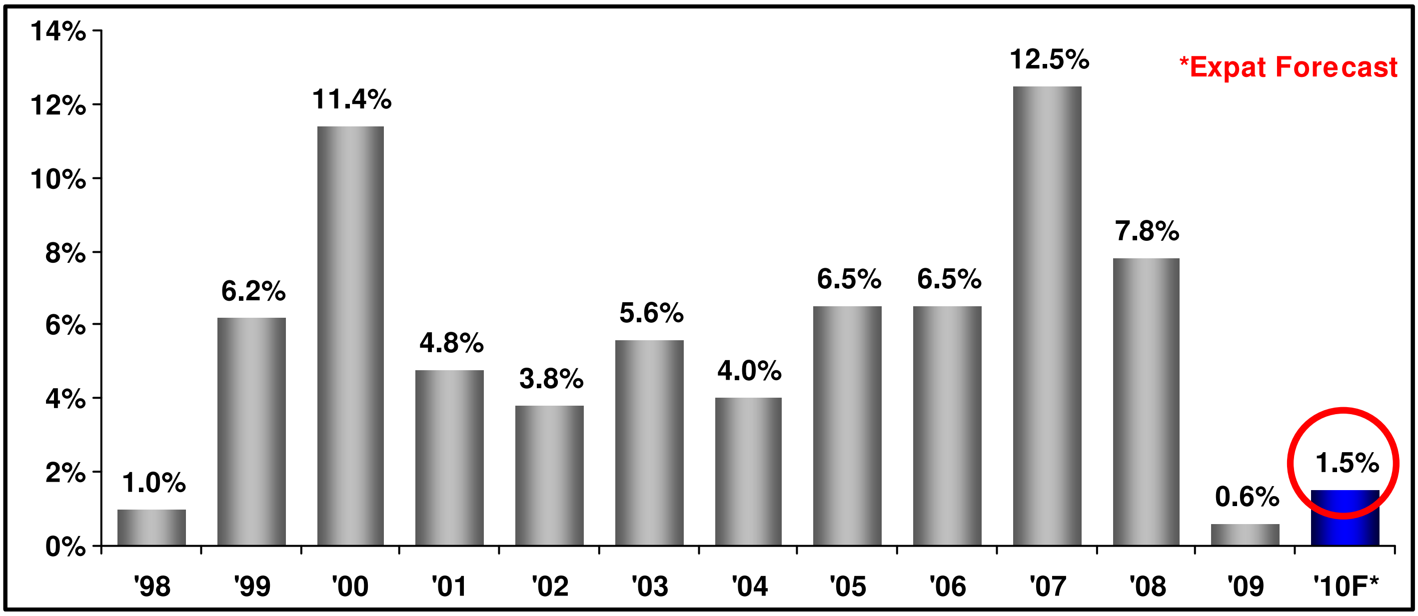
Implications for the currency board: negative

Real GDP Growth, %, 2010



V) INFLATION

Chart 5. CPI Inflation, %, Year-End



Source: National Statistics Institute, Eurostat, Expat Capital

Inflation is not currently a problem, but asset deflation is detrimental

The inflation diagramme (bottom right) is the only one where there is no clear green-to-red, i.e. good-to-bad scale. With a currency board and the 2009 inflation just above zero, which is good and which is bad? Double-digit inflation is obviously bad for the currency due to the resulting loss of price competitiveness. However, we believe that the sharp deflation of real estate and stock prices is also very detrimental for the economy due to the large evapouration of wealth and to the worsening business sentiment.

According to anecdotal evidence, **real estate prices** have fallen at least by a third. However, numerous flats, vacation and commercial developments are now completely unsellable and illiquid. The real estate market has largely stalled. Since many bank loans are secured by real estate, this should create major problems for the banks in 2010.

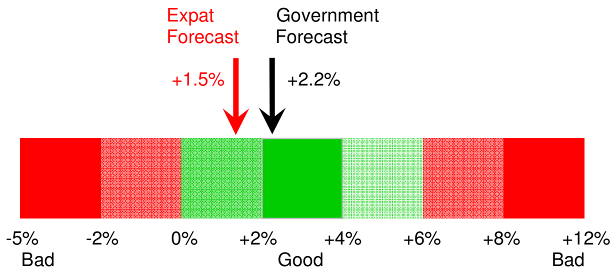
The **stock market** reached its historic peak in late 2007 after rising over 27 times in euro terms, or over 40 times in dollar terms, for 6 years. A year later, it lost over 85% of its value, and has risen by over 65% since then. The super bullish sentiment of 2001-07 will hardly come back soon. The factors to watch in 2010 are corporate earnings, real estate prices, and non-performing loans.

We can argue that Bulgaria's economic policy was proinflational in 2006-08. Today, inflation does not pose a problem. The government expects 2010 inflation of +2.2%. We are more conservative at +1.5%, because we are less optimistic about the recovery.

Diagnosis: "green"

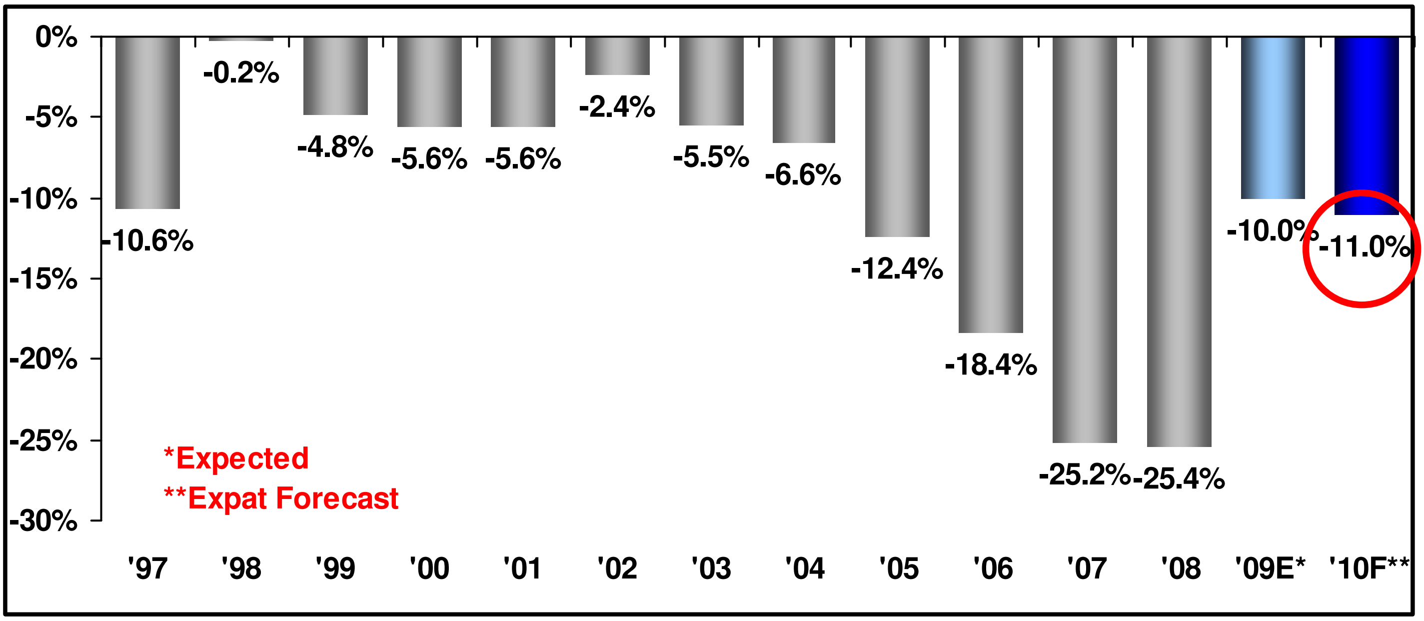
Implications for the currency board: positive

Inflation, %, 2010, Year-End



VI) CURRENT ACCOUNT DEFICIT

Chart 6. Current Account Deficit, % GDP



Source: Bulgarian National Bank, Expat Capital

The current account deficit has improved strongly, but is still dangerously high

Asking an economist whether a current account deficit of over 25% of GDP is dangerous for a country with a currency board is like asking a doctor if the patient's temperature of 41℃ (106℉) is worrying. We think such a level is very dangerous and unsustainable. *Ceteris paribus,* such a country might head towards a currency crisis.

Now, ignoring the paragraph above, is a current account deficit of 8-14% dangerous for a country with a currency board? Well, 10% is obviously lower than the astronomical 25.4% (2008), but it is still not good by itself. In 2001, the newly-elected government considered the 5% deficit in 2000-01 not desirable, and through an array of policies reduced it to 2.4% in 2002. After 2005, the problem was broadly ignored, and, had it not been for the global crisis, the dangerous levels might have continued.

Consistently large trade and current account deficits mean that the country does not produce enough competitive products and services, that it imports too much and lives beyond its means, and the currency might be strongly overvalued. True, there are some mitigating circumstances. Between 2002 and 2008, Bulgaria attracted EUR 30 bn of **foreign direct investment** (FDI). In 2007 alone, FDI was EUR 8.6 bn, or 28.9% of GDP – one of the highest in the world as % GDP. Thus, FDI was high enough to finance the current account deficit up until 2007. Not in 2008, however.

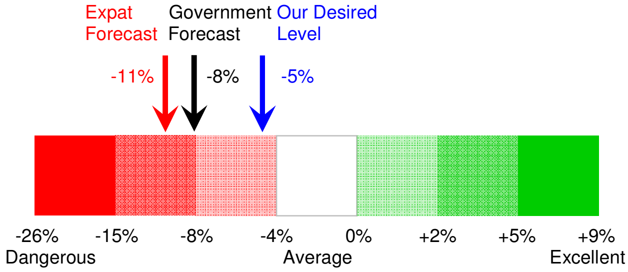
We are satisfied that the current account deficit has halved in 2009 – solely due to the crisis and the resulting reduced consumption and investment, and not to any deliberate economic policies. The government forecasts a 2010 current account deficit of 8%, while we are more pessimistic at 11%. In order to become optimistic, we would like to see some policies promoting exports and tourism, as well as high exports growth. Not in sight at the moment, unless the EU grows strongly in 2010 – also not in sight at the moment.

We are also worried that this government, just like its predecessors, is not concerned enough about the current account deficit and is not initiating adequate policies in this direction. We will continue monitoring this important indicator.

Diagnosis: from "dark red" to "red" – still dangerous

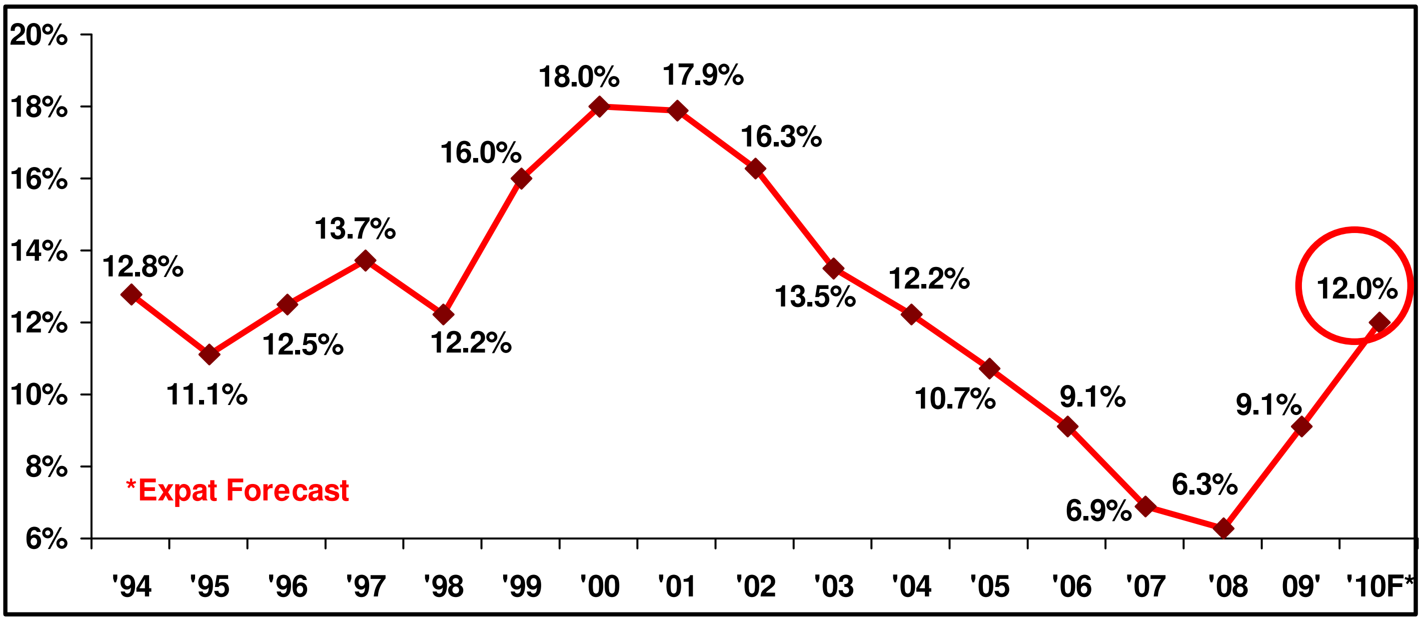
Implications for the currency board: very negative, but improving strongly

Current Account Deficit, % GDP, 2010



VII) UNEMPLOYMENT

Chart 7. Unemployment, %, Year-End



Source: Employment Agency, Expat Capital

Unemployment is rising, wages have shown flexibility

After 8 years of quickly falling unemployment – from 19.3% in Feb 2001 to below 6% in 2008, the crisis has reversed the trend. It is difficult to predict the level of unemployment for the end of 2010. Our current forecast is for 12%, but things might get worse, should the recession continue.

The average monthly salary was increasing by 15-20% per year in the last several years, quickly improving the living standards. This increase has now stopped due to the crisis.

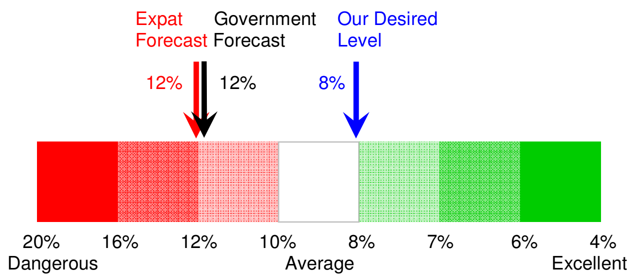
It has been interesting to monitor the behaviour of the labour market in a recession. We believe that the downward rigidity of wages is a major structural problem for an economy. However, salaries in Bulgaria have shown significant flexibility in the last year. Officially, the average nominal salary increased by up to 10% for 2009. However, it is very likely that some of this increase is due to higher salaries being *reported,* not actually *paid.* It is well known that not all incomes are reported for tax purposes. Anecdotal evidence suggests that in many companies the salaries have been effectively reduced by 10-20, and on some occasions by up to 50%, primarily through the introduction of mandatory unpaid leaves. In our view, the reduction of salaries helps keep jobs and improve the suffering competitiveness of the economy.

Public sector salaries, as well as the minimum wage, have been frozen since 2008. We consider this a positive reformist measure by both governments, although other countries have even managed to decrease nominal public-sector incomes. As we mentioned in the budget section, pensions in Bulgaria have increased strongly.

Diagnosis: "red"

Implications for the currency board: average, but worsening

Unemployment, %, 2010, Year-End



GUEST COMMENT

THE ECONOMY IS FLEXIBLE IN TIMES OF OVERWHELMING EXTERNAL SHOCKS

Photo: Indeximoti.bg

Lachezar Bogdanov was born in Sofia, Bulgaria in 1976. He has a Master's degree from the University of National and World Economy. In 1996, he started to work as a researcher at the Institute for Market Economy in Sofia, a leading NGO and think-tank. Since 1999, he has coordinated business environment and deregulation projects with the Institute.

He is founder and a board member of the Bulgarian Society for Individual Liberty (2003) and founder of the Bulgarian Economic Association (2003). In 2004, he co-founded the Industry Watch Group – a private economic research and analysis company.

The major fields of his work include tax and fiscal policy analysis, public-private partnerships and privatization, analysis of the real estate market, assessment of macroeconomic risks.

The Bulgarian economy has proved to be relatively flexible in times of overwhelming external shocks. Despite its record levels in 2007 and 2008, the current account deficit shrank significantly in 2009. Moreover, imports fell faster than exports; in fact, in November exports grew by modest 3.6% y-o-y. Employment figures also imply remarkable adjustability of the labour market – the suspected "bubble" sectors are the ones with the highest rate of lay-offs in just 9 months during 2009. All concerns for a massive capital flight from the country have not materialized. The contraction, though severe, still leaves a sizable amount of net positive capital inflows to the economy.

On the domestic side, banks are well capitalized and pose no immediate systemic risk. However, the volume of reported bad loans continues to rise. Losses need to be liquidated fast so that balance sheets are cleared of high debt, and a new phase of capital formation can start. The restructuring of the real sector is inevitable and yet to come in 2010 and 2011; the process will be painful if there is no massive inflow of new foreign capital to finance the purchase of distressed assets.

LACHEZAR BOGDANOV
Industry Watch
Managing Partner

ABOUT EXPAT CAPITAL

EXPAT CAPITAL is a financial services company based in downtown Sofia, offering asset management and financial advisory services to local clients and foreign investors. We are also a licensed asset management organization, managing a family of mutual funds, real estate investment trusts and individual investment accounts for a select group of clients.

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