Issue 4 September – October 2010

expat compass

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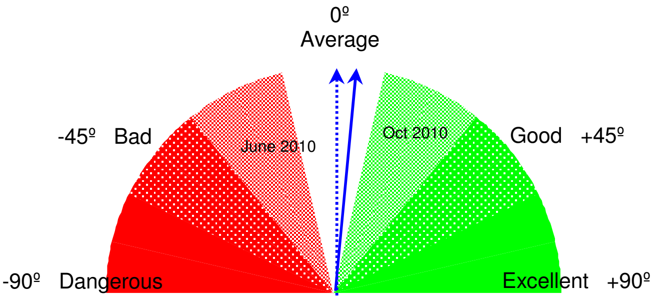
EXPAT CURRENCY BOARD WATCH



OUTLOOK: STABLE

For the time being, **we are optimistic about the currency board and see no immediate danger of devaluation (see page 2).**

GUEST COMMENTS:

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INITIAL COMMENT

This fourth issue of the Expat Compass is the first one in which we are cautiously moving the arrow rightwards, i.e. in a **positive direction.** We are not saying there are no problems with the economy, but most of the negative news regarding the 2010 budget and the lack of reforms were already 'priced in' in the third issue (May – June). During the last several months, we have seen the following **positive developments:**

1) The budget has been balanced for Q2+Q3 2010
2) Exports have performed better than any expectations
3) The unemployment has been steadily falling, mostly for seasonal reasons
4) Standard & Poor's confirmed Bulgaria's investment grade rating of BBB with a 'stable outlook'. This is good news, especially compared to the downgrades of Greece, Portugal, Ireland, and Spain. Moody's also confirmed its Baa3 rating for Bulgaria with a 'positive outlook'. No other countries in the region have a positive outlook
5) The government has made some steps towards the reduction of the state administration. There have been no intentions to increase pensions and public sector salaries – good for the budget balance – unless such a decision is reversed

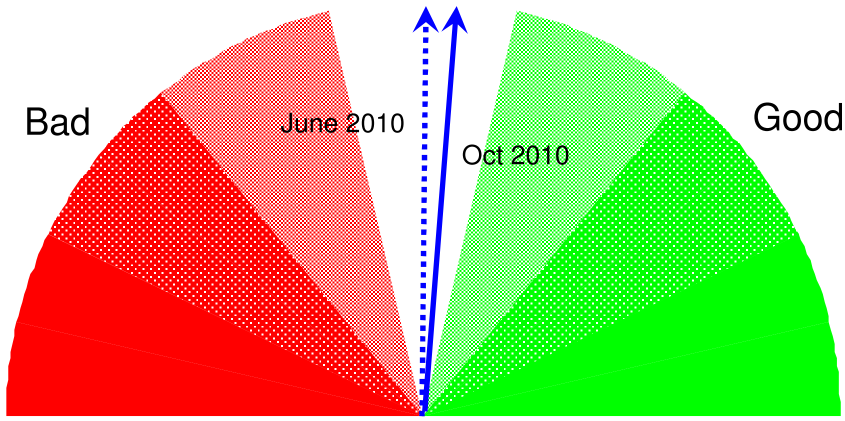
While we have become a bit more optimistic about the health of the currency board compared to June 2010, we see no reason to become complacent. All our major **concerns** remain intact:

1) The budget was amended to allow for a high deficit of 4.8% for 2010 on a cash basis – we favour a balanced budget. The eventual deficit for 2010 could be anywhere between 2.9% and 5%, depending on how 'generous' the government will be with the different interest groups at year-end
2) None of the crucial reforms have really started yet, namely in the areas of pensions, health care, administration, education and science
3) We have seen no privatisation or concession deals
4) The financial sector has not seen the worst yet, while the capital markets have almost been paralysed
5) We do not share others' optimism that Bulgaria has come out of the recession. On the contrary, we still expect a wave of bankruptcies
6) We do not think that real estate prices have bottomed out yet

Unless we are surprised by some sudden reforms in the autumn, our expectations for the arrow of the Compass in Q4 2010 are negative rather than positive.

EXPAT CURRENCY BOARD WATCH

OUTLOOK: STABLE



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.

Date	Reading of the Compass (Angular Degrees)	Change	Comment
2005	+64º		Currency board very stable
2008	+44º	-20º	Deterioration due to current account concerns
Jan 2010	+20º	-24º	Deterioration due to budget and recession concerns
Mar 2010	+9º	-11º	Deterioration due to budget and reforms concerns
Jun 2010	0º	-9º	Deterioration due to budget and reforms concerns
Oct 2010	+4º	+4º	Improvement due to exports growth

This is the sixth reading of the Expat Compass. It is becoming more difficult to draw all the arrows and the dates in the picture. That is why, we are also providing a table with all the historical data. The measure is angular degrees (º). The reading of the Compass can change between +90º (horizontal to the right, Excellent) and -90º (horizontal to the left, Dangerous). 0º is a neutral (vertical upwards, Average) reading.

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	OLD	NEW	COMMENTS
I. Political issues			
1. Does the government support the currency board?	+	+	Yes, but less so
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, not very large yet
5. Budget spending	--	-	Less excessive
6. Government debt	+++	+++	Very low
7. Foreign liabilities of the private sector	--	--	High
8. Fiscal reserves	-	-	Expected to fall
III. Economic cycle related issues			
9. GDP growth	--	-	Close to zero
10. Inflation	+++	+++	Low
11. Unemployment	-	-	Stable, seasonally falling
12. Strength of the banking system	+	+	Good but worsening
IV. External balances			
13. Current account deficit, trade deficit	-	+	Improving fast
14. Foreign direct investment	---	--	Low
15. Revenues from international tourism	+	+	Moderately high
16. Foreign exchange reserves	++	++	High

Legend: Good Bad

This table has never been 'greener'. While sentiment in the economy remains weak, many economic indicators have numerically improved. The current account deficit has fallen faster than our expectations, the recession might officially end soon. Budget spending has been in control lately, although it might deteriorate at year-end.

In this issue of the Expat Compass, we have updated our Expat forecasts in the seven charts (see the next page), all of them in a positive direction, i.e. to the right, towards the green end.

1) **The budget deficit** has been lower than expected for Q1-Q3. The Ministry of Finance might be able to keep it at around -3% of GDP, if it wished. However, we expect the government to give in to certain political pressures by December. Thus, we are improving our forecast from -5.5% to -4%.

2) **Budget spending** is more difficult to predict than the deficit. It is the sum of the collected revenues and the allowed deficit. We have lowered our forecast from 43.5% to 41.9% and expect to lower the number again.

3) **GDP growth.** We have improved our 2010 forecast from -2.5% to -1%, still in the negative territory.

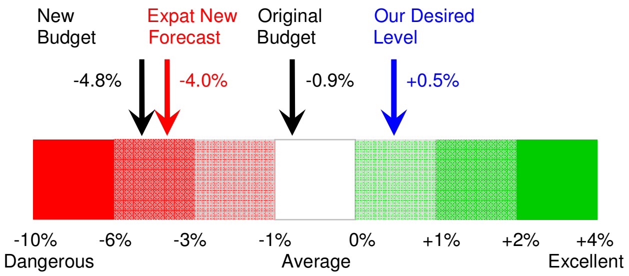
4) **Inflation.** We have increased our year-end forecast from +1% to +3%, but do not consider it a problem. In our view, low single-digit numbers are a safe territory. Very low numbers (-1% to +1%) would correspond to a continuing recession. Thus, we would consider +3% a "better" number.

5) **Current account deficit.** Just like in the last issue, we have to admit we have been very wrong about this indicator. Exports have grown beyond any expectation – see the section on page 6. We are changing the forecast from -8.5% in March to -4% of GDP.

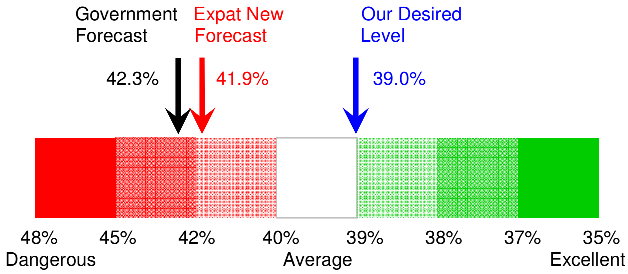
6) **Unemployment.** We are lowering our year-end forecast from 12% in January to 10.5%.

INDICATORS

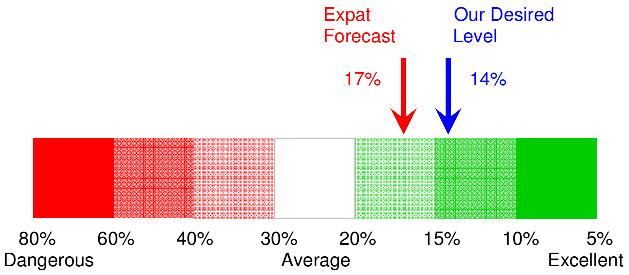
I) Budget Surplus/Deficit, % GDP, 2010



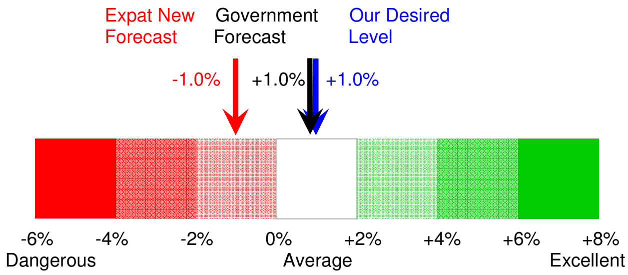
II) Budget Spending, % GDP, 2010



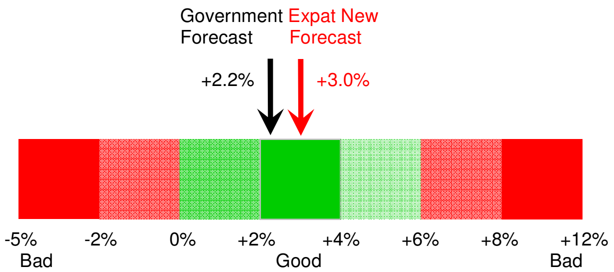
III) Government Debt, % GDP, 2010, Year-End



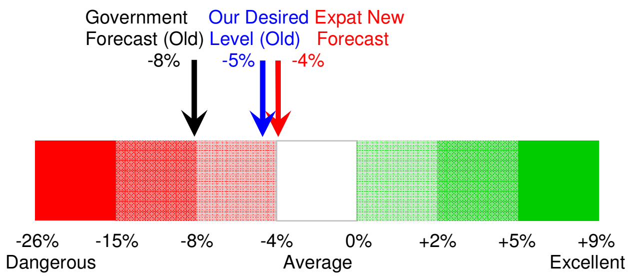
IV) Real GDP Growth, %, 2010



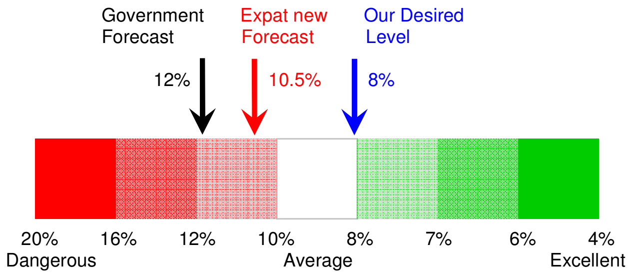
V) Inflation, %, 2010, Year-End



VI) Current Account Deficit, % GDP, 2010

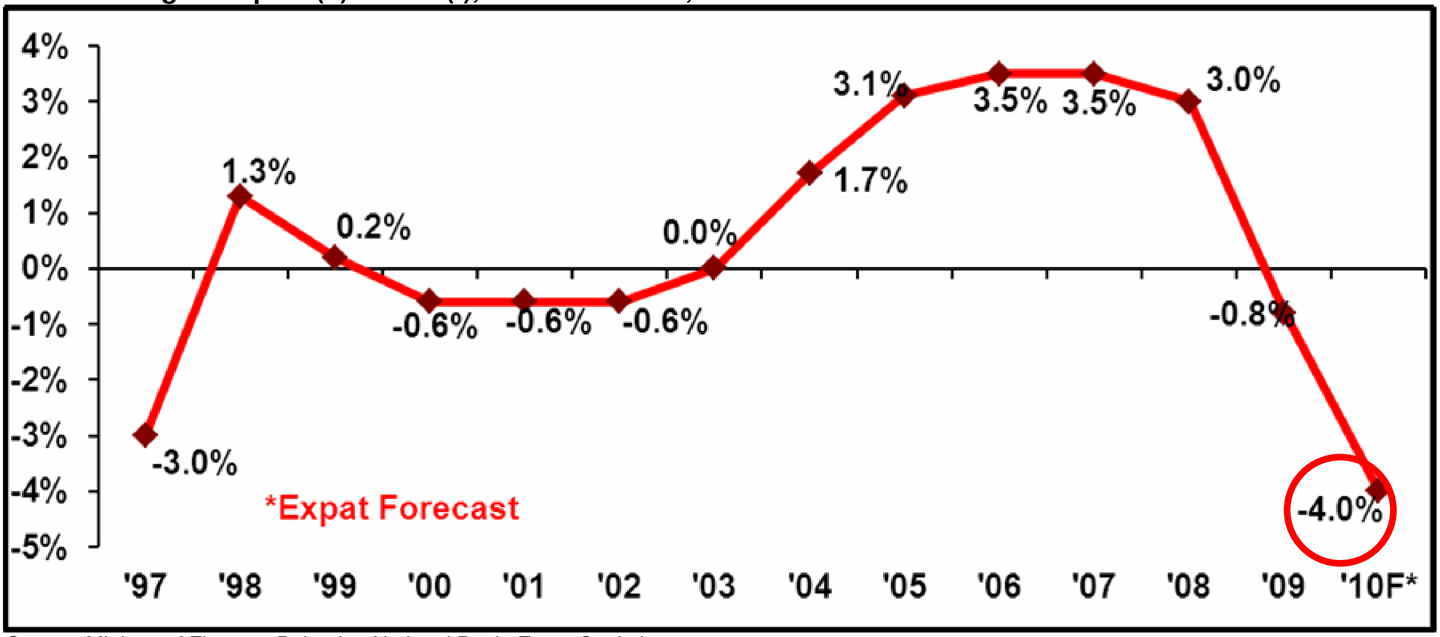


VII) Unemployment, %, 2010, Year-End



I) 2010 BUDGET – A LOW DEFICIT TILL SEPTEMBER

Chart 1. Budget Surplus (+)/Deficit (-), on a cash basis, % GDP



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

Year-to-date, the budget situation has been better than our very negative expectations in the third issue of the Expat Compass. There, we predicted a year-end budget deficit of BGN 4.2 bn, or -5.5% of GDP. In Q2-Q3, the budget was almost in balance, which is a definite success for the Ministry of Finance after the weak January and February. We are now improving our year-end budget deficit forecast to -4%.

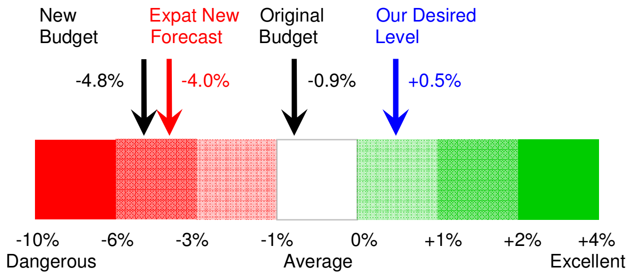
The eventual number is more a function of political behaviour than of economic factors. Economic growth might turn positive in Q4, although low. This is good for revenues. We see the risk, however, in spending. Trade unions seem active before the winter, and the government has made the impression that it easily gives in to pressure and demands from interest groups.

The usual suspects for additional December spending are: health care, pensions, police, and all other sectors across the board. We would consider any additional spending a sign of weakness. Given the current circumstances, any deficit below the EU's 3% target would be a success, but our forecast is -4%. Let us remind you again that we favour a balanced budget policy.

Diagnosis: we are still in the "red" (i.e. negative) zone, but we are moving the Expat arrow rightwards

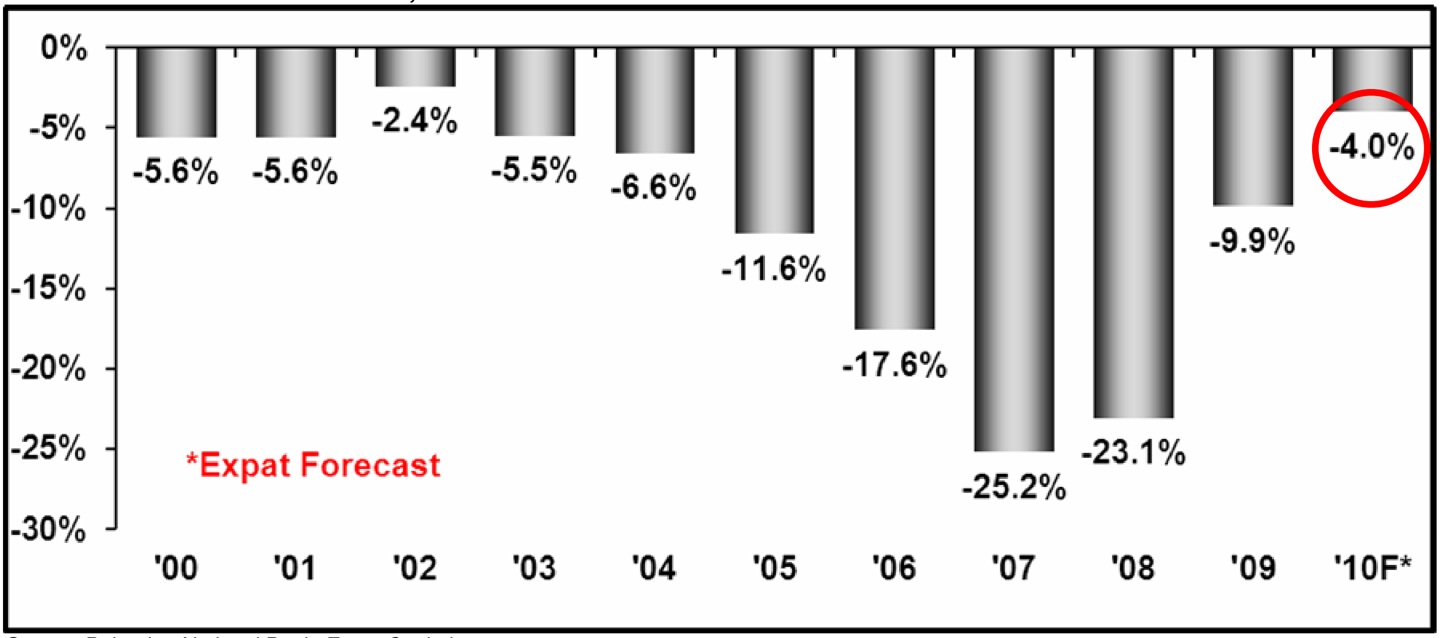
Implications for the currency board: negative but improving

Budget Surplus/Deficit, % GDP, 2010



II) 2010 – MOVING TOWARDS A MUCH LOWER CURRENT ACCOUNT DEFICIT

Chart 2. Current Account Deficit, % GDP



Source: Bulgarian National Bank, Expat Capital

One of the trends which we were unable to predict in January (see the first issue of Expat Compass) is the quickly shrinking trade and current account deficits. There are four classical reasons: growing exports, slow imports, possibly higher revenues from incoming tourism, falling expenses on outgoing tourism.

1) Exports have risen by the impressive +22.8% year-on-year (yoy) in H1 2010, and by +47.6% yoy in August. In terms of geography, the growth is across the globe. For H1, the most important non-EU markets to mention are Turkey (BGN +459 mln increase), China (BGN +130 mln), Russia (BGN +124 mln), India, and Brazil.

In terms of products, the following groups stand out (although this is not our preferred type of breakdown):

For H1 2010	Growth (yoy)	Share in total exports
Machinery and equipment	+26.6%	17.8%
Chemical products	+24.5%	8.3%
Fuels, lubricants	+37.8%	11.9%
Raw materials (not food and fuels)	+66.0%	8.2%

Source: Investor.bg

2) Imports, in contrast, only grew by +1.7% yoy in H1 2010. Imports of machinery and equipment have decreased by -13%, which is directly related to the falling investment in the economy.

3) Incoming tourism, a bit surprisingly, might end up having a strong year. The number of foreign tourists increased by +6.9% yoy for July. All the growth is coming from outside the EU – mostly from Russia, Turkey, and Macedonia (+34-35% year-on-year each). The August numbers are also strong.

4) Outgoing tourism is slowing down. The number of Bulgarians travelling abroad was down by -35% and -32% year-on-year in June and July, respectively. The statistics for the actual amounts spent are less reliable, naturally. Interestingly, travels to neighbouring Greece are down by -60%.

5) Foreign Direct Investment (FDI) reached EUR 358.5 mln in H1 2010 (1% of GDP) after being negative in the first months of the year. This is 78% lower than in H1 2009 (EUR 1.62 bn, 4.8% of GDP). We are now raising our 2010 whole-year FDI forecast from EUR 500 mln to EUR 800 mln – still an unimpressive number. The smaller FDI is one of the reasons for the lower imports of equipment, i.e. for the lower trade deficit.

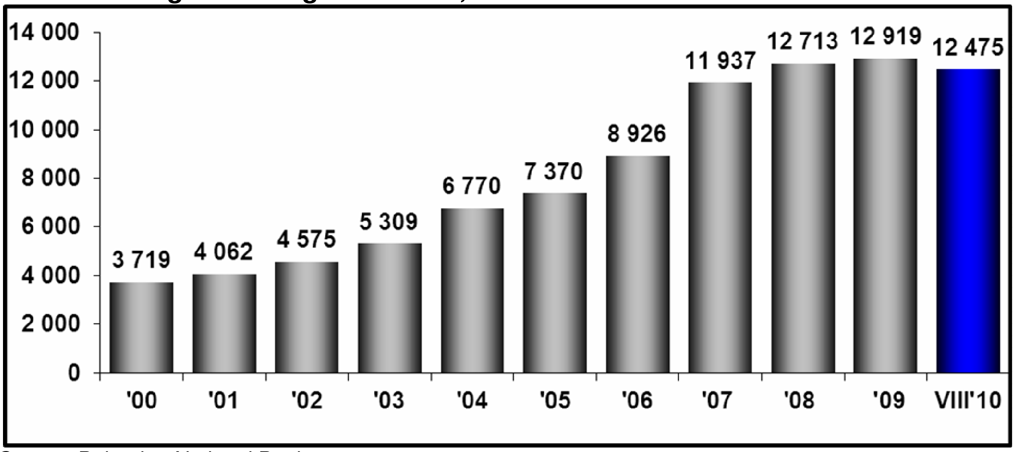
Strong exports are the healthiest source of growth

To summarise, we are **very happy** with the trade deficit and tourism numbers. Some observers have downplayed the role of exports as a driver of growth. Their argument is that budget revenues do not improve in the short term as a result of exports. They also say that the low trade deficit is bad news, because low imports correspond to a continuing recession.

We, on the contrary, view strong exports and incoming tourism as the healthiest path to the future recovery as they bring foreign currency revenues into the country. High internal demand would mean rising imports, which would be negative for the currency. Please note that the Expat Compass focuses on the health of the currency board, not on domestic consumption. Nothing can be better for the currency than a falling trade deficit.

III) SHRINKING RESERVES AND MONETARY AGGREGATES

Chart 3. Foreign Exchange Reserves, EUR mln



Source: Bulgarian National Bank

Globally, there have been many discussions about currency boards in general. **Fans** of fixed exchange rate regimes (like us) point out that this system ensured strong growth with enviable stability for over a decade. Between 1997 and 2008, all aggregates were expanding: forex reserves, money supply, fiscal reserves, deposits and credits, asset prices (stocks, bonds, real estate), incomes (salaries and pensions), corporate profits, investments... Although the currency board has also been a strong restraint against excessive public spending, the GDP and the size of the state budget have tripled in nominal terms within a decade or so – impressive.

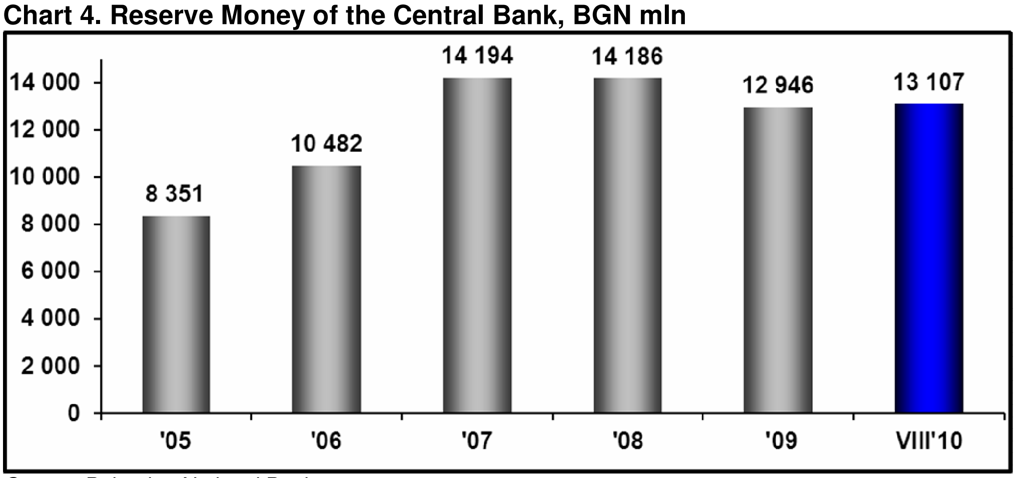
The **critics** counter that the currency boards are very successful when the economy is growing, but are dangerous at 'reverse gear'. In recession times, there is a danger of a vicious circle: confidence deteriorates, the currency flows out of the country, the money supply shrinks, interest rates rise, aggregate demand falls and so does investment. There is a widespread shortage of money around. The government cannot and should not do much to restore growth.

'But what is really the problem?', fans would ask. The currency board is an automatic mechanism. If money supply falls, so would all prices, the process is self-correcting. However, we are dealing with politics and human behaviour. In theory, the correct steps would be to sharply cut spending and incomes. In practice, the process is more difficult.

One of the keys in such moments is the **labour market flexibility.** If wages can fall, competitiveness can be restored, and devaluation might be avoided. It is interesting to see what is happening in Bulgaria at the moment. Private sector wages have been somewhat flexible downwards. Public sector wages and pensions have been frozen (we support this).

As chart 3 shows, the **forex reserves** of the Central Bank are still very high, but they have fallen from the maximum reached a year ago. We expect them to stay flat and to possibly decrease if fiscal deficits continue. Chart 4 demonstrates that **BNB's reserve money** fell in 2009 by some 9%, but has stabilised since. We will continue monitoring all the reserve and monetary aggregates. If they shrink further, that would be considered bad news for economic activity and for the strength of the currency board.

Chart 4. Reserve Money of the Central Bank, BGN mln



Source: Bulgarian National Bank

ABOLISHING THE FLAT TAX WILL SLOW DOWN THE RECOVERY FROM THE GLOBAL CRISIS

VLADIMIR KAROLEV, CFA

Vladimir Karolev is a leading Bulgarian economist with extensive experience in the field of privatisation advisory, mergers and acquisitions, business development, corporate finance.

Currently he is a municipal counsellor in Sofia and managing partner at Balkan Advisory Company. Previously, he worked for KPMG, Europa Capital Management, and the Bulgarian Post Privatisation Fund. Mr. Karolev has a Master's degree in Economics from the University of National and World Economy (Sofia), a PhD in Industrial Economics from the University of Chemical Technology and Metallurgy (Sofia), and an MBA from the University of Alberta (Canada).

Photo: Vsekiden.com

In the past 10 years, the majority of the European countries have been running persistent budget deficits that resulted in a piling government debt. Bulgaria was one of the few exceptions – for the last 8 years, Bulgaria had budget surpluses in 6 years and in only two years (2002 and 2009) it had deficits. It seems that the current government, while blaming the global economic crisis, will be running deficits not only in 2010 but in 2011 and 2012, as evidenced by the 3 year macroeconomic and budgetary forecasts prepared by the Ministry of Finance (www.minfin.bg).

In the past 6 months, politicians not only from the left spectrum but also from the ruling party GERB (which claims to be center-right), pose the question whether the flat tax should be abolished, allegedly in order to increase tax revenues and shrink the budget deficit. However, I am of the opinion that the abolition of the flat tax and the return to a progressive personal income tax may even decrease the amount of total income tax collected, will result in an increase of the grey economy and shrinkage of the tax base, will hamper economic growth and decrease savings, and hence investments.

The flat tax is not a new concept (Hong Kong has had a flat tax since 1947) but was introduced by many European countries only starting in the mid-1990s when in 1994 Estonia introduced it. Today, 14 European countries, including 7 EU members, have a flat tax. And in all cases tax revenues grow substantially year after year with rates statistically higher than before the introduction of the flat tax.

At the beginning of 2001, the corporate tax in Bulgaria was 28.5% (partly paid to the state, partly to municipalities, while the personal income tax had four different rates – the highest was 38% and the lowest 10%. People receiving the minimum salary officially approved by the Government did not pay income tax. The pension security tax applied to all salaries was almost 30%. Since 2002, all year tax rates have been decreased, and in 2006-7 a flat tax of 10% on personal income and corporate profit tax was introduced. The pension security tax was also gradually decreased to about half of what it used to be – currently it is 16%. Despite this substantial decrease of all direct tax rates, the tax revenue from all direct taxes increased year after year with a double digit growth with rates much exceeding the rate of economic growth. And the state budget which was in a small deficit in 2001 turned into surplus of 1 to 4 percent every year from 2003 up to 2008 inclusive.

The flat tax also simplifies enormously the tax code and procedures, decreases the red tape, and minimizes the possibilities for mistakes in computing the annual tax return, as well as for fraud in the tax system. With its introduction all exemptions are removed, and the tax return form becomes a simple document easy to prepare and understand.

The fact is that, despite the common ideological argument that the flat tax is good only for people with high salaries, it is not the case. In Hong Kong, where the flat tax was introduced in 1947, the 100 000 richest people (about 8% of the population) pay 57% of all tax revenues in the country. In Bulgaria, the still ongoing academic research (inconclusive because the flat tax was introduced less than 3 years ago and there is still not a long enough series of data) shows that people with high incomes pay more taxes after the introduction of a flat tax while the tax burden of the people with lower incomes has not changed. Thus, overall, people with higher incomes pay a higher portion of the direct taxes. Even politicians from the left spectrum should be content with the flat tax because the rich really start paying more taxes. Well, what is really important for the treasury? To have a high tax rate or to have a high amount of taxes collected?

In conclusion, similarly to the experience of other countries (for example Russia, Estonia, Slovakia, Latvia, Romania, Lithuania), the flat tax brings many benefits to the economy and the society. In terms of "whitening" the economy, increasing the tax revenue, widening the tax base, decreasing tax evasion, increasing the disposable personal income, and stimulating savings and economic growth. Abolishing the flat tax and returning to a progressive tax will not help Bulgaria to recover from the aftermath of the global financial and economic crisis. On the contrary, it will slow down the recovery and will decrease the potential long term economic growth prospects.

THE BUDGET DOES NOT MATTER

GEORGI ANGELOV

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He has published numerous analyses and articles about tax and fiscal policy and the budget, economic reforms and development, etc. He is a co-author of the books "Bulgaria in International Rankings", "Anatomy of Transitions", "The State against the Reforms".

Mr. Angelov has a Bachelor's degree in Finance from the University of National and World Economy (Sofia).

Photo: Ikonomika.org

Journalists say, 'the Budget Law is the most important one'. It shows the direction of macroeconomic policy, taxes, expenditures and structural reforms. In general, the budget law is the most important financial document.

Not anymore. Here is some evidence.

Firstly, GERB (the ruling party) won the elections with balanced budget promises and during the first months of the new government it claimed that it was working in that direction. At a certain moment it decided 'to loosen' the belt and ended 2009 with a budget deficit of BGN 500 mln. Then it turned out that the government was delaying payments of BGN 1-1.5 bn (to businesses, the health insurance fund, VAT refunds, etc.).

Hence, instead of a balanced budget, in 2009 we had an "excess deficit". There was no way to forecast that: either from the 2009 Budget Law, or from any other budget or government document.

Secondly, the government was claiming that in 2010 it would follow a balanced budget policy – that was explicitly written in the Budget Law. However, at the very beginning of the year, the government did not look like it would stick to the law. The budget deficit started growing, the expenditures to increase, and the government announced on several occasions that it might allow for a 'small' budget deficit (first 1%, then 2%, etc.).

Finally, there was an amendment of the budget in July 2010, which set even higher budget spending and a budget deficit of almost 5% of GDP on a cash basis (almost 4% on an accrual basis). Again an "excess deficit" – this of course was noticed by the European Commission which opened an excess deficit procedure against Bulgaria. Please note that this was not written in the Budget Law again.

Thirdly, the amended 2010 budget was published in July and there were an additional BGN 200 mln allocated for healthcare. Just a few weeks later, the Prime Minister promised another BGN 200 mln to doctors who had threatened with protests (the same happened to others who had the chance to meet the PM and to threaten him with protests). They got the money – an expense which was not planned in the budget. In practice, the Budget Law passed by the parliamentary majority was being implemented only for several weeks before it was violated.

Fourthly, let us not forget the 2011 budget. Its main principles were adopted by the government during the summer and they envisioned keeping the tax burden intact. The actual budget structure was approved by the government in September. It did not contain tax increases and provided for disciplined spending. Just a week later, under pressure from the trade unions, the PM suddenly announced that social insurance contributions would rise by 3 percentage points. He also committed to an additional over half a billion levs for healthcare. Please note – only a week after the government's approval a basic characteristic of the budget is being changed, and in a direction opposite to the pre-election promises, government programmes, etc.

In brief, there are at least two problems:

1. The government and GERB have absolutely no discipline and cannot stick even to their own budget laws, especially in the spending part and the deficit. Respectively, what is written in the Budget Law is not relevant because most probably it will not be implemented anyway.

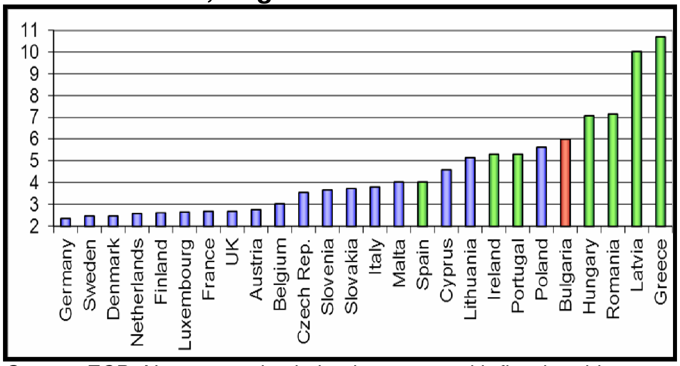
2. The data for the implementation of the budget cannot be taken as very reliable, because manipulation opportunities not only exist, but are used as well (even at the moment, there are delayed payments from the government to the healthcare system and the private sector for hundreds of millions of levs, and there are no official data about the VAT not being refunded on time).

The practical conclusion – irrespective of what is written in the Budget Law or in the reports about its implementation, most probably the situation is worse, not better. Unless the PM and the government go through a sudden catharsis, this conclusion will be also valid in the future. In other words, the unpredictability and volatility of the government's fiscal policy is high, and this cannot be neglected, without regard to what is written in the Budget Law.

Some might say this is not a problem – Bulgaria has such a small government debt that it does not matter. Maybe this is true, maybe the small government debt (reduced due to the efforts of three consecutive governments) will save us from a serious collapse. However, the risk remains.

For example, in 2008, Romania had an even lower government debt in comparison to Bulgaria. But the coming crisis, together with pre-election populism, brought upon the country the need for outside help. Spain also had a small public debt only two years ago – but this year its budget problems have shaken the EU so strongly, that a rescue fund of USD 1 trillion had to be created. Ireland also had a small public debt, but its bank problems changed that within days (even overnight).

Chart 5. Yield of long-term government bonds in local currencies, August 2010



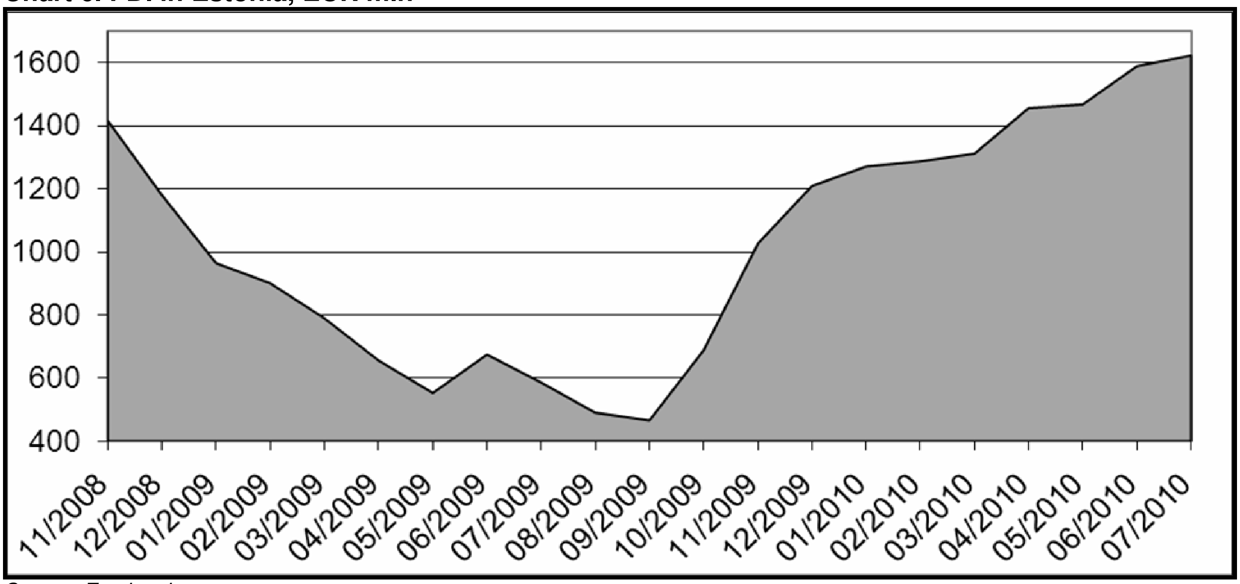
Source: ECB. Note: countries in bankruptcy or with fiscal problems are marked in green

By the way, regardless of the small government debt, the long term interest rates in Bulgaria are among the highest in the EU (they were among the lowest before the crisis). And the FDI continues to fall, regardless of recovering exports. I.e. the insecurity around the fiscal and economic policy of the government affects the risk perception of the country and slows down the recovery.

At the same time, despite some Keynesian statements that the budget discipline is an obstacle to economic recovery, Estonia is enjoying a fast recovery due to its strict budget discipline and keeping the budget deficit to a minimum. FDI in Estonia has recovered to the levels before the crisis, the interest rates have fallen sharply, industry has experienced the highest growth in the EU, and so has GDP.

If you pass a budget with a minimum deficit and implement it even in a serious crisis, you will win great trust from the markets (Estonia). If you do not implement your own budgets, you create insecurity and lose investor confidence (Bulgaria).

Chart 6. FDI in Estonia, EUR mln



Source: Eestipank

REVIEW OF THE REAL ESTATE MARKET IN BULGARIA, H1 2010

GVA Sollers Solutions

The unstable economic situation tangibly influences the commercial property market in the country. A large part of the tendencies in the segment, outlined in 2009, continue to define the market in the first months of 2010. The development of the segment on all levels is slowed down invariably by the significant decrease of foreign investments, decreased purchasing power of the population, and the low turnover realized by some of the market participants. During the period, some of the largest shopping centres in the country started to operate, as a result of which retailers with more than one newly opened trade centre experience difficulties.

Construction-related FDI in H1 2010 is EUR 5.5 mln, which is a reduction of 40% in comparison with the same period in 2009.

Shopping Malls

Until the middle of 2010, the total area of the functioning trade centres in Bulgaria has increased to over 420,000 m^2. In comparison, at the end of 2009 the area was 233,460 m^2. During H1, 5 new shopping centres were put into operation – The Mall, Serdika Centre (Sofia), Grand Mall (Varna), Galeria (Plovdiv) and Mall Gabrovo. The only outlet centre in the country (Sofia Outlet Centre) also started to function. Another 417,830 m^2 of mall shopping areas are under construction in the big regional cities. According to the investors' intentions, around 75% of them will be finished and put into operation by the end of this year, and the rest in H1 2011. However, over 552,000 m^2 of retail space are still frozen at different levels of construction. The demand for retail space in shopping centres in the past period remains at a much lower level in comparison with previous years. Due to the higher supply, the attraction of tenants has become more difficult, especially for projects with unattractive locations and tenant mix.

Commercial streets

The unstable economic situation in the country reflects on the main commercial streets. A huge part of the premises change their tenants, others stay unoccupied for a long time, regardless of the regulated rent levels and the flexible conditions in order to let the areas faster and for longer periods.

Hypermarkets

In H1 2010, hypermarkets (discounters) continue their expansion and despite the hard economic situation they preserve the same turnover. At the end of the year, the first project of Lidl – the German chain for fast moving consumer goods – is expected. This moment continues to be the most appropriate for the discounters to buy and rent land (plots and retail space) at attractive prices, in order to open new locations.

Retail parks

The rates of development of retail parks in the country are still slow. In 2009, only one was open – Retail Park Plovdiv. In the mid-term, more investors are expected to approach this segment of the commercial space market.

Forecasts for H2 2010

Increase in the % of unoccupied retail space. Shopping centres with unattractive location and tenant mix, bad management and a lack of flexibility of letting conditions should be the most affected. Apart from the shopping malls, the occupancy rate of retail space will decrease outside the main streets. By the end of 2010, the activity in the segment will be very low. The tenants (except the hypermarkets) will continue being cautious in their expansion.

ABOUT GVA Sollers Solutions

GVA Sollers Solutions is a part of the FOROS Group – National Company for Real Estate, a leading participant in the commercial real estate market in Bulgaria since 1993. It offers a full package of services and solutions in the area of conceptual and investment consulting, project management, consulting and brokerage services, etc. The company operates in the commercial real estate segment, more concretely in industrial, office and retail areas and plots. Since 2009, GVA Sollers is a member of the GVA Worldwide Organisation and is its exclusive representative for Bulgaria.

The full analysis can be read at www.gvasollers.com.

14 GOLDEN RULES OF GOOD ECONOMIC POLICY

NIKOLAY VASSILEV, CFA

The current crisis is just a bad recession, not a paradigm-changing phenomenon

Over the last 2-3 years, globally, the economic profession has asked more question than given answers. Many critics have tried to discredit the neoclassical and neoliberal economic model, arguing for even more regulation in the economy and more restrictions to the banking system. My prediction is different: in 20 years' time the economic history books will read that there was just another recession in 2008-2010, and not that the current cataclysms have led to a completely new world economic order. I do not think that some totally new textbooks have to be written and new tools have to be invented. On the contrary, the same basic principles that applied in 1990 are valid today and are likely to be valid in 2020.

Had the world not seen any asset bubbles before 2007? Of course it had – just remember the tulip bulbs in the Netherlands in the 17th century when when one bulb was as valuable as 12 acres (5 ha) of land. Or the surreal Japanese real estate bubble just 20 years ago when only the price of the Imperial Palace in Tokyo (7.4 km^2) was equal to the value or the total real estate in the state of California.

Or the world did not know the dangers of excessive leverage and risk taking? Of course we knew all that. The most important chapter in my favourite textbook in Corporate Finance was called "The Cost of Financial Distress". It said it all, and that is why I have always preferred buying shares of less leveraged companies.

Do we know better now? This has to be seen, but I doubt it. It is likely that a new economic boom will start, and many of the current lessons will be temporarily forgotten. The more things change, the more they stay the same…

14 rules of successful economic policy

How to design a good economic policy mix and how to judge whether the decisionmakers are doing the right things? I suggest the following checklist of 14 rules:

1) **Stable currency.** *Ceteris paribus,* the economy is better off with a relatively stable and predictable exchange rate. This reduces the risks, risk premiums, and other transaction costs. In the case of Bulgaria, keeping the currency board until we join the Eurozone is the obvious option.
2) **Balanced budget.** The current global fiscal and debt crisis should have persuaded us that governments should avoid running budget deficits. What is more, countries should aim at surpluses in 3 cases: a) during economic booms (as during most of the last 20 years for the world); b) if the debt/GDP level is excessive (as it is now in most countries but not in Bulgaria); c) if there is a high current account deficit (Bulgaria in 2005-2008).
3) **Healthy banking system.** While this is mostly the job of the private sector, good monetary and fiscal policies, as well as appropriate regulations of the central bank can contribute strongly to the stability of the banking system. Bulgaria has been a good example since 1997.
4) **Keeping good external balances.** A very large trade and current account deficit could lead to instability and a currency crisis. The government's tools to affect the external balances include sound fiscal policies, export and tourism promotion.
5) **Lower budget spending as % of GDP.** A smaller role of the state leaves more room for the private sector to thrive. Lower taxes, privatization, and outsourcing of business activities to the private sector would lead to higher GDP growth.
6) **Lower direct taxes.** These include the corporate profit tax, personal income tax, capital gains tax. Social security contributions are similar. Lower direct taxes stimulate the business activity and economic growth. Bulgaria consistently lowered its direct taxes in the last decade to reach the lowest levels in the EU.
7) **Privatization, concessions, public-private partnerships.** Life has shown that in almost all cases the private sector is much more efficient in running commercial entities than the state bureaucrats. Whoever disagrees should suggest that Eastern Europe go back to the system before 1989. The countries in CEE that privatized the earliest have achieved the most of the transition: the Czech Republic, Hungary, Poland. The 1990-2010 history of the Bulgarian state-owned corporate sector is a story of decline, bankruptcies, and corruption. There are some exceptions.

8) **Vibrant capital markets.** If you do not understand this, do not worry. Sadly, most Bulgarian governments do not understand it either. Capital markets provide an important financing alternative to growing companies and strongly increase the investment in the economy. Entrepreneurship without a capital market is like a tree without water and sunshine. The government can help with good regulation (mostly okay after 2002) and with listing of state-owned companies on the stock exchange (none since 2005).
9) **Successful management of state-owned companies.** While privatization and concessions are a better option, it is better to run the still state-owned companies professionally and successfully than not.
10) **Better regulation – fewer regulatory regimes.** Business needs more freedom, not more bureaucracy. The deregulation and liberalization of whole sectors have produced excellent results. The explosive growth of the telecoms sector has had nothing to do with the state. More regimes and regulations also mean more corruption.
11) **Aggressive export promotion policy.** Higher exports directly mean larger foreign currency revenues, higher growth, more jobs, and more investment. This is even more important for countries with a large current account deficit (Bulgaria in 2005-2008). While abiding by the rules of the EU and the WTO, the state can help by supporting companies in their international marketing efforts, lobbying abroad for deals and opening new markets, etc. No Bulgarian government has ever excelled at this.
12) **Aggressive tourism promotion policy.** Obviously, we mean incoming tourism. Very similar to export promotion. Again, no Bulgarian government has ever excelled at this.
13) **Aggressive investment promotion policy.** Here we mean both foreign investment and local investment. High capital formation as % of GDP, as well as high FDI (foreign direct investment) directly contributes to higher growth and more jobs. Even better if investment flows into export-oriented, as well as higher value added sectors – like in Hungary and not in Bulgaria.
14) **Deregulation and reforms in the labour market.** It might be counterintuitive, but a freer labour market leads to lower unemployment, not higher. It should be easy to hire and fire people. Private sector job agencies should be given a larger role. A high minimum wage as well as sector-wide mandatory collective labour agreements are harmful, not helpful. Good examples are the US, the UK, Hungary, Spain before the crisis, Bulgaria in 2002-2008.

ARTICLE

IS ~~GREED~~ *Leverage* GOOD?

NIKOLAY VASSILEV, CFA

The title of this article has been inspired by Gordon Gekko's book in the movie 'Wall Street: Money Never Sleeps', September 2010

Three important rules of investments

Having lived through several smaller or larger market downturns in the last 15 years, having read a number of relevant books, and having analyzed a large number of companies, I would like to reinforce three well-known recommendations to potential investors:

1) Do not put all the eggs into one basket – i.e. diversify your investments
2) Do not borrow money to speculate with securities – especially with instruments you do not understand
3) When doing business, refrain from excessive leverage in order to avoid financial distress

This article focuses on the third rule.

Does the capital structure matter?

All financiers have read their Corporate Finance books and remember well the **Modigliani-Miller theorem.** It says that '*the market value of a firm is determined by its earning power and the risk of its underlying assets, and is independent of the way it chooses to finance its investments or distribute dividends' (Google).* In other words, it should not matter whether a company has 100% equity and zero debt, 50-50, or 1% equity and 99% debt. All these combinations should result in a similar WACC (weighted average cost of capital). What is more, leverage creates a so-called *tax shield* due to the fact that interest payments are deductible from taxable income. The higher the leverage, the higher the tax shield and the lower the taxes to be paid. The conclusion: under all circumstances you should borrow more. Or so it seems.

Many businesspeople would honestly persuade you that it is an excellent idea to borrow because this is how you can maximize your ROE (return on equity). They would even consider you stupid if you did not borrow. The Oxford Dictionary says that **leverage** means *to use something to maximum advantage.* I.e. even the etymology of the word suggests a positive connotation. But is this always the case?

More borrowing is like driving faster

If you drive faster from Sofia to Varna (c. 450 km, only 1/3 is highway), will you arrive earlier? The superficial answer is: yes, of course. However, this is true about lower speeds, say 60-100 km/h. If you reach an average speed of over 125 km/h, however, you would seriously risk to crash.

Both some of the best drivers and some of the best financiers have made the same mistakes. Ayrton Senna, probably the best pilot of F1 of all times, died in the track of Imola in 1994 while leading in the race. One of the smartest investment banks in history, Lehman Brothers, became history mostly due to high leverage. It took excessive financial risk and paid dearly for it.

My conclusion:

1) Driving faster would mean arriving earlier if there was no risk of crashing. However, higher speeds exponentially increase that risk. It is suboptimal to drive too fast as you might actually never reach your destination.

2) Excessive leverage exponentially increases the risk of financial distress. Financial distress is not a free exercise. Negotiating with banks and planning daily cashflows would take most of the management's valuable time. Key customers and employees might leave due to uncertainty. Suppliers would demand prepayment. Banks would insist on lowering the credit exposure and raising the cost of credit. If the company is listed, the stock price would fall to levels which make new equity capital increases impossible… All this is a vicious circle. It is just not worth it.

Are extraordinary events extraordinary?

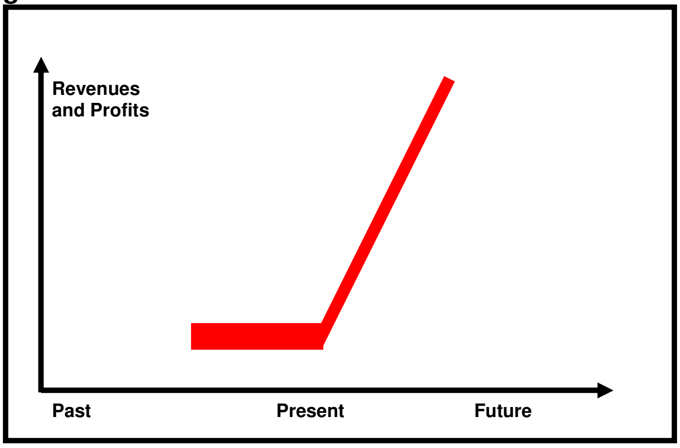
Many good companies have gone bankrupt. Going bust almost by definition means having excessive debt which the company cannot service – probably due to an unexpected deterioration of the market conditions: a recession, credit crunch, changes in consumer preferences, etc. Most of those entities would have survived, had they had a stronger balance sheet, i.e. more equity and less debt.

Have you heard the following statements:

1) Real estate is the safest investment as the prices will never fall (until recently, this seemed very certain)
2) Oil and energy prices will always go up
3) Why insure the house? There will never be an earthquake (the Kobe earthquake brought the investment bank Barings down in 1995)
4) The economy has reached a 'new paradigm'. There will be no more recessions and economic cycles. Growth will be high forever due to the high-tech boom (or so we believed 11 years ago before the Internet bubble burst)
5) Why take the umbrella? It never rains in July (in Bulgaria, it rained every day for a few weeks last July)

This is not about being superstitious or believing in Murphy's laws. The point is, doing any business in a market economy is somewhat risky. Unforeseen circumstances can always happen. In fact, it is less likely that everything will go according to the best plan. Then, why do so many companies live on the edge? Why do they consider the super-optimistic 'hockey stick' (Chart 7) scenario as normal, and all the other scenarios as force majeure? Is everything just bad luck, or is it an inherently wrong way of doing business? I claim it is the latter.

Chart 7. The 'hockey stick' projections: past performance was flat, but we tend to expect strong growth in the future



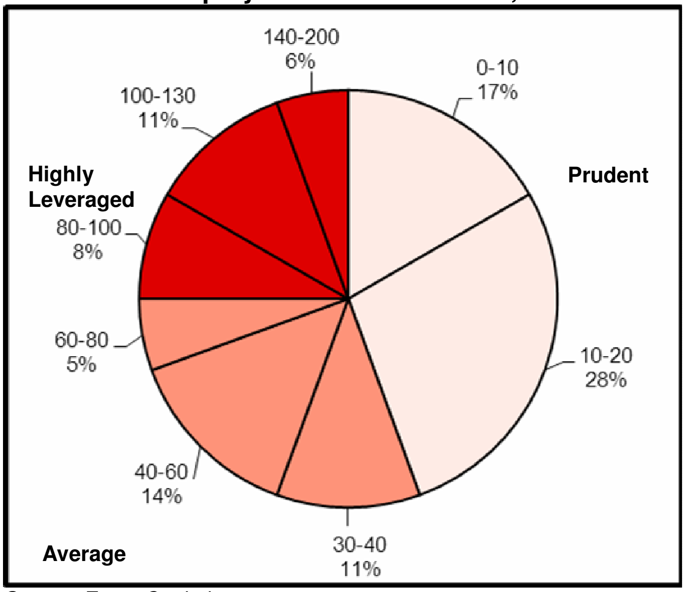
The classical real estate debacle

Between 2002 and 2008, almost everyone believed that Bulgarian (and global) real estate was an excellent investment. Under the typical scenario, developers would intend to build shopping malls, houses, office buildings, or golf courses on just about every empty spot in the country. The 80-300-1000 rule applied: borrow 80% of the money from the bank, build for 300 EUR/m^2, sell for 1,000 EUR/m^2. For some time, it worked. Until it turned out that there were more shopping malls in Sofia than in Athens, more office space than tenants, etc. Anecdotal evidence suggests that now the number of property sellers is dozens of times larger than the number of buyers. Today, many such developers are on the verge of bankruptcy, and the bad loans at the banks have increased from the enviable 2-3% to the reported 16%, possibly much more. Had the developers' leverage been lower, say, 30-50%, most of them might have survived. Maybe with some losses of equity, but without bankruptcy. So, whose fault was it: did banks lend unreasonably, or did borrowers borrow recklessly? I reckon, both. Both the banks and borrowers would most probably disagree. They would blame it on the force majeure.

The leverage of Bulgaria Inc.

It would be useful to sum up all the companies' financial statements (excluding the financial sector) and to analyze dynamically their profitability and debt/equity ratios for the last decade. At Expat Capital, we actively cover 36 non-financial listed Bulgarian stocks. Please see Chart 8 with their Debt/Equity ratios. The aggregate D/E ratio for this group of companies is 0.64 – frankly, below our expectations. One reason might be that some of the listed companies, especially some (but not all) REITs, might have lower leverage than many privately held businesses.

Chart 8. Debt/Equity Ratios of 36 Stocks, %



Source: Expat Capital

Having seen dozens of individual companies' financial statements, I argue that a significant part of Bulgarian businesses have the following characteristics:

- Lacked adequate financing until 2001
- Borrowed heavily in 2002-2008, reaching a debt/equity ratio of 100% or above
- Were quite profitable in 2002-2008
- Have experienced a severe fall in revenues since 2009, and have possibly become loss-making
- Are struggling with major inter-company indebtedness
- Are facing serious difficulties in servicing their bank loans and other obligations
- Are trying to restructure or refinance their debt
- Are blaming the 'greedy' banks for not willing to lend and for charging high interest
- Still do not admit that the excessive leverage has been a large part of the problem

What do we do about this?

Our firm, Expat Capital, advises a number of Bulgarian companies on IPOs, capital increases, mergers & acquisitions. Our principles include:

- We do not recommend that highly leveraged companies borrow more
- We do not think that the period of recession is a good time to borrow at all
- We help the companies raise equity if possible, and to provide high returns to equity investors
- We encourage our clients to operate with a strong balance sheet in order to avoid financial distress, and not depend strongly on banks which might not be willing to lend more
- We do not encourage our clients to default on their debts and obligations, including corporate bonds
- We advise companies how to restructure and reduce costs
- We run our own businesses without any bank loans

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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- Torn AD (private placement)

Private investment accounts

- Customized

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