Issue 2 March – April 2010

# expat compass

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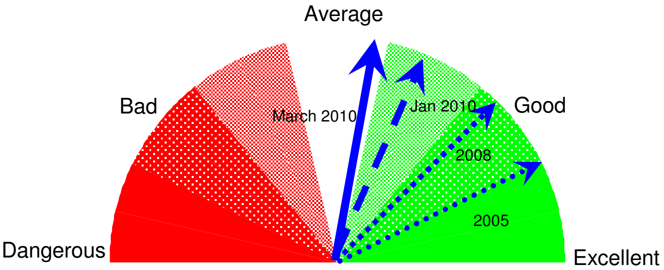
## EXPAT CURRENCY BOARD WATCH




**OUTLOOK: WORSENING FASTER THAN EXPECTED**

Our proprietary indicator – the **Expat Currency Board Watch** (page 2) – 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. In this issue, **we are moving the pointer leftwards, i.e. in the negative direction** due to the rising budget deficit and the falling fiscal reserves.

## MILEN VELTCHEV:
## THE CRISIS BITES THE TREASURY

The fast entry into the Eurozone waiting room is of utmost priority for the financial stability. The conservative management of the state finances is not less important. The minimum 2009 deficit created confidence among investors and was also appreciated by the IMF. **Page 9**

## SUMMARY

We are publishing the second issue of our *Expat Compass* slightly earlier than planned. As the economic situation is developing quickly, some of our conclusions might soon become outdated. The government and the public have started discussing potential fiscal stabilization measures which are aimed at containing the budget deficit. The measures might take place after our publication date, and we should discuss them in our future issues.

To summarize, we would express our support for any austerity package which would help keep the budget deficit very low. Although we, being part of the business and financial community, might not be happy with some individual measures such as any increase in direct taxation (no such decisive announcements have been made so far).

In the sections in this issue, we express our concerns about the 2010 budget – falling revenues and increasing spending. However, we are impressed by the strong improvement of the current account deficit and the continuing still good foreign direct investment in 2009. We have not been satisfied with the speed of reforms before February, but hope this will change soon with the new fiscal reform package.

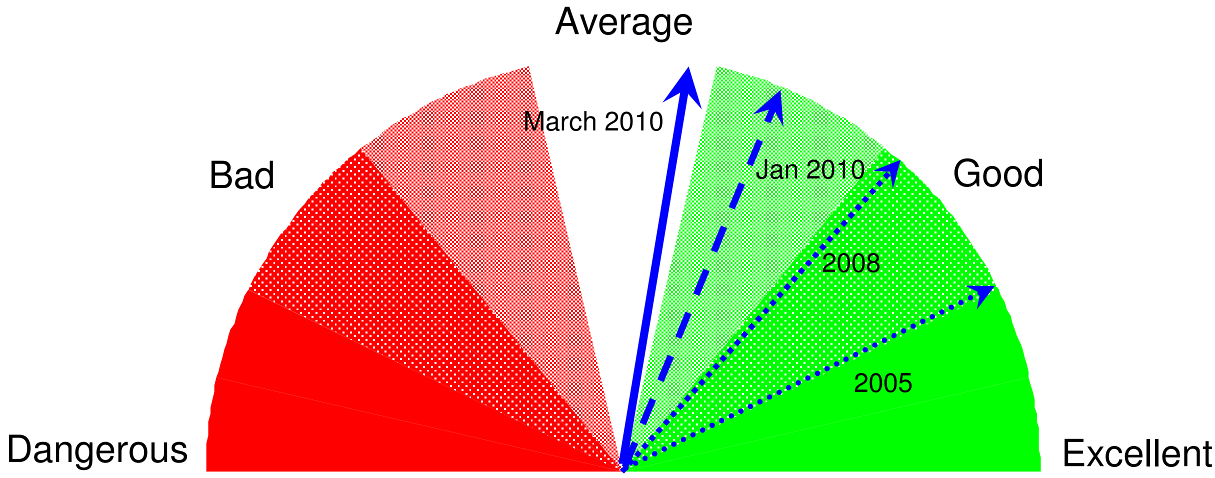
As far as the health of the currency board is concerned, we are moving the pointer (needle) of the compass leftwards – i.e. in the negative direction. This is due to the high budget deficits in January and February 2010 and the falling fiscal reserves. The “verdict” is worse than last time: **worsening faster than expected.**

We are aware that we have not yet addressed all important topics relevant to the stability of the lev-euro exchange rate. In the future, we intend to discuss the prospects for the banking system in 2010, as well the changes in the monetary aggregates and reserves.

In this issue, we have included a summary of the *Business Sentiment Index 2010 Q1* kindly provided to us by GS Research (page 8).

# EXPAT CURRENCY BOARD WATCH

## OUTLOOK: WORSENING FASTER THAN EXPECTED




In the first issue of the *Expat Compass,* we gave our positive conclusion: **We are optimistic about the currency board and see no immediate danger of devaluation (4 February 2010).** Now, **the situation is worsening faster than expected, and urgent decisive measures are needed.**

In this second issue, we are still not pessimistic, but we are less optimistic than two months ago. There are three reasons for this: 1) The budget has slid into an unexpectedly large deficit in January and February 2010; 2) The fiscal reserves have shrunk, possibly below BGN 6 bn; 3) We have not seen any decisive reform measures yet.

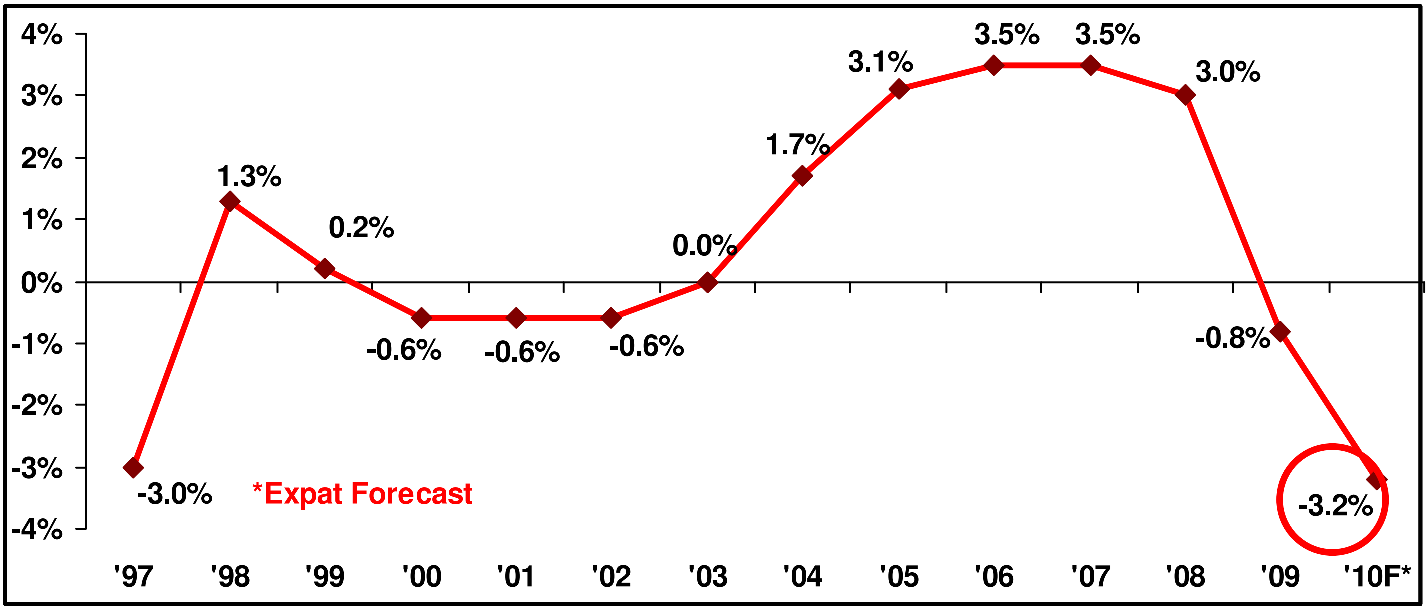
How to assess the stability of the currency board and to predict any danger of devaluation? We suggest the following checklist of 16 questions and provide our answers:

| ISSUE | OLD | NEW | 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 | - | -- | Deficit, rising very fast |
| 5. Budget spending | -- | | Excessive and rising |
| 6. Government debt | +++ | | Very low |
| 7. Foreign liabilities of the private sector | -- | | High |
| 8. Fiscal reserves | ++ | + | Falling |
| **III. Economic cycle related issues** | | | |
| 9. GDP growth | -- | | Recession |
| 10. Inflation | +++ | | Low |
| 11. Unemployment | - | | Rising |
| 12. Strength of the banking system | + | | Good but worsening |
| **IV. External balances** | | | |
| 13. Current account deficit, trade deficit | -- | - | 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 Bad

## I) BUDGET 2010 – IS A DISASTER ON THE WAY?

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




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

In the first issue of the *Expat Compass,* we warned about two important risks for 2010:

1) That the budget deficit would reach 2.0% of GDP instead of the 0.9% envisaged in the Budget Law; and
2) That spending would reach 43.5% of GDP instead of 42.3% – by far the highest level for the last two decades.

**Only bad news since January**

When we published the first issue (4 Feb), we had not expected the bad numbers for January: revenues down by BGN 1 bn year-on-year (yoy), expenses up by BGN 500 mln yoy. Deficit of BGN 500 mln compared to a large surplus in Jan 2009 when the country was already in a recession. Traditionally, in the first months of each year, Bulgaria has generated large surpluses. The opposite, the year-end is always characterized by huge deficits.

Thus, by all measures, the January 2010 budget situation can be considered worrying. The preliminary (undisclosed) numbers for February are even worse: a monthly deficit of BGN 700-1,000 mln. The fiscal reserves might have fallen to below BGN 6 bn. Not good.

The IMF mission to Bulgaria (the country has no programme with the IMF) in February resulted in mixed messages to the public. The IMF officials warned that a deficit of 1.8% was possible and dangerous, while Bulgarian officials mentioned even 2.5%. Well, by the end of February, the deficit reached 2.2% of the expected annual GDP. Let us remind you again that in the first months we should have normally seen a surplus.

**More populist promises**

We have not seen enough tax-collection-improvement measures. Meanwhile, certain sectors demand additional spending and get promises or half-promises: healthcare, police, agriculture, and possibly pensioners.

**We are worsening our deficit forecasts…**

In this second issue of the *Expat Compass,* we will disappoint you with worsening forecasts: the deficit might reach 3.2%, in our view. A yet larger number is very possible for the third *Expat Compass,* due in late spring. I.e., the outlook is negative. Unless an austerity package is implemented immediately.

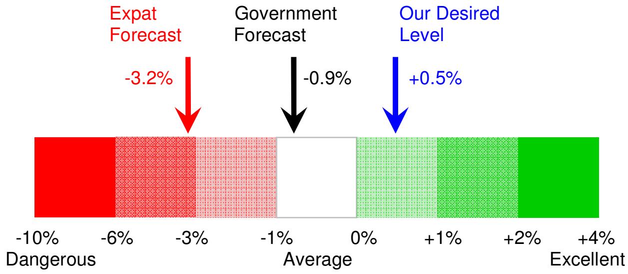
**… but not the spending forecasts**

A bit paradoxically, we are not changing the spending/GDP forecast at the moment (43.5%), and might even reduce it significantly in the future. The reason is that the more severe problem for the moment is not larger expenditures (as we thought) but lower revenues (which we did not suspect in January). Put under pressure, the government might respond with containing certain investment and other spending.

**Diagnosis:** deeper into the "red" (i.e. negative) zone

**Implications for the currency board:** worsening

**Budget Surplus/Deficit, % GDP, 2010**



## II) TAX POLICY – SWITCHING TO REVERSE GEAR?

For years, the Bulgarian low direct tax policy has been the envy of foreign observers:

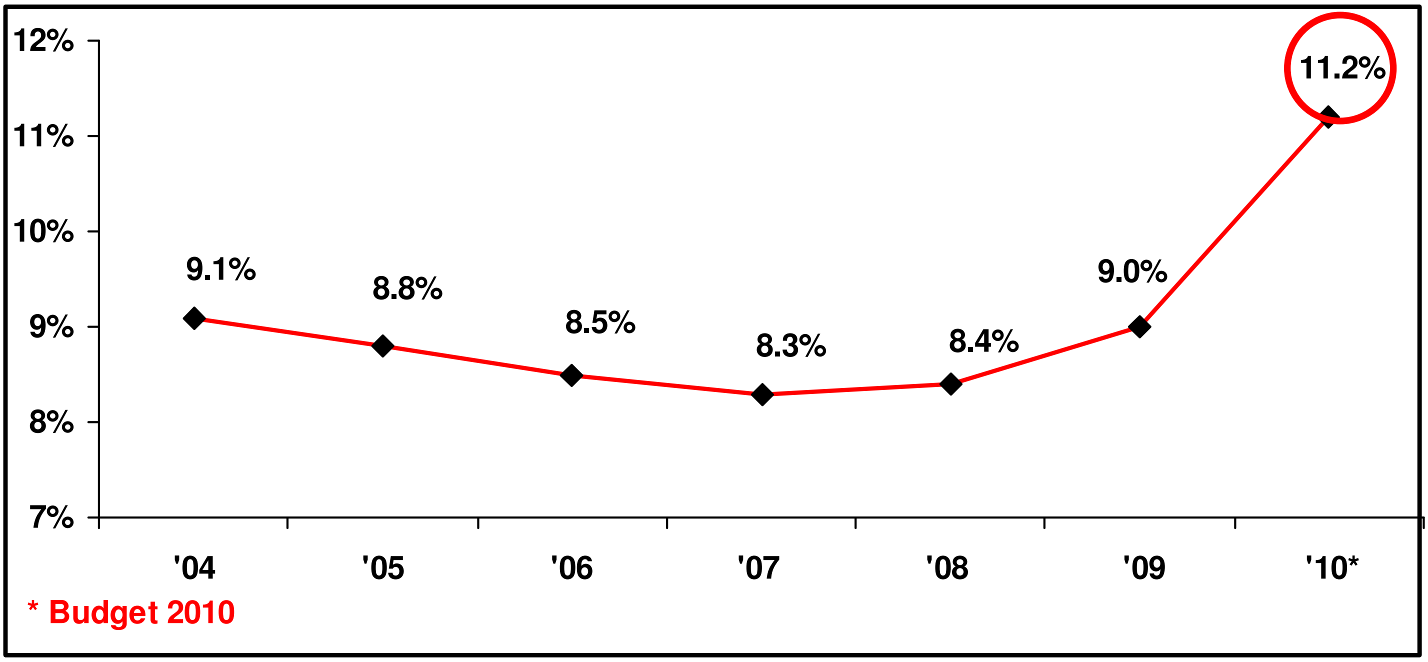
- Flat personal income tax: 10%
- Corporate profit tax: 10%
- Dividend tax: 5%
- Capital gains tax: 0% (for securities trading, mutual funds)
- Interest income tax: 0%
- REIT (real estate investment trusts) profit tax: 0%

This combination has made Bulgaria very attractive for investments and for the financial markets.

In addition, social security contributions have fallen by 11 percentage points for the last 5 years – 2 of these percentage points are the successful contribution of the current government. In early March 2010, a surprise move was announced to raise the health contributions by 2 percentage points. Later, the decision was reversed. A potential increase of the 10% flat personal income tax was mentioned – a taboo before. Finally, a “luxury tax” on deposits over BGN 100,000 was suggested. In our view, its most likely effect would be that such large deposits would disappear from the banks, worsening bank liquidity and further tightening an already difficult credit situation.

If any of these are implemented, that would be the first increase of any direct tax since, probably, the middle of the 1990s.

**Chart 2. Pension Spending, % GDP**

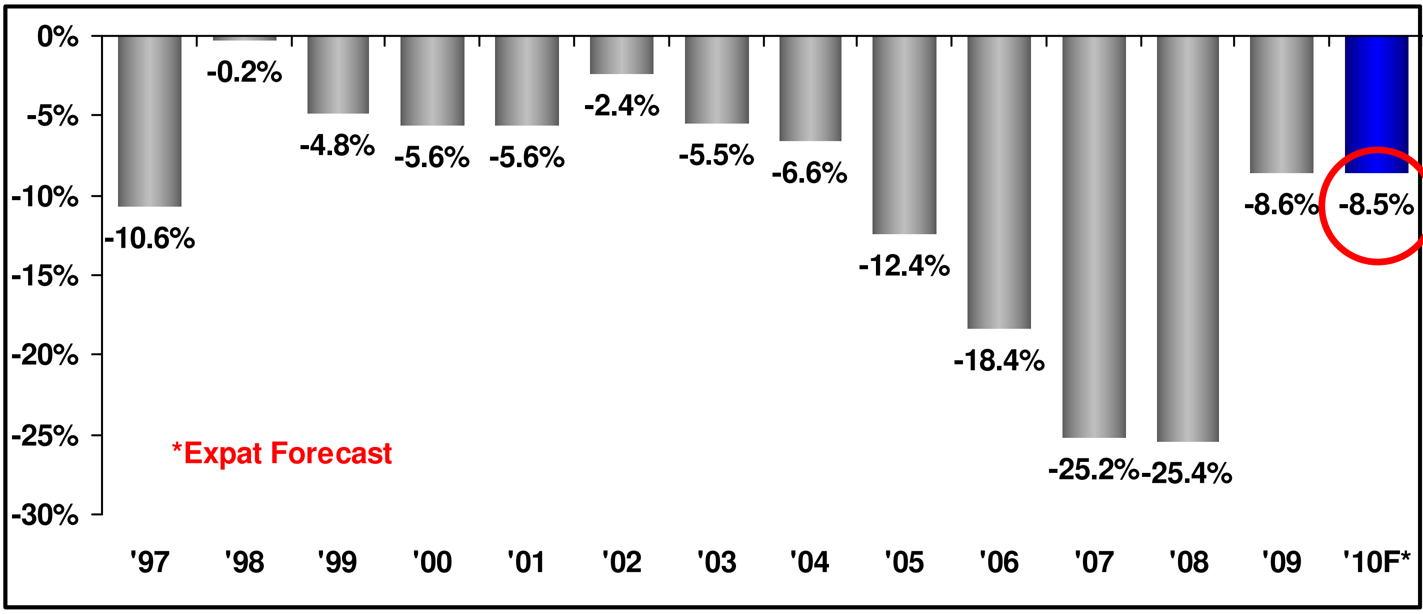



*Source: Ministry of Finance*

The rising spending on pensions is the single largest fiscal problem.

## III) CURRENT ACCOUNT DEFICIT – IMPROVING FAST

**Chart 3. Current Account Deficit, % GDP**




*Source: Bulgarian National Bank, Expat Capital*

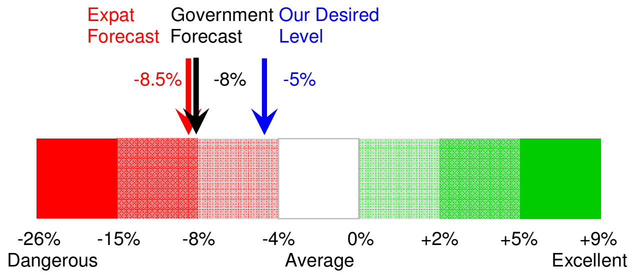
The fast contraction of the dangerously high external deficits is among the few pieces of good news we can share with you. We have now put the final 2009 current account number in the chart (-8.6%), and have strongly improved our 2010 forecast from -11% to -8.5%.

We now have to admit that in the first issue of the *Expat Compass* we were more pessimistic about the 2009 current account deficit. We had not yet seen the better data for November and December 2009 when exports rose and imports fell further due to the much lower domestic demand. Also, the government did not spend excessively at the end of 2009, which had resulted in large year-end trade deficits in previous years.

**Diagnosis:** from “dark red” to “red” – less dangerous

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

**Current Account Deficit, % GDP, 2010**



## IV) FOREIGN DIRECT INVESTMENT

**Chart 4. FDI, EUR mln**

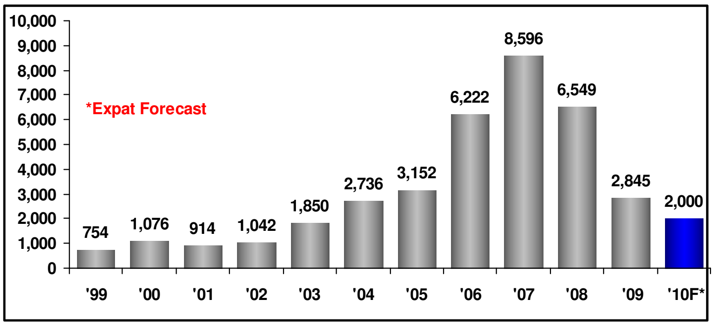
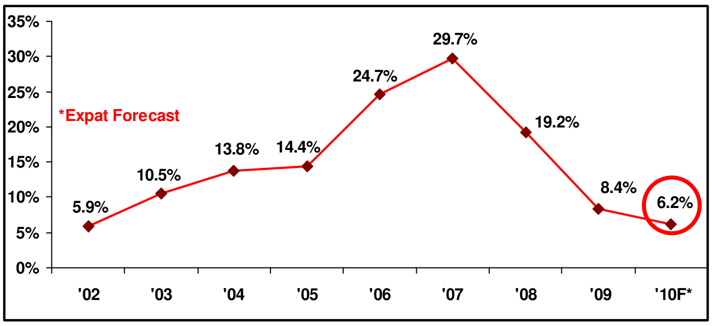



**Chart 5. FDI, % GDP**




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

After record levels of FDI in 2006-2008, capital inflows have obviously fallen due to the crisis. This has also indirectly resulted in much lower trade and current account deficits. However, we are not unhappy with the numbers. Regardless of the crisis, FDI was still almost EUR 3 bn in 2009. And these are just the preliminary data – the final numbers have traditionally been upgraded by a billion or so. At 8.4% of GDP, this might still be the highest level in Europe (FDI as % GDP).

The breakdown by sector looks diversified and healthy. Real estate related FDI was just one sixth of the total.

FDI was almost equal to the current account deficit in 2009, which we consider success.

**Diagnosis:** Average

**Implications for the currency board:** Average

**Foreign Direct Investment, 2010, EUR bn**

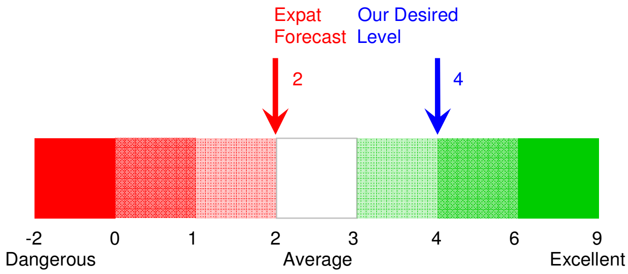
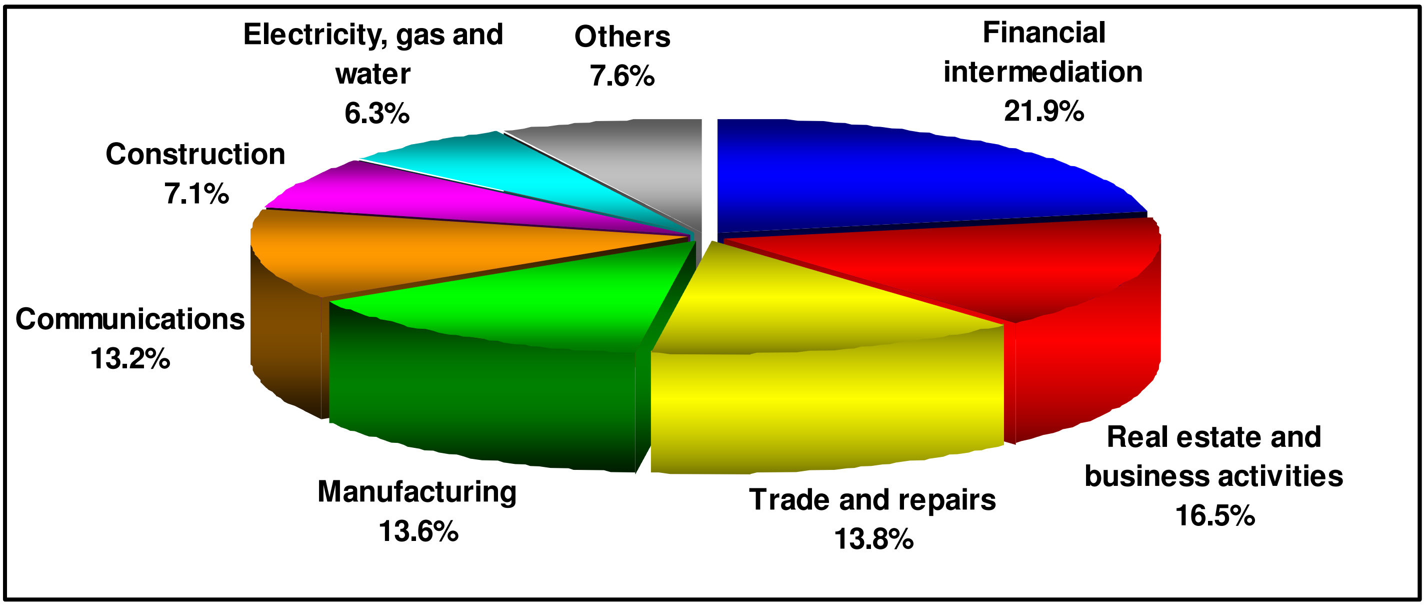



**Chart 6. FDI, Breakdown by Sector, 2009**




*Source: Bulgarian National Bank*

## V) 2010: WILL REFORMS START?

**Slow movements till February**

In its first months of office, the new government had enviable reformist rhetoric: pensions, healthcare, administration, higher education and science – all had to be downsized and modernized. In our first issue of the *Expat Compass,* we expressed our support for this agenda. However:

- In February 2010, the pension reform was "postponed till 2012" – i.e. completely killed, in our view. Disappointing. We continue to see the high pension spending as the largest threat to macroeconomic stability.
- Announced healthcare reforms such as the closing of many regional hospitals have been effectively put on hold in the face of vocal public opposition. No immediate plans and measures are discussed in that field. The current strategy seems to be a "go with the flow" approach, which would preserve the status quo to the detriment of the budget and the quality of healthcare services provided to the public.
- We have seen no aggregate numbers on the downsizing of the state administration (let us remind you that the number of administration employees was reduced by 17,000 during the previous mandate).
- We have not heard of any results in higher education and science.
- The broad smoking ban, which was supposed to happen, starting 1 June 2010, was surprisingly cancelled. An unnecessary and disappointing move, we think.
- The policies on genetically modified organisms (GMO) were changed back and forth a few times. Eventually, the parliament imposed severe restrictions against GMO, which coincided with the public opinion.

**Anything else?**

- No privatization deals; no concessions; no IPOs of stakes in state-owned companies yet
- No immediate optimism about the large energy projects (the Belene nuclear power plant, the Burgas – Alexandroupolis oil pipeline, the AMBO (Bugas – Vlore) oil pipeline, the Nabucco gas pipeline, the South Stream gas pipeline)
- A moratorium on renewable energy projects has been announced

**Anything positive?**

- Progress with selecting the contractors to build parts of the Trakia highway
- A lot of successful actions in fighting crime and corruption
- The number of traffic casualties has been strongly reduced due to better control

The bottom line? You have guessed our conclusions by now.

**A possible reform package is expected in April**

When we were about to finish the current issue of the *Expat Compass,* the government and the public started discussing potential austerity measures. We have not yet seen any final document. As expected, the measures are supposed to achieve simultaneously two goals: increase revenues and sharply reduce spending.

**We see two scenarios:**

**1) Reformist:** very unpopular spending cuts – possible and desirable to us, but not very likely

**2) Populist:** almost no cuts; tax rate increases instead – more likely at the moment, although undesirable to us.

To summarize, we would welcome a reform package which would result in containing the budget deficit by reducing the spending, although some individual measures might seem undesirable.

**Reforms checklist**

1. Reduce pensions
2. Healthcare reforms
3. Reduce public sector salaries
4. Reduce the number of public sector employees
5. Reduce other spending
6. Improve tax collection (without raising rates)
7. Keep the current direct tax rates (see page 4)
8. Privatizations, concessions, stock market deals
9. Agreement with the IMF
10. Eurobond issue

If none of these occurs, we do not expect an optimistic third issue of the *Expat Compass* in a couple of months.

# BUSINESS SENTIMENT INDEX – 2010 Q1 (EXCERPT)

The Business Sentiment Index (BSI) is one-of-its-kind leading economic indicator issued quarterly. The Index incorporates an innovative survey and analysis approach developed by GS Research. It strives to portray the top managers' views regarding the future development of their own companies and the Bulgarian economy as a whole. The BSI-BG does not only reflect the current economic conditions but also mirrors the short-term and mid-term business sentiment.

**BSI-BG VALUES**

| Reference Period | Index Value |
|---|---|
| 2009 Q3 | 38.3 |
| 2009 Q4 | ⇧ 41.1 |
| 2010 Q1 | ⇧ 43.2 |
| 2010 | ⇔ 56.7 |
| 2011 | ⇩ 72.1 |

**Index Value Interpretation**

Min 0, Max 100

**50** – business sentiment remains neutral

**Above 50** – positive signal, business sentiment improves

**Below 50** – negative signal, business sentiment deteriorates

⇧, ⇩, ⇔– comparison to a previous survey

With an index value of **43.2**, the business leaders' panel believes that for the first quarter of 2010 the **Bulgarian economy still remains in the midst of the financial and economic turbulence.** The Arts & Entertainment, Real Estate, Human Resources and Commerce sectors weigh the index value down. Education and Renewable Energy keep lifting the index higher in 2010 Q1.

Few of the sectors surveyed exhibit negative expectations for 2010. The primary drivers of this deterioration in sentiment lie within the **contracting retail and wholesale markets as well as the clogged debt financing and the mounting intercompany debt,** amid higher credit risk in the economy.

Optimism struggles to edge two points higher compared to the 2009 Q4 expectations. Managers now see less inertia from 2009 and more recovery expectations as well as improved performance in certain sectors in 2009 Q4, this in turn incites the higher 2010Q1 expectations.

The BSI-BG value for 2011 tucks just above **72** points. This confirms the strong recovery expectations. The Renewable Energy, Motor Vehicles, Retail Trade and Transportation sectors contribute the most to the significant surge in positive expectations.

*Obtain a complete copy of the Business Sentiment Index and Report, after 1 Apr 2010 at:* http://klikshop.bg/

*Participate in the quarterly surveys, voice your expectations among the business leaders and the institutional investors. Request a questionnaire at:* survey@gsresearch.eu

**ABOUT**

GS Research is an independent, for-profit, analytical consortium comprised of Georgi I. Bylgarski, FRM and Simeon Ivanov, FRM. Both authors are investment consultants with experience in financial analysis, asset management and investment banking.

## THE CRISIS BITES THE TREASURY

**MILEN VELTCHEV**

24 chasa (daily newspaper), 11th March 2010

*Milen Veltchev was Minister of Finance of the Republic of Bulgaria (2001-2005). In this period he was appointed to the Board of Governors of the World Bank and the Board of Governors of the European Bank for Reconstruction and Development. He previously worked as Vice President in Emerging Markets, Investment Banking, at Merrill Lynch (London, UK).*

*In 2002, Euromoney and Business World gave him the Minister of Finance of the Year award. In 2003, he was named one of the 100 Global Leaders for Tomorrow.*

*Veltchev has a Master's degree in International Relations from the University of National and World Economy, Sofia, and an MBA in Financial Engineering from the Massachusetts Institute of Technology. He had also studied Business Management at the University of Rochester, New York.*

*Photo: 24chasa.bg*

In March, the IMF mission made comments about processes which could have fundamental importance for our economic development in the following years. The experts from Washington said that "…it is of key importance to keep the restrictions on budget spending in order to avoid a more significant deficit". According to unofficial information, by the end of February we have exceeded not only the annual deficit envisaged in the law, but also the 1.8% expected by the IMF. Let us hope that the Minister of Finance is right that after March the budget will function with a surplus, in order to compensate for the deficit in the first three months.

As of today, I feel that the Budget 2010 revenues are overestimated. It is difficult to analyze the reasons which have led to a fall in the January revenues by almost BGN 1 bn year-on-year. Both incidental factors and one-time inflows – which were present last year but not this year – could have influenced this outcome. However, it is obvious that the new working methods at the customs are not producing the expected results, and the dissatisfaction of the business community with the improper behaviour of the state has resulted in migration to the grey economy.

We should strategize in advance how the economy, as well as the budget, can live through the crisis. The fiscal reserves are a luxury unavailable to Greece and Romania. However, those reserves are not at last year's level and there is a risk that they will be exhausted unexpectedly fast. Our public debt is the lowest in the EU, with the exception of Estonia. But seeing Greece's difficulties in the capital markets, why should we expect investors to assess Bulgaria positively?

The fast entry into the Eurozone waiting room is of utmost priority for the financial stability. The conservative management of the state finances is not less important. The minimum 2009 deficit created confidence among investors and was also appreciated by the IMF. The credit rating agencies gave positive signals.

Structural reforms are also necessary. Privatization, concessions, pension and healthcare reforms are included here as well. The government should urgently take the following initiatives:

- Make the delayed payments to businesses: even the IMF made explicit demands that the avalanche increase of inter-company indebtedness be stopped.
- Begin the pension reform: another unambiguous recommendation of the IMF, which calls for an increase of the pension age and/or an increase of the required years of work.
- Privatization and concession deals: selling all the minority stakes owned by the state, as well as state assets in the energy sector such as Bulgargaz, coal power plants and mines, which will fill the fiscal reserves, while the airport and port concessions would bring regular budget revenues.
- Avoidance of any forms of increase of the direct taxes and health insurance contributions: such an increase in the middle of the year not only contradicts the law, but is also a signal of desperation. It alerts the Bulgarian businesses and the foreign investors that the times of low taxes in Bulgaria have passed.
- Liberalization of the business environment: this will return the lost business confidence, even partially, and will contribute to the attraction of new foreign investments, creating new jobs. Here we should mention that detrimental initiatives such as compulsory collective employment contracts should be avoided as well.
- Urgent attraction of fresh foreign resources of at least EUR 1 bn: either through an agreement with the IMF, which seems more and more inevitable, or through issuing new debt in foreign capital markets. The reason is for this is that the budget – and common sense – does not allow a reduction of the fiscal reserves below BGN 6 bn.
- Long-term credit lines for Bulgarian businesses through the Bulgarian Development Bank (not directly but through commercial banks). The resources for this can also be provided by the international capital markets.

# EXPAT NEWS

### Capital Increase of Expat Beta REIT

*24/02/2010*

On 24 Feb 2010, the Board of Directors voted a capital increase of Expat Beta REIT from the current BGN 4,342,890 to BGN 47,771,790. The increase will be effected through an initial public offering of 43,428,900 ordinary registered dematerialized shares. The issue price of the shares is BGN 1.00.

Expat Beta is a real estate investment trust – a public company listed on the Bulgarian Stock Exchange – Sofia and regulated by the FSC. The fund has targeted investment-grade properties with operating licenses in financial distress at prime Sofia locations, and intends to take advantage of the severe market downturn and acquire such assets at very low prices, close to the level of bank debt used to finance their construction. Expat Beta REIT is one of the very few stocks in Bulgaria which are trading at broadly the same price as a couple of years ago, before the crisis. One of the reasons is that the fund has zero debt.

Expat Beta currently holds 140,099 $m^2$ of land zoned for development in the Kamchia resort on the Black Sea Coast. The current capital increase is intended for distressed prime quality assets.

### Mekom to Float BGN 14 mln Preferred Shares

*17/03/2010*

The Silistra-based company Mekom plans to increase its capital from BGN 56 mln up to BGN 70 mln by issuing 14,000,995 preferred shares with a BGN 1.00 nominal and issue price. The capital increase will be considered successful if at least 140,010 new shares are subscribed (1% of the issue).

The non-voting shares guarantee a cumulative annual dividend of 12% of the nominal value. All the preferred shares will be automatically converted into ordinary ones 5 years from the date of registration of the issue at the Trade Register. Alternatively, they can be converted at any time before that (standing convertibility option), with 1 preferred share being converted into 1 ordinary share). This gives a capital gains upside potential to future shareholders in addition to an attractive guaranteed annual dividend.

Mekom plans to use the proceeds from the planned issue for executing a EUR 17.2 mln investment plan for capacity expansion and reconstruction. Part of the financing will be provided through a bank loan. The project is scheduled for implementation during 2010-2011.

Mekom is the biggest meat-processing company in Bulgaria and the largest Bulgarian meat exporter to the EU.

Expat Capital is a consultant on the IPO, BenchMark Finance has been chosen as the investment intermediary.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