Issue 5 February 2011

expat compass

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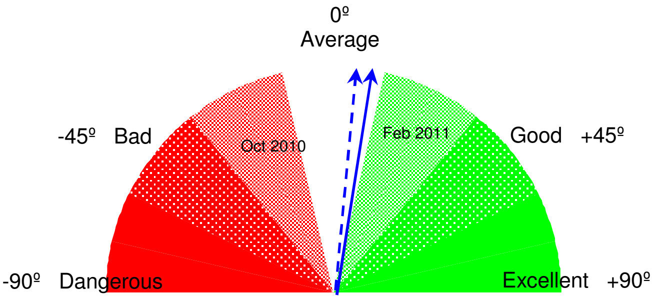
EXPAT CURRENCY BOARD WATCH



OUTLOOK: POSITIVE

We are optimistic about the currency board and see no immediate danger of devaluation (see page 2).

GUEST COMMENTS:

LACHEZAR BOGDANOV: RECOVERY, STAG-FLATION OR A NEW CRISIS FOR BULGARIA
Page 11

PETER GANEV: MURMUR ABOUT THE PRICES
Page 12

MOST ECONOMIC INDICATORS ARE BETTER THAN OUR EXPECTATIONS

We are now publishing the first issue of Expat Compass for 2011 (#5 overall). This is a good moment to recapitulate how our predictions scored over the past year, and what we got right or wrong.

Although we have historically been critical of some economic policies or the lack thereof, we are happy to admit that on most fronts reality seems to be better than our relatively pessimistic expectations after the disastrous budget gap of Jan-Feb 2010:

- 2010 GDP growth turned out to be positive (+0.3%), although we have some comments about the changes in methodology – see p. 10
- Budget spending as % of GDP ended up being lower, i.e. better (37.9%) – see p. 8
- Year-end unemployment remained in the single-digit territory (9.24%)
- The 2010 current account deficit (not reported yet) might be the lowest in a decade

The table on page 3 has never been 'greener'.

OUR CONCERNS REMAIN, HOWEVER

- No reforms
- No privatization and concession deals
- No policies for the capital markets
- Some wrong moves, such as the partial nationalization of private pension funds and the nationalization of the stock exchange

We are now making a new set of forecasts for 2011 – see the new charts on page 4. The economy should do better in 2011 than in 2010. Bulgaria seems to be coming out of the crisis late, but relatively unscathed.

THE GUEST COMMENTS AND ARTICLES

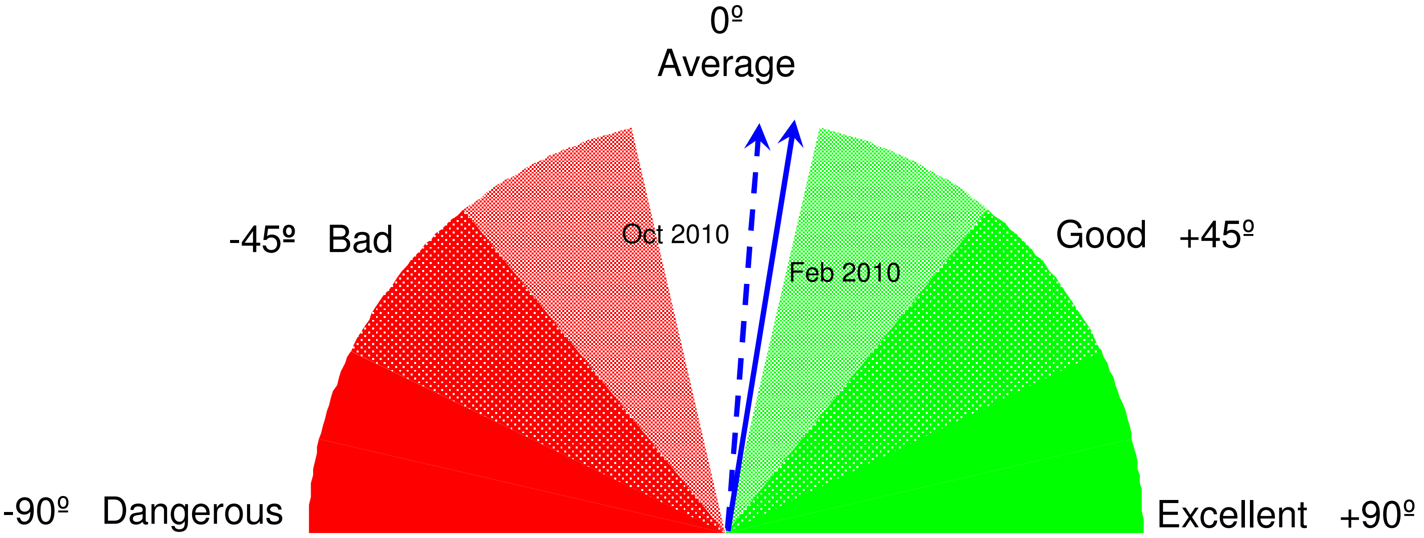
In this issue, we invited Lachezar Bogdanov – who wrote the very first analysis a year ago – to contribute again with his macroeconomic comments.

We also borrowed Peter Ganev's article (published by Mediapool.bg) on the prices of important foods. We share his view that in an open market economy the public should not blame the speculators. Rather, we should improve competition.

We have also included our own article. We support the Financial Stability Pact proposed by the Finance Minister.

EXPAT CURRENCY BOARD WATCH

OUTLOOK: POSITIVE



A year ago, the exchange rate was frequently discussed at economic discussions and business meetings. More recently, concerns have faded away as most economic indicators have started improving since the middle of 2010. Here is our positive conclusion:

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

In the future months and years, we will continue constantly monitoring 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 occur.

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
Feb 2010	**+8º**	**+4º**	Improvement in many economic indicators

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
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, moderately large
5. Budget spending	-	++	Not excessive anymore
6. Government debt	+++	+++	Very low
7. Foreign liabilities of the private sector	--	--	High, falling
8. Fiscal reserves	-	+	Average
III. Economic cycle related issues			
9. GDP growth	-	-	Close to zero
10. Inflation	+++	++	Low, rising
11. Unemployment	-	-	Stable
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 looks better than a year ago. While sentiment in the economy remains weak, many economic indicators have numerically improved. The current account deficit has improved very fast, the recession seems to have ended. The budget picture is mixed.

In this issue of Expat Compass, we have kept most of our qualitative assessments unchanged. Here are some comments:

1) **The budget deficit** for 2010 of -3.9% on a cash basis was very close to our October forecasts, and lower than expected in mid-2010. We project another -3.0% for 2011.

2) **GDP growth.** Our latest forecast for 2010 was -1%. The preliminary number for 2010 has been reported at +0.3% positive growth. We have our minor skepticism about the GDP methodology changes implemented by the National Statistics Institute, which have resulted in higher reported growth for 2010. We expect growth for 2011 of +3.0% compared to the government's +3.6%.

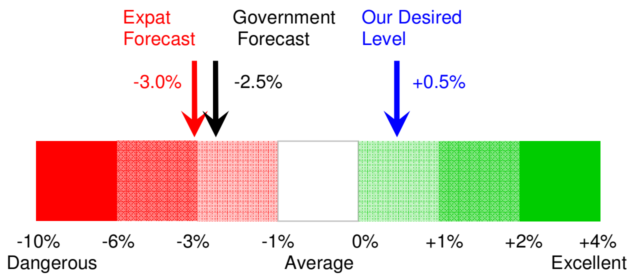
3) **Inflation.** The year-end inflation crept up to +4.5% compared to our latest forecast of +3%. The average inflation for 2010 was +2.4%. We have removed one of the 'pluses' in the table above due to the growing inflationary pressures (fuels, foods), but do not consider this a problem.

4) **Trade and current account deficit** – much lower than in 2009 and better than our expectations.

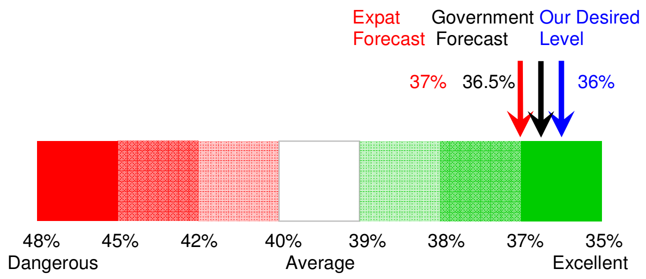
5) **Unemployment.** The year-end unemployment of 9.24% was lower than our forecast of 10.5%. Bulgaria is coming out of the crisis without double-digit unemployment, which is a success.

INDICATORS, 2011

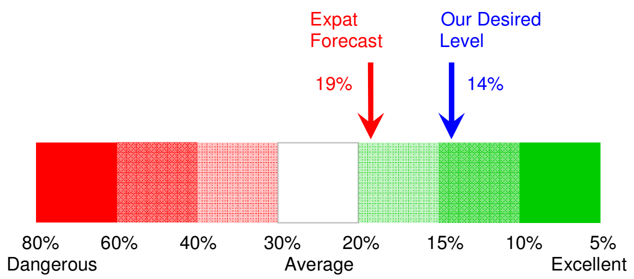
I) Budget Surplus/Deficit, % GDP, 2011



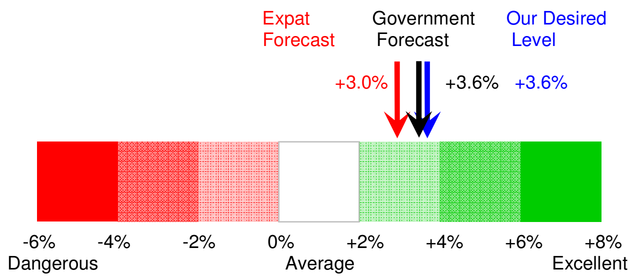
II) Budget Spending, % GDP, 2011



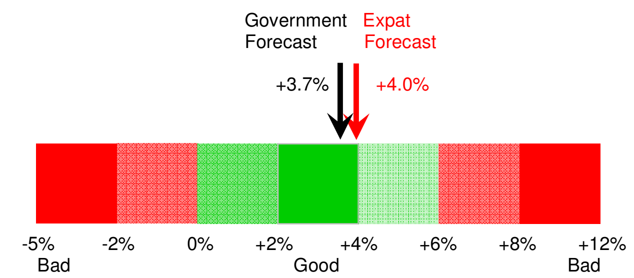
III) Government Debt, % GDP, 2011, Year-End



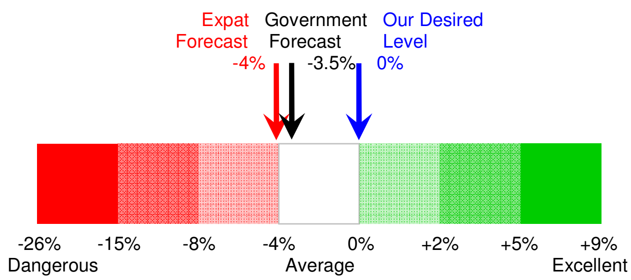
IV) Real GDP Growth, %, 2011



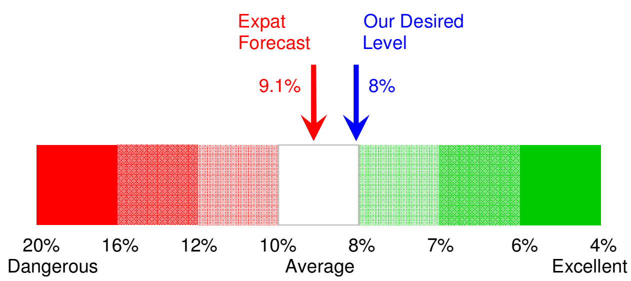
V) Inflation, %, 2011, Year-End



VI) Current Account Deficit, % GDP, 2011



VII) Unemployment, %, 2011, Year-End



2010 SUMMARY

From the point of view of Expat Compass, the year 2010 was mixed for the Bulgarian economy. The glass is half-full or half-empty, depending on one's expectations.

It could have been a bit better, if:

- the budget was balanced
- there were at least some privatization and concession deals, or public-private partnerships
- Bulgaria reported higher GDP growth than, say, Poland
- FDI was more impressive

However, it could have been much worse, if:

- Bulgaria had fiscal and debt problems similar to most of the rest of Europe and the world – see Greece (but it hadn't)
- the banking system was in a deeper trouble – see Ireland (but it wasn't)
- there were serious question marks about the exchange rate (but there weren't)

Below, we have enumerated the best and the worst achievements for the Bulgarian economy, ranked by importance. Please note that the budget situation is listed as number 1 in both rankings – as it could have been both a bit better and much worse.

The best achievements in 2010:

1. The **budget** did not blow up like it happened in many other countries. A year-end deficit of around -3.9% on a cash basis would be envied by two dozen EU members. After the disastrous results in January and February (see the second issue of Expat Compass), the budget was practically balanced in March-September. *This final number is extremely close to our forecast of -4.0% which we published in the 4th issue on 25 October 2010. We correctly expected that there would be large spending in December, but the budget would not need to be amended again at year-end.*
2. **Exports growth** was impressive at +23% year-on-year (yoy) in H1 2010, rising further in H2: +47% yoy in July, +48% in August etc. Consequently, the **current account** was even in a small **surplus** for January-October – something not seen in over a decade.
3. Under the strict supervision of the Bulgarian National Bank, the Bulgarian **banking system** has been in a better shape than elsewhere.
4. **Direct taxes** remain low, the lowest in the EU. We disapprove of the social security contributions increase by 1.8% from 2011, though.
5. The **credit rating agencies** have not downgraded Bulgaria – unlike other countries. Most recently, Moody's reaffirmed its Baa3 rating with a positive outlook.
6. The **labour market** did not deteriorate according to our negative expectations from a year ago. The official **unemployment** figure has fallen to 9.24%.
7. A bit surprisingly to us, a small breakthrough was achieved in the **reform of the pension system.** The so-called 'point system' (see page 9) was changed in a direction making it more difficult to retire – good for the budget.
8. Nominal **pensions and public sector salaries** have not been increased (and also not been decreased) since mid-2009. The right policy, in our view.

The missed opportunities in 2010:

1. The **budget** has not been balanced, although the government had repeatedly said so before February 2010. The deficit was -3.9% of GDP on a cash basis, or -3.6% on an accrual basis. We favour a balanced budget policy, thus, we are not happy.
2. Good opportunities were missed to **reform the most important sectors** in 2010:
   – The **pension system** is the largest long-term problem for the budget and thus for the economic policy of Bulgaria. Please see our comment on page 9
   – Absolutely nothing good can be said about **healthcare** – 3 ministers have been appointed so far, but we remain skeptical about the future of the sector
   – Some progress in the area of **state administration** – but we have not seen any final numbers about the optimization
   – Efforts but no major breakthroughs in **education and science**
3. The very dangerous **partial nationalization of the private pension funds,** Hungarian style. See page 9.
4. Low **FDI** due to:
   – objective external factors such as the global economic crisis
   – internal political factors such as the general perception of chaos and lack of direction of economic policy
5. Not a single important **privatization, concession** or **PPP** deal. We view this as a major proof of the lack of commitment to do reforms.
6. The dire straits of the **capital markets** due to the lack of any government policy in the area.

2011: EXPECTATIONS

Our expectations for 2011 on the economic front are somewhat better:

On the positive side:

1. **Stable currency board** – no threat to the exchange rate
2. **Budget deficit of around -3.0%** of GDP both on a cash basis and on an accrual basis
3. Positive **economic growth of 3.0%**
4. No major changes to the **unemployment rate of above 9%**
5. No dangerous **inflation** – in the low single digits
6. No deterioration of Bulgaria's **credit rating**
7. A **mild fall in the interest rates** on deposits and loans
8. Progress with large transport infrastructure projects such as highways, the Sofia underground, the second Danube bridge

On the negative side:

1. No **concession** deals
2. Hardly any **privatization** deals to remember. We promise a special analysis of Bulgartabac, if privatized ☺
3. No large **capital markets** transactions
4. No major reforms

In other words, more of the same.

Our wish-list

In every issue of Expat Compass, we directly or indirectly make policy recommendations. In the 4th issue, we published an article called *'14 Golden Rules of Good Economic Policy'* where we expressed our views. Specifically for 2011, under the best-case scenario, here is our 'wish list':

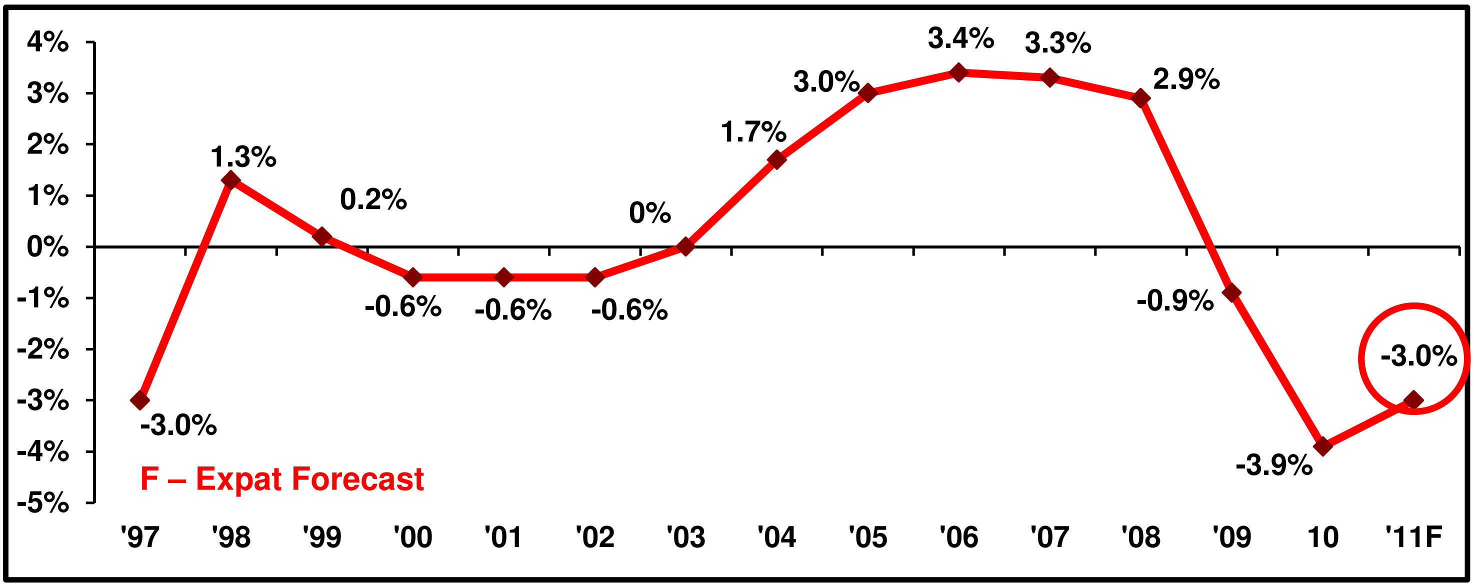
1. A **balanced budget** – unlikely to happen
2. Significant progress towards **Euro Zone** membership – regardless of the current problems of the common currency – unlikely
3. Keeping the **low direct tax rates** intact – likely
4. Keeping the low **budget spending** as % of GDP of around 36% – likely
5. **Privatization** of Bulgartabac, VMZ Sopot, several energy companies – possible, but unlikely, in our view
6. **Concession deals** for airports, ports, elements of the railway system, highways, water companies and other infrastructure projects – unlikely
7. Selling a number of stakes in state-owned companies through the **stock exchange** – possible, but unlikely, in our view
8. **Pension reform** in order to reduce the long-term deficit of the state pension system – unlikely
9. **Health reform** in order to introduce a better economic model into the system – unlikely
10. Aggressive promotion of **FDI, incoming tourism, and exports** – unlikely

This requires political will – difficult in practice.

ANALYSIS

I) 2010-2011 BUDGET DEFICITS – THE GLASS IS HALF FULL

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



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

Let us start with our long-term statement that we favour a balanced budget policy. We believe that running balanced budgets would have the following positive consequences for the country:

- The government would need no new financing, which is sometimes difficult to raise, especially in view of the recent global crisis
- Public debt would not rise, but would rather fall, both nominally and as % of GDP – as it was happening between 1997 and 2008. This would also facilitate Bulgaria's joining the ERM-II and the Eurozone
- The country would pile large fiscal and foreign exchange reserves. This is prudent, especially in view of the disastrous demographic forecasts for the 21st century
- Running no deficit would put stronger pressure on the tax authorities to improve tax collection
- Lower spending would put stronger pressure on the government to implement reforms in the public sector that are otherwise conveniently postponed by spending more

We remind that Bulgaria was running more or less balanced budgets between 1998 and 2003 (see the chart above) and large surpluses between 2004 and 2008. We think those were the right policies for those periods. In comparison, a deficit started looming since the middle of 2009. Since then, the country has gotten used to operating with an annual budget deficit of around -3-4%, and no one is intending to reduce it any time in the future. We would like to reinforce our view that *the budget deficit is not a mathematical phenomenon, but a state of mind.* I.e., certain families, rich or poor, always save – in good times or bad, while other families, rich or poor, always overspend – in good times or bad. Long-term, the first type would accumulate massive wealth. The second would go bankrupt. Bulgaria as a country belonged to the first group for over a decade, and is now joining the second group, may be for another decade. Not good.

2010 finished with a lower-than-expected deficit

The budget amended in mid-2010 envisioned a deficit of -4.8%. The budget was practically balanced for March-September 2010, which we considered remarkable, especially compared to the disastrous January and February, as well as to the large deficits elsewhere in the world.

In our October 2010 issue of Expat Compass, we published our forecast for a -4.0% deficit on a cash basis. The final number was very close at -3.9%. Lower than the planned -4.8% and one of the lowest in Europe, but still a deficit. So, the glass is half full.

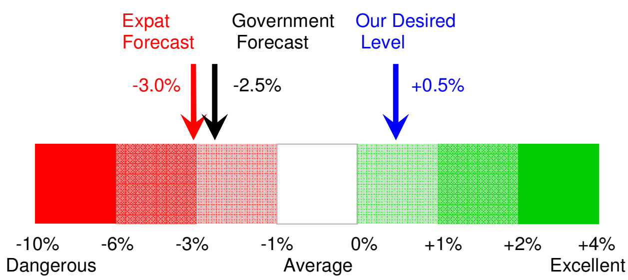
2011 – more of the same

The Budget Law was passed with a deficit of -2.5%. Lower than the one in 2010 and lower than the Maastricht criterion of -3.0%, but still unambitious. It is too early to say what would actually happen during the year. We do not expect the economy to grow as fast as the planned -3.6%. In addition, the local and presidential elections in the coming autumn increase the risk of higher spending. Hence, our current forecast of -3.0%.

Diagnosis: mildly in the 'red' (i.e. negative) zone

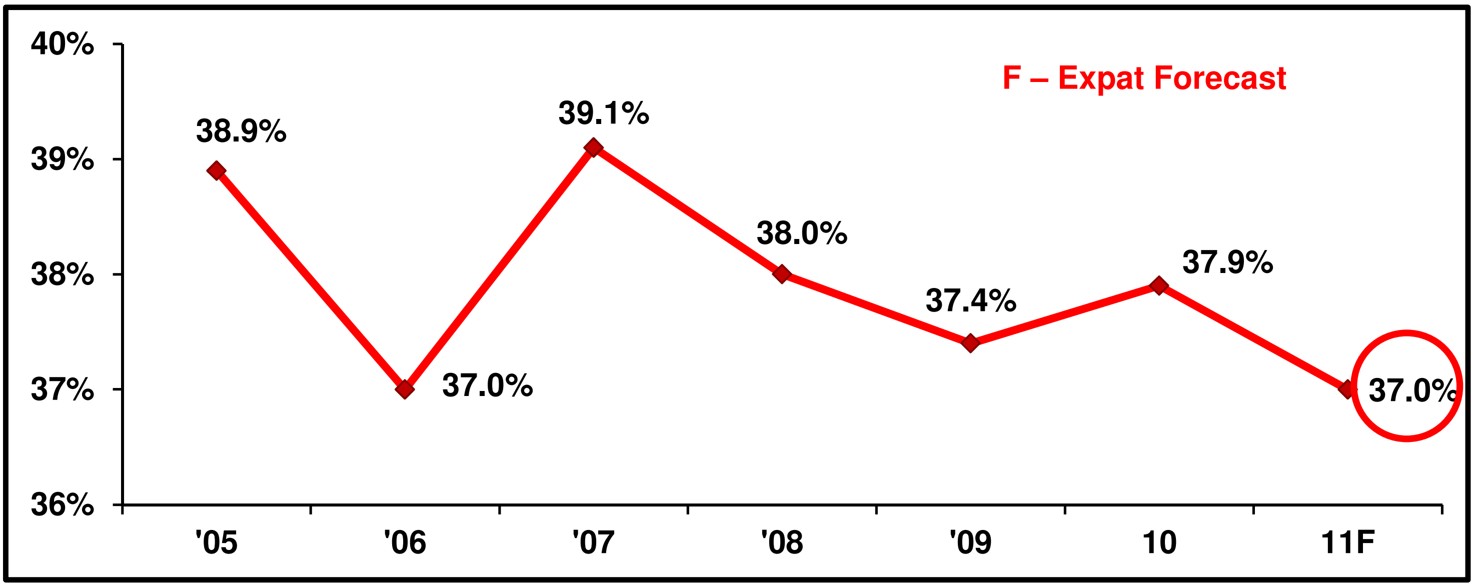
Implications for the currency board: negative to neutral

Budget Surplus/Deficit, % GDP, 2011



II) BUDGET SPENDING: MUCH LESS LAVISH THAN WE FEARED

Chart 2. Public Spending, % GDP



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

2010 ended up with lower spending: 37.9% of GDP

In the previous issues of Expat Compass, we expressed our concerns that budget spending as % of GDP would be excessive, probably reaching the highest level for two decades. The amended budget in mid-2010 envisioned spending of 42.3%, which we considered too lavish. However, the final number was 37.9% on a cash basis. We see 4 reasons for this:

1. The Finance Minister was successful in cutting spending – a good achievement
2. Real GDP increased in 2010 by +0.3% instead of falling
3. Inflation was double the initial expectations, which additionally increased nominal GDP. As a result of reasons 2 and 3, the denominator in the ratio spending/GDP was larger
4. Budget revenues were lower than planned and much lower than in 2009: 34% of GDP in 2010 versus 36.5% in 2009

This last reason is also important to understand, and we tried to explain it in the previous issues of Expat Compass. Usually, governments and analysts consider the **budget deficit** number to be much more important than the level of revenues and spending. Rightfully so, just like in football games it is more important who wins and by how many goals, and not whether the score is 3:0, 4:1 or 5:2.

When governments collect more revenues than expected, they are inclined to spend some of the excess revenues, while targeting a certain level of budget deficit or surplus. This was going on for a number of consecutive years till 2008.

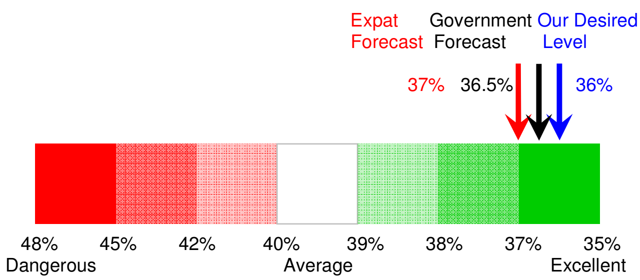
Opposite, when revenues fall short of targets, there is pressure for cutting expenditures, so that the deficit is not too large. This is what happened in 2010.

The government should be commended for not raising public salaries and pensions for 2 years. As we all know, this is not very easy to achieve politically.

Diagnosis: from 'red' (i.e. negative), we are moving to the "dark green" (i.e. very positive) zone

Implications for the currency board: very positive

Budget Spending, % GDP, 2011



III) PENSIONS – A SMALL VICTORY AND A BIG MISSTEP

A small victory in the area of pensions

We cannot be honest if we do not mention two positive achievements (positive for the budget and the currency, not for the pensioners):

1) Pensions have not increased since the government came to power in mid-2009

We have repeatedly expressed our opinion that pensions had increased more than they should have between 2007 and mid-2009. Decreasing them in nominal terms is politically difficult in any country. Keeping the nominal level of pensions while GDP is rising in nominal terms is the other way to reduce the weight of pensions in the budget. This is what the government has done – so far, so good.

2) The government surprisingly abolished the so-called 'point system'

… but in the opposite direction of what trade unions and pensioners had hoped for. Without going into much detail, during the past decade one could retire if he/she reached a certain age OR had worked for a certain number of years. Both brought 'points'. Pensioners demanded that the second condition be dropped, so that people could retire more easily even if they had not worked enough or at all. The government made retirement more difficult by replacing the OR with AND. No one protested as this change was not widely discussed and noticed.

Although we like this step, we still cannot call the whole situation a 'pension reform'. There is no reform.

We are very critical about the partial nationalization of private pension funds

In 2010, Hungary nationalized all its private pension funds – worth over EUR 10 bn. It is hard to believe that this is happening not in Venezuela, but in the EU and in one of the most reformist CEE countries. Hungary had been the second country in Europe after the UK to introduce the third pillar of the pension system – the private pension funds.

Bulgaria was contaminated with the idea. The government tried to nationalize all the so-called professional private pension funds worth almost half a billion BGN. After the big scandal, a compromise was reached, and 'only' a quarter of those funds was nationalized.

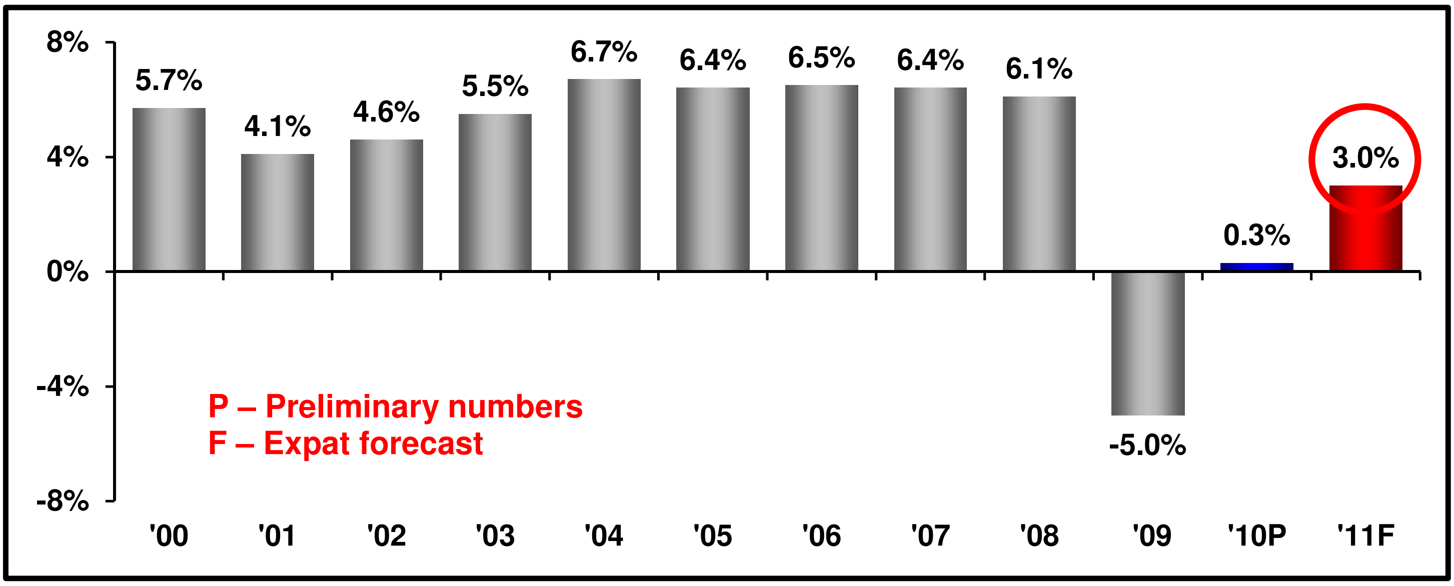
We find it difficult to characterize this move in appropriate words. This resembles the nationalization after 1945. It is very strange that such an idea never occurred to a socialist cabinet after 1989, but was implemented by allegedly right-wing governments both in Hungary and Bulgaria. Several times in this Expat Compass, we say 'The Gods must be crazy'.

Compared to this nationalization, the increase of social security contributions by 1.8% seems peanuts

Obviously, we did not support that, either. Social security contributions are a kind of direct tax on employment. We do not think higher direct taxes are a good policy.

IV) GDP GROWTH – WE SEEM TO BE COMING OUT OF THE RECESSION

Chart 3. Real GDP Growth, %



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

As Winnie the Pooh says, "The more… the more".

Bulgaria is likely to finish this recession with scratches only. Deep scratches they might be, but not lethal wounds. No bank failures, no major budget deficits, no extraordinary tax hikes, no currency devaluation, no reduced pensions or salaries in the public sector, no credit rating downgrades, no IMF or European Commission bailouts. If you do not like the picture, check out our neighbours Greece and Romania, or Hungary, Latvia, Ireland. Not to mention the US and the UK. The big local casualty was the stock market. Bulgaria might be the only country in the world where the indices plummeted by 85% from the peak and have not recovered much yet.

+0.3% growth for 2010

After the drop in GDP of -5.0% in 2009, the preliminary numbers for 2010 show annual growth of +0.3%, the Q4 number being +2.1% year-on-year. On the one hand, we share some analysts' small concerns about the changes in NSI's methodology (the National Statistics Institute). For the first time, they published GDP numbers taking into account the lower number of working days in 2010 compared to 2009. Yes, your guess is correct. This was done because it improves the GDP growth number from possibly -0.1% (this is our own guesstimate) to +0.3%. Naturally, this methodology would not have been used, if it had resulted in a worse number.

On the other hand, we are happy with the +0.3%. We improved our forecasts throughout 2010, but we were always lagging behind the recovery. Thus, any positive number for 2010 is good news for us.

The sources of growth – mostly (or only) exports

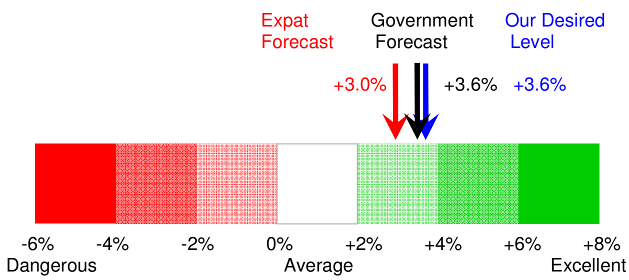
We discussed this topic in the 4th issue of Expat Compass on page 6. We reinforce our view that rising exports are the healthiest path to growth, especially from the point of view of the currency board. We disagree with a number of analysts who think that domestic demand is a better factor of recovery. Rising domestic demand would result in worsening external deficits, which would be bad for the currency. On the contrary, rising exports are excellent news for the currency.

The other components of GDP were not growing in 2010 – domestic consumption, investments. European funds should have had a positive effect on GDP in 2010, and this trend should continue in future years.

Diagnosis: from 'red' to green – the recession is ending

Implications for the currency board: mildly positive

Real GDP Growth, %, 2011



RECOVERY, STAGFLATION OR A NEW CRISIS FOR BULGARIA?

LACHEZAR BOGDANOV

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 working as a researcher at the Institute for Market Economy in Sofia, a leading NGO and think-tank. From 1999, he 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.

Photo: Capital.bg

More than two years after the financial crisis burst in the fall of 2008, the Bulgarian economy is still not on a clear path for recovery.

First, the good news: from a technical point of view, i.e. the dynamics of the GDP, the recession is over, and the economy has already recorded slight positive growth since Q2 of 2010. It was by all means export driven growth – the rise in exports was 23.8% towards EU markets for January-November (year-on-year) and an astonishing 48.5% for 2010 towards non-EU countries. Despite the price increase effects (mostly, in commodities), the real growth will be double-digit. What stands behind this positive development, aside from rising commodity prices, is the recovery of the manufacturing economies in the EU, mostly – Germany. As main trade partners recover from the recession, Bulgarian exports typically respond with a 3-6 month delay. The Industrial Production index has been recording positive growth rates (compared to the respective months of 2009) ever since April 2010.

The banking sector proved to be healthy mostly due to the relatively prudential credit policies prior to the crisis. Therefore, despite the accumulation of bad debt on the balance sheets, we witness no mass business and individual foreclosures. Moreover, households accumulated additional BGN 3 billion (about 4.5% of GDP) savings in domestic bank deposits during the year.

But the grounds are shaky. Macroeconomic fundamentals, especially in the financial sector, are not looking good both in Europe and the US. Banks have a lot of illiquid assets on the balance sheets, the latter propped-up for the time being by the extremely loose monetary policies of the Fed and the ECB. A new banking crisis, resulting in yet another sharp decline in investment, is still a possibility. A side effect of the quantitative easing on both sides of the Atlantic is the rise in commodity prices. For Bulgaria, a net importer of natural resources, the negative impacts on the cost structure of the economy are quite real, while at the same time the "stimuli" which supposedly stem from such monetary policies are confined to the banks and governments (in Western Europe and the US) that receive them.

As already demonstrated in 2010, even a spectacular rise in exports in a relatively open economy is not sufficient to boost the overall GDP growth and job creation. Moreover, once major industrial exporters approach the capacity ceiling, growth rates will quickly fall. Therefore, export growth can be maintained in the mid- to long-term only through a substantial flow of investment. At the same time, as the last decade proved for Bulgaria, domestic demand – for both final consumption and capital formation – is driven by the inflow of foreign capital. Until foreign direct investment and bank lending financed from abroad do not recover, almost all sectors in the economy are doomed to stagnation or at most, quite low growth.

As the potential for a fast and sound recovery is there, we should by no means rule out the risk of a new economic crisis in Bulgaria. As already mentioned, the single most important factor for high growth is the level of capital flows to the country. The latter, however, became extremely sensitive to political risk in the recent years. As fiscal adjustment is particularly difficult with a high unemployment rate and low growth, investors should closely monitor public finances. Bulgaria maintained an average (from the EU perspective) level of its budget deficit – 3.8% of GDP in 2009 and probably another 3.8% in 2010. However, the inefficient public sector requires bold reforms that are repeatedly delayed – in health and pensions in particular. If the lack of hard budget constraints in state-owned monopolies (e.g. the railways, the electricity and heating companies, etc.) is added, the immediate threats to fiscal discipline become quite substantial. Until these are resolved in a decisive and sustainable manner, the perception of risk and uncertainty will remain high, thus hindering the flow of foreign capital into the Bulgarian economy.

MURMUR ABOUT THE PRICES

PETER GANEV, INSTITUTE FOR MARKET ECONOMICS

Mediapool.bg, 13/02/2011

Petar Ganev is a Senior Economist at the Institute for Market Economics – Bulgaria. He is working with the Institute since 2007. His current work is focused on fiscal policy, competition and regulation. He is also interested in economic development, including issues such as extreme poverty and climate change.

Mr. Ganev studied Macroeconomics at the University of National and World Economy (Sofia). He is the founder of IME Students Club – an informal libertarian youth organization created in the beginning of 2009. The Club consists of more than 350 students from different universities in Bulgaria.

Photo: Segabg.com

In the last weeks, there have been persistent talks about the prices – some are too high, others are too low. Of course, some 'experts' appeared immediately who started talking about the interference of the state – restricting the rise in food prices, while fighting the low prices at hypermarkets. How these two goals are combined is not clear to the 'experts' themselves, but everyone is pushing his/her own ideas.

Let us start with the high prices – the food prices have increased a lot, and now the whole Europe is trying to deal with this problem. 'The whole Europe' means only Cyprus, where the government put price limits with the EU approval – not exactly permission, but rather a lack of veto for such an action. This measure in Cyprus is not a surprise – this is the only country in Europe where the whole power is in the hands of the Communist Party. So, generally speaking, this is a great example for the front page of a Bulgarian newspaper.

In addition to the Cyprus example, there was news that the EU is discussing measures against the high food and fuel prices, throwing the main blame on financial speculators. However, these conclusions have strong political character – after all, it is better to blame a financial speculator than government policies. All these debates are based on an EC report, in which it is explicitly claimed that speculations are pushing up the prices. However, it was not mentioned in Bulgaria that the report was slowed down after the rough reaction of the French president Sarkozy – the reason is that a draft of the report appeared in the media where the speculators were not blamed for the high prices. However, political interference changed the conclusions. This event resembles the reports on global warming – scientists write one thing, politicians edit it.

It is a fact that the food and fuel prices have increased – not so much due to speculations, but because of state policies and conflicts, as well as because of purely climatic reasons. With regard to the food price speculations, this is not a new phenomenon at all – there have been speculations since the end of XIX century, and back then even farmers, who had real production for sale were speculating on commodity exchanges with 'virtual' wheat.

This is all clear, but it does not lead to some bombastic conclusions that when prices are high, the state should interfere – there is no state which has interfered actively in the setting prices, even food prices, and has prospered from it. Exactly the opposite, this is the path leading to more serious problems. Price ceilings mean only one thing – the prices will be low, but the goods will be missing. What is the benefit of low bread prices, when there is no bread in the store? There is no administrative way to fight high prices.

The solution to the high prices problem is competition. The competition which sometimes works so well that people start complaining about low prices – the store chain suppliers were pushed (read as pushed by the competition), and the Minister of Agriculture frankly said 'low prices are a kind of fraud for consumers'. It is not very clear how one could explain to the ordinary person that low prices are a fraud and also a huge problem.

The thesis is that hypermarkets hold the whole market – in a way, one can either sell there, or nowhere, i.e. there is no choice. Yes, but no. The chains definitely compete with small stores – there are such stores in every town and every neighborhood. In my neighborhood in Sofia, for example, there are over 10 family stores and two big hypermarkets – they all offer a choice to their customers. Yes, chains take the business from small shops, but this does not mean that the latter have disappeared. The hypermarket has its advantages and gradually finds its place, but it does not fully replace a small store.

We reach the following situation – hypermarkets are not full masters, but they have strong influence on the market. However, what do hypermarkets mean? Why are they viewed as one, as if they are owned by the same person and do not compete with each other? Exactly the opposite, there are a lot of chains in the country, and obviously they compete severely for customers. If someone does not agree with this statement, please remember the video showing 'people are fighting for cheap bananas'. If the chains act together, how about all the 'sales'? Since when does the 'lack' of competition lead to lower prices?

The conclusion is clear – hypermarkets have serious influence on the market and compete strongly among themselves. In such a situation, low prices and a lot of promotions can be expected – they are real, the practice confirms the logic. The murmur for pressure is just murmur against competition – certain businesses are apparently looking for their market niche in the legislative and the executive power.

I will finish with a text from Ludwig von Mises. In his founding writing 'Human Action', in the chapter 'The Government and the Market', Mises discussed the 'fair' price. He wrote:

'It is 'fair' for a person, when the price of the products and services he is selling is increasing, and when the price of the products and services he is buying is falling. For the farmer, for example, the price of wheat, no matter how high, seems 'unfair'.

The 'experts' in Bulgaria think exactly as Mises had written, but without the quotation marks around the word fair. Mises also wrote, 'the concept for 'fair' or 'honest' prices lacks a scientific explanation; this is a mask for wishes; ambition towards a certain state, different from reality'.

THE BULGARIAN FINANCIAL STABILITY PACT

NIKOLAY VASSILEV, CFA

A revolutionary step forward, although not ambitious enough

MY SIMPLE AND CLEAR PROPOSAL
(In a different order of importance)

1. No budget deficit
2. No increases of direct taxes
3. Government spending up to 37% of GDP

All of the above can be overruled by a 2/3 majority in parliament.

THE FINANCE MINISTER'S PROPOSAL
(As of 22 February 2011)

1. Government spending up to 37% of GDP, not counting European funds and domestic co-financing
2. Any increases of direct taxes should be passed by a 2/3 majority in parliament
3. A) Budget deficit up to 3% of GDP
   B) Public debt up to 40% of GDP

MY CONCLUSION

I strongly support the Finance Minister's intention to introduce the so-called 'Financial Stability Pact' (FSP) in the Bulgarian Constitution. Even in an imperfect form, it would be much better to have it than not. Will it pass through the current parliament? Probably, and I hope so.

MY RECOMMENDATIONS TO MINISTER DJANKOV

I. KISS = Keep It Simple and Stupid. Any formulas such as how to forecast the deficit are not likely to be understood by the public and might derail the whole idea
II. Be more ambitious on the deficit side. Replace the 3% allowed deficit with 0%. Otherwise, politicians will be stimulated to always allow a 3% deficit
III. Make sure these rules are passed by this National Assembly as the next one might be more populist than the current one

THE 'BUDGET AMENDMENT' DEBATE IN THE US IN THE MID-1990S

I was a student in the US during the 1990s and was fascinated by the 'budget amendment' debate which was going on around 1995. A new Republican-dominated Congress during President Bill Clinton's first term attempted to write down the following rule in the US Constitution:

- No federal budget deficit. This can be overruled by a 3/5 majority (if I remember correctly)

As a student, I supported the amendment. Sadly, it was passed by the Congress but not by the Senate as the Democrats opposed it. Their reasoning was: you never know what the future state of the economy will be. Thus, you should not say in advance what future economic policy should be. The Republicans' answer: but this rule can be overruled by 60% of the members of Congress. So, in especially difficult times, there could be a temporary deficit.

THE IRONIC AND TRAGIC DEVELOPMENT IN THE US SINCE 1995

Ironically, with President Clinton, a Democrat administration ran budget surpluses, although the very Democrats did not support the balanced budget amendment. How do you remember the Clinton era? I remember it like this: strong dollar, rising stock market, falling government debt, very strong United States.

Later, the George W. Bush administration (Republican) allowed record budget deficits, and so has Barack Obama (Democrat). What do you predict to happen? My expectations for the US are grim: astronomical government debt, weakening dollar (have you moved your savings to Chinese yuans, Bulgarian levs, or gold yet?), a shift of global reserves away from the dollar (strategically bad for the US), excessive dependency on uncertain borrowings from Asia and the Middle East. This century is not likely to be so dominated by the US like the 20th century. And all this because the budget amendment was narrowly not passed? The Gods must be crazy.

THE EU'S SIMILAR EXPERIENCE

The Maastricht criteria (e.g. budget deficit up to 3%, public debt up to 60%) were not strictly enforced even under the excellent economic conditions in the 1990s and until the global crisis hit in 2007-8. Even countries with very high debt (Italy, Belgium, Greece) were proudly allowed into the Eurozone. Then the terrible crisis came unexpectedly (so much about the 'New Paradigm' – the theory from 10 years ago that we are now very smart to avoid any economic cycles). Today, **most** EU members do not meet the Maastricht criteria. The Eurozone might fall apart. We might see drachmas in the future, but seeing Deutschmarks would be even more weird.

The usual economic policy wisdom is that you should save during the boom (as Bulgaria did responsibly between 1998-2008) so that you have more room to maneuver during a recession. What did countries such as Hungary and Greece do? They ran crazy deficits instead of surpluses during the best economic cycle ever, amassed huge debts, and practically went bankrupt a couple of years ago. The international community bailed them out with a total of over 100 billion euro, which makes the US$ 1 billion IMF support for Bulgaria in 1997 look like pocket money. Bulgaria seems to have learned the 1997 lesson well. Others still need to learn.

Over the last year, Greece has suffered major protests because the government was trying to reduce the deficit from 15% to … 8%. In my modest view, Greece should be running consistent **surpluses of +5%** for one or two decades in order to just stay afloat. A feat not seen since Achilles' times. Can they do it? No. Do you hold any Greek bonds? Good luck.

HOW ABOUT THE WORSENING DEMOGRAPHY IN EUROPE AND JAPAN?

The expected demographic catastrophe makes the picture even worse. How Europe plans to manage the situation by allowing a generous 3% deficit per year (and seldom keeping the rule) is unclear. The numbers just do not add up. Maybe we should suggest the Maastricht rule be changed to a **surplus of at least +3%.** Can it happen politically? No.

The fate of Japan is even more incomprehensible. The government debt is over 200% (!) of GDP. Among 131 countries (Wikipedia), Japan ranks 2nd after Zimbabwe which is notorious for its hyperinflation and mismanagement. Are the Gods not crazy? And Japan's demographic outlook is definitely worse than Africa's. Standard & Poor's recently downgraded Japan's credit rating to AA-, and Moody's changed the outlook to negative.

THE COALITION AGREEMENT IN 2005-2009

I claim to be the main author of the so-called '3 anchors' of economic policy for the previous government, which were included in the Coalition Agreement of 2005:

1. No budget deficit – overfulfilled, large surpluses in 2005-8
2. No increases of direct taxes – overfulfilled, direct taxes and social security contributions were strongly reduced in 2005-9
3. Government spending should not exceed 40% of GDP – overfulfilled, spending was 37-39.1% in 2005-9

Those 3 anchors strongly resemble the logic of the current FSP. Or maybe they have partially inspired it – nothing wrong with that. Here are my comments on the 3 components of the FSP, suggested by the Finance Minister.

1. THE 37% SPENDING RULE

Excellent. This is lower than the 40% anchor in 2005. The reason we put the less ambitious 40% in 2005 was that with a leftist government we wanted at least to avoid a Hungarian-style 50% spending in Bulgaria. You might remember that in 2005-7 the leftist politicians quoted Hungary as having very successful economic policies that Bulgaria should copy – especially the 50% hike in public sector wages. Later, history proved different. The same people stopped mentioning Hungary after 2007.

The 2011 budget envisions spending of only 36%. The fact that this low (i.e. good) number was primarily achieved due to the low budget revenues and not due to conscious policies is not so important. I believe that lower budget spending leads to higher economic growth and is thus good for the country. If you think the opposite, see what David Cameron, the new UK Prime Minister, is saying. Super-capitalist Britain is spending 51% of GDP, and communist China only 24%. Which country has been economically more successful lately?

Conclusion: I support the 37% spending rule as suggested.

2. THE DIRECT TAXES RULE

Excellent. I strongly believe that the lower the direct taxes in Bulgaria, the better. These include taxes on personal income (10% flat), corporate profits (10%), and capital gains (0% since 2002). The social security contributions should also be included here (first reduced by 11% after 2005, then increased by 1.8% in 2011).

If you believe that higher and progressive taxes are more socially just (whatever that means), please check that all tax revenues were strongly **increased** after the tax rates were **reduced.** The rich actually paid more taxes with the lower rates. Bulgaria also attracted c. EUR 30 bn of FDI for a decade.

Conclusion: I support the direct taxes rule as suggested.

3. THE 3% DEFICIT RULE

Not good enough. I have always favoured a balanced budget policy. Full stop. One might say that limiting the deficit to 3% is better than not limiting it at all. Well, it depends. With no formal limits in the Constitution, the governments of Kostov (1997-2001) and Saxe-Coburg (2001-05) were running either very small deficits or surpluses. You think that was easy? The Stanishev government even achieved very large surpluses in 2005-8 – a result of the 3 anchors in the Coalition Agreement and of the prudent policies of the Ministry of Finance.

Allowing a 3% deficit in the Constitution would invite future politicians to always pass budgets with a deficit of around 3%. In addition, they would consistently look for ways to circumvent the rule, e.g.:

- the EU funds should not be counted in the 3% rule
- the special pre-election pension increase of 10% is a one-off extraordinary item due to special circumstances (say, Bulgarian pensioners are the poorest in the EU) and should not be counted as well
- this year was particularly difficult for whatever reason – as if politicians would ever say that a certain year was not particularly difficult and would be happy to pass a budget with a large surplus
- the other EU countries have much higher deficits, so why should we be greater saints than the Pope? As if it is okay to have a very large mortgage if your unemployed neighbour has an even larger one

The students would always vote for a longer vacation, if asked. The politicians would always be happy to spend more, if allowed. Even the 1995 Newt Gingrich Republican Revolution was unsuccessful, as far as the long-term budget policy is concerned. That is why, the Constitution should simply allow no deficit.

If you believe that running budget deficits helps the economy, you must have missed the history of the last decade. Just look at the developments in the US, the UK, Japan, Hungary, and Greece.

Conclusion: I suggest the 3% rule to be replaced by the 0% rule.

WILL THE PACT PASS?

Trust me, making the socialists agree to the 3 anchors in 2005 was not an easier job. If you do not believe me, watch what their position will be in this debate. Then, you can imagine what could have happened after 2005 without the 3 anchors.

There seems to be a unique opportunity to put the state finances in order in the long run. If we miss this opportunity, there might not be a similar chance in the future. Then, Bulgaria is likely to repeat the US experience. For the benefit of the next generation, we should not allow this to happen. Thus, let us support the Finance Minister.

EXPAT CAPITAL – 2010 IN NUMBERS

Asset Management

Expat Bonds

In 2010, the assets under management in this fund increased from BGN 112,000 to BGN 3.9 mln. The target of over +12% yield for the first 12 months of the fund's history was achieved (+12.3%), and now the performance varies between 8 and 9%. At the end of 2010, Expat Bonds ranked fifth according to its performance among 86 funds in Bulgaria: +8.37%.

Expat New Europe Stocks

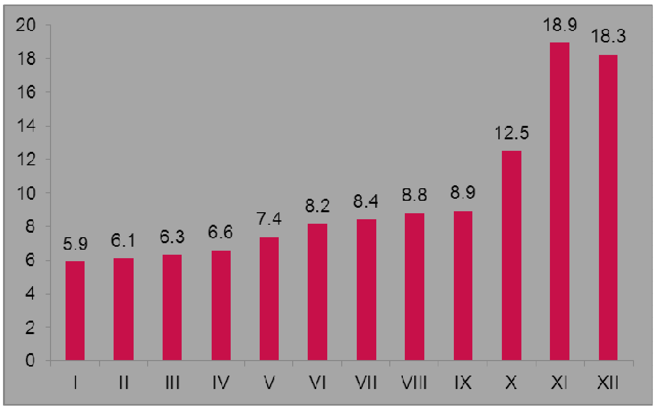
During the past year, the fund was one of the well performing funds in the market, and for the last 12 months it had positive yield of +3.43%. At the end of November 2010, it reached the highest quotation in its history of BGN 1,001.66 per share, and this was the first time it exceeded its nominal value.

Expat New Europe Properties

Despite the hard year in the area of real estate, the fund managed to preserve its capital with a yield of a little less than zero (-0.74%) for the last 12 months. During 2010, SOFIX fell by -15.2%, BGREIT by -9.7%.

Private Investment Accounts

- ✓ 45 clients with private accounts
- ✓ BGN 7.9 mln assets under management



Assets under management, BGN mln

Advisory Deals

Sofia Commerce – Pawn House AD

Re-financing of a bond issue of around EUR 1 mln. Sofia Commerce is one of the few companies which fully repaid its corporate bonds.

Torn AD

Private placement of preferred shares with a guaranteed cumulative dividend of annual 25% for 4 years. Result from the 1st stage of the capital increase – BGN 2.11 mln.

Mekom AD

- ✓ Sale of 7 mln shares in the secondary market, which increased the free float of the company from 4.58% to 18.26%
- ✓ An issue of new preferred shares with a guaranteed annual dividend of 18% for 5 years – 284,775 subscribed shares

REIT

Expat Beta REIT

- ✓ Focused on investments in high-quality newly finished buildings or empty plots in Bulgaria
- ✓ Listed on the BSE – Sofia in 2008
- ✓ Capital increase in summer 2010 from BGN 4.34 mln to 5.14 mln, almost doubling the number of shareholders
- ✓ Zero bank debt
- ✓ Market price around the nominal value – has not fallen during the crisis
- ✓ 100% free float
- ✓ 3 concluded deals

Concluded Deals

	KAMCHIA	TSAREVO	VARNA
Location	Kamchia Resort, Varna Region	Tsarevo, Burgas Region – waterview property, overlooking the marina	Varna City, Vinitsa District
Description	Zoned for development and construction	4-storey building with 9 apartments	A yard with a 3-storey residential building with Act 14
Property size	140,099 m^2	Plot – 284 m^2 Built-up area – 826 m^2	Plot – 390 m^2 Built-up area – 640 m^2
Price	BGN 4,096,094	BGN 300,000 (186 EUR/m^2; land – for free)	BGN 300,000 (240 EUR/m^2; land – for free)

EXPAT CAPITAL – 2010 IN NUMBERS

Internship Programme

In Summer 2010, 4 students from leading universities in the UK and the US joined Expat Capital's internship programme. The trainees worked in the fields of asset management and private equity. Each of them received an Internship Certificate for the successful completion.

In 2011, Expat Capital is continuing its policy for training young professionals. At the beginning of the year, the first 2 trainees joined Expat's team.

Expat Compass

Since the beginning of 2010, Expat Capital has been publishing and distributing the economic bulletin Expat Compass. The electronic product is in Bulgarian and English languages and is distributed free of charge. For the last year:

- ✓ 4 issues
- ✓ 7 guest analyses
- ✓ Over 3,000 e-mail subscribers and several thousand readers from internet sites and blogs

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