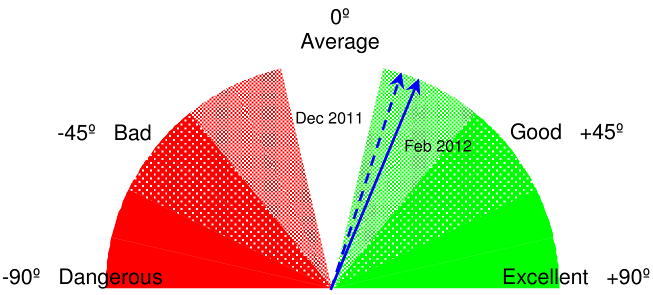
Issue 9 February 2012

expat compass

8 Feb 2012

## EXPAT CURRENCY BOARD WATCH




**OUTLOOK: STABLE/POSITIVE**

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

## GUEST COMMENTS



## ARTICLES



## EDITORIAL COMMENT

**Expat Compass is two years old and is becoming more international**

Dear readers and friends,

First of all, thank you for your growing interest in our economic bulletin. Over the last 24 months, we have published 9 issues in Bulgarian and English, more or less one per quarter. They are distributed to about 5,000 recipients globally, and are then additionally distributed by a number of web media. Over 20 external analysts and professionals have contributed their articles and analyses, some of which have also been reprinted by the mainstream Bulgarian media.

Our bulletin is independent and non-political. We give preference to reformist, market-oriented economic views. We have repeatedly expressed their support for the currency board, for a balanced budget, and for deeper pension and other structural reforms in Bulgaria. In this issue, however, there are authors with opposing opinions.

**Expat Compass is neither a commercial product, nor a media**

We do not compete with the think-tanks or with the media. Rather, the NGOs and the media are our partners.

**More international materials**

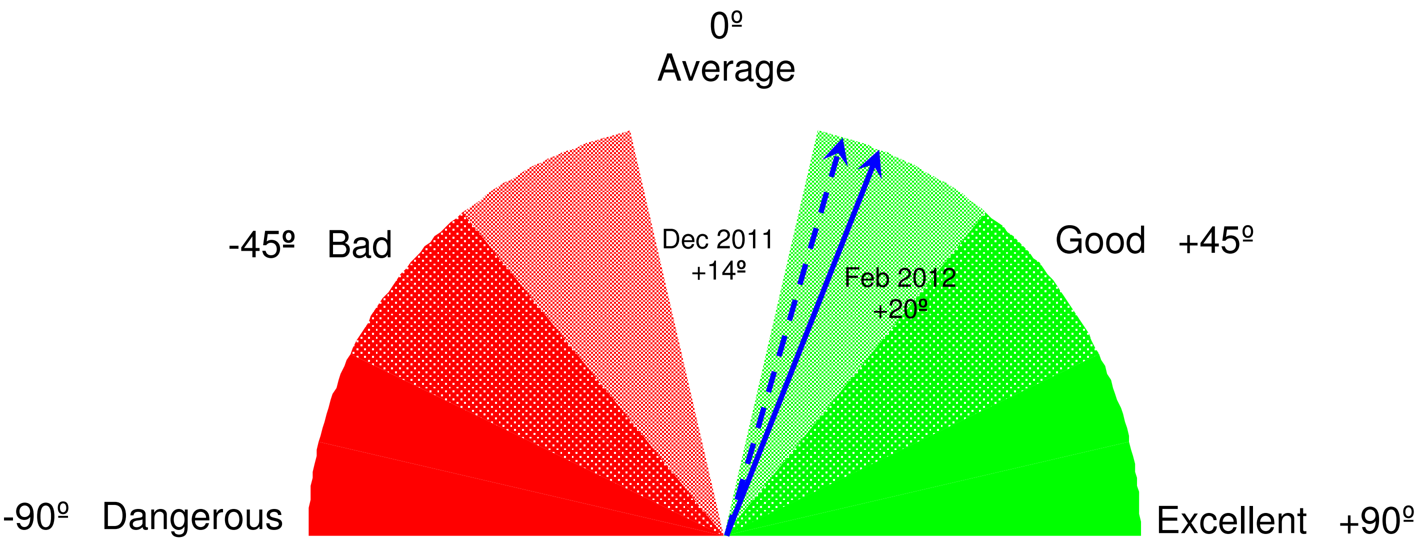
Using our extensive contacts in the business, political, and scientific circles, this time we have invited 6 prominent foreigners to contribute their materials for our 9th issue. Among them are three internationally famous economists and two politicians, and one successful businessman. All the 6 individuals accepted our request and wrote interesting pieces. We are very happy that they are among the readers who value our bulletins. The 6 articles cover diverse topics – from money supply and market sentiment in the Eurozone, through economic achievements and troubles in Hungary, Romania, and Serbia, to the views of a Greek expat about social tolerance in Bulgaria.

**Expat Compass has focused on the health of the currency board**

Our bulletin does not provide a full-fledged economic analysis. We have tried to concentrate primarily on those issues which might potentially affect the fixed exchange rate of the lev against the euro: the budget, the trade balance and the current account, the banking system, economic growth, as well as the most important economic reforms – or the lack thereof. Frankly, we will feel very happy if our conclusions are relatively boring – i.e. if we see no risks of a financial or currency crisis. This is the case at the moment. Other than the pains of no growth, no other "earthquake" is expected.

# EXPAT CURRENCY BOARD WATCH

## OUTLOOK: STABLE/POSITIVE




In the last year, the main issue of concern for the business community in Bulgaria and globally has been the debt crisis, including in Greece and in Western Europe. Bulgaria has not been directly hit by these tremors. While high economic growth cannot be expected in Bulgaria soon, 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 2011 | **+8º** | **+4º** | Improvement in many economic indicators |
| May 2011 | **+10º** | **+2º** | Smaller concerns about the budget |
| August 2011 | **+12º** | **+2º** | Small budget and trade deficits |
| December 2011 | **+14º** | **+2º** | Conservative 2012 budget, some pension measures |
| February 2012 | **+20º** | **+6º** | Troubles in the Eurozone; good 2012 budget |

*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, low |
| 5. Budget spending | +++ | +++ | One the lowest in the EU |
| 6. Government debt | +++ | +++ | Very low |
| 7. Foreign liabilities of the private sector | -- | -- | High, falling |
| 8. Fiscal reserves | - | - | Must not go lower |
| **III. Economic cycle related issues** | | | |
| 9. GDP growth | - | - | Close to zero |
| 10. Inflation | ++ | ++ | Moderate |
| 11. Unemployment | -- | -- | Average, rising |
| 12. Strength of the banking system | + | + | Average |
| **IV. External balances** | | | |
| 13. Current account deficit, trade deficit | + | + | Improving fast |
| 14. Foreign direct investment | -- | -- | Above zero |
| 15. Revenues from international tourism | ++ | ++ | Moderate, rising |
| 16. Foreign exchange reserves | ++ | ++ | High |

**Legend:** Good Bad

**How do we evaluate the current economic situation in Bulgaria?**

**We see some positives:**

- Relatively low budget deficits (although we would prefer balanced budgets or even surpluses)
- A dramatic improvement in the current account since 2008
- Low public debt
- A relatively stable banking system compared to other countries
- No immediate risks for the currency
- The government has frozen incomes (2 positives: no populist increases of salaries and pensions, and also no painful reductions of incomes)
- Continuing low-tax policies
- A non-economic issue: the number of traffic casualties has fallen significantly due to the stronger controls
- Positive but small measures in the administration and in the pension system
-

**… and many disappointments:**

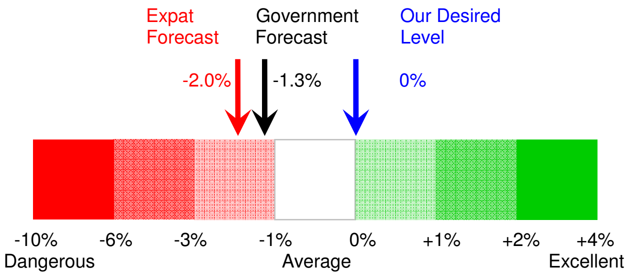
- The budget will be in a deficit every year from 2009 to 2013 (again, we support balanced budgets)
- Lower fiscal reserves
- FDI is low (please see the interview with Mr. Đelić on page 13 – FDI in Serbia is higher)
- No economic growth
- Many businesses are facing financial difficulties
- After years of improvement, Bulgaria's position in most international rankings has now deteriorated: economic freedom, competitiveness, freedom of the media, corruption
- Almost no reforms in any sector, especially health care. Missed opportunities for a deeper pension reform
- Continuing deadly silence about the Belene nuclear power plant
- Very few privatization and concession deals
- Capital markets are not a priority

**Why are we improving our Expat Currency Board Watch reading?**

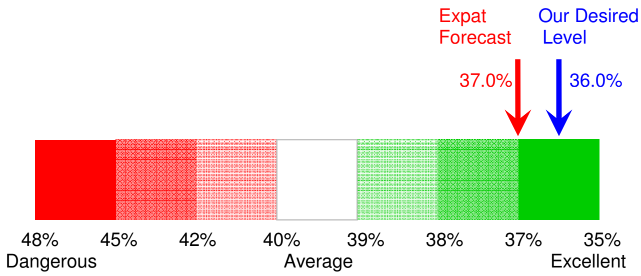
After reading the list of disappointments above, one might expect that our forecasts would be rather negative. However, this depends on the question you ask. If you ask whether there is higher probability of devaluation of the lev against the euro, our answer is NO – which is reflected in the +20˚ reading, as well as the Stable/Positive Outlook. The reason is not any special strength of the Bulgarian economy, but the weakness of the reserve currency (the euro). We see no reasons why the lev should be devalued against the currencies of the countries in South Europe – weather euro or other.

# INDICATORS, 2012

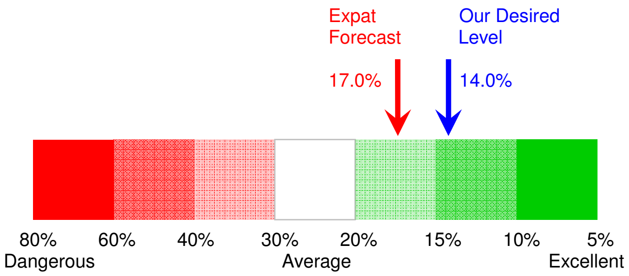
### I) Budget Surplus/Deficit, % GDP, 2012



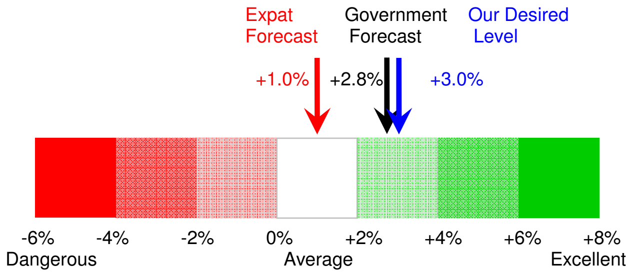

### II) Budget Spending, % GDP, 2012



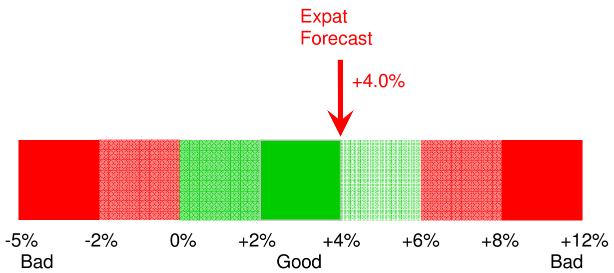

### III) Government Debt, % GDP, 2012, Year-End



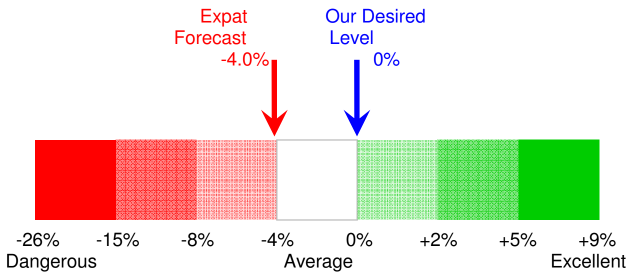

### IV) Real GDP Growth, %, 2012



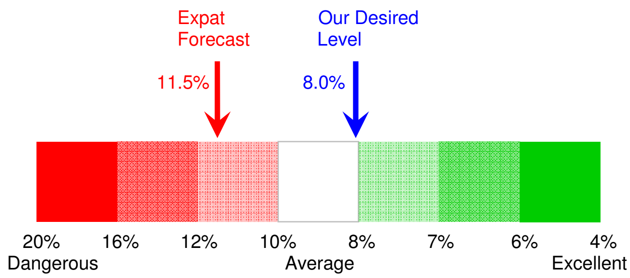

### V) Inflation, %, 2012, Year-End




### VI) Current Account Deficit, % GDP, 2012




### VII) Unemployment, %, 2012, Year-End



## INCREASING DEFAULT FEARS TO PUT PRESSURE ON ITALY AND SPAIN

JAN VON GERICH

*Jan von Gerich is Chief Analyst and Global Fixed Income Strategist for Nordea, the largest bank in Scandinavia. He has worked in the financial industry more extensively since 2004. He was an expert on government bonds already before the financial crisis hit, so he knows the market inside out. His analyses are read by some of the biggest investors in the world. Jan has been working for Nordea in Helsinki, Copenhagen and Stockholm. Before that he was briefly in New York, in the financial industry again. Jan strives to start from the big picture, as he believes that understanding the wider context is essential in current times, and proceeds to the more market-oriented views from there.*

Traditional debt investors, i.e., the ones investing in bonds primarily for safety and rather stable returns, are very sensitive to any fears that they may need to take losses on their holdings. When such fears arise, these investors can change their behaviour at an instant. As an illustration, consider what happened to the credibility of all banks, when Lehman Brothers collapsed in 2008. Until that point, bank debt had enjoyed an implicit government guarantee, but once this assumption had been violated, many investors rushed out of bank debt. It took a huge amount of further support measures to bring the confidence back.

Most investors in Euro-zone government bonds also considered their holdings virtually risk free. After all, the regulatory framework awarded them 0% risk weightings, while the European Central Bank (ECB) and Euro-zone leaders considered even suggestions that a Euro-zone country would not pay its debt back ridiculous. In fact, the problems of Ireland largely stem from the fact that to avoid losses to senior creditors of the country's banks, the Irish government offered blanked guarantees to the banks – under pressure from the ECB and its Euro-zone partners.

It should be no wonder then that when Germany's Merkel and France's Sarkozy first proposed private sector burden-sharing in Deauville in October 2010, the consequences were severe. At this point, Greece had already received its first bailout package, but the comments from Merkel and Sarkozy pretty much crushed the chances of Ireland (and later Portugal) to survive without a bailout package. Even though the Euro-zone leaders tried to clarify later that any losses for investors in Euro-zone government bonds would become possible only for debt issued after the middle of 2013, the damage was already done.

Ireland and Portugal received their bailouts, and the ECB's purchases were also there to calm the situation. However, another shock to confidence came in the summer of 2011, when talks about the private sector having to contribute to a new Greek aid package surfaced. This news threw Spain and Italy in the middle of the debt crisis, as it created the perception that Euro-zone debt was not safe any more.

It took large-scale bond purchases from the ECB to calm markets, but the debt crisis quickly struck back. This time an important catalyst was the call by the Euro-zone leaders for private creditors in Greek debt to take a 50% hit in their debt holdings, whereas the talks had previously been centered on extending maturities and lowering interest payments. Still, the leaders argued that this debt restructuring needed to be voluntary, i.e., nobody would be forced to take losses.

Another huge liquidity injection from the central bank has brought some order to the markets again, but another setback likely lies ahead. It looks increasingly clear that a voluntary deal on Greek debt restructuring will not happen, so a forced approach probably lies ahead. The Euro-zone leaders naturally argue that Greece is a special case and the private sector involvement in Greece will not be repeated with any other country. These same leaders of course argued before that all Euro-zone countries – i.e. also Greece – would honour their debts, and later that any Greek debt restructuring would have to be voluntary in nature. Backing away from previous pledges will do nothing to make the new pledges credible. A forced Greek debt restructuring would thus be another big hit to confidence and risk escalating the debt crisis once again.

The good news is that unlike the Lehman episode, investors have had time to prepare for notable losses from their holdings on Greek debt. The bad news is that backing away from previous promises would have negative effects on the confidence Italy and Spain are very much fighting for to maintain their access to bond markets. More support measures are likely to be needed – foremost from the ECB. Still, the credit risk Euro-zone decision-makers have introduced to government bonds means that several Euro-zone countries will have to pay a higher price for their borrowings for a long time.

## FROM HERO TO ZERO. AN UNORTHODOX STORY OF ECONOMIC POLICY-MAKING

PETER HEIL, PH.D.

*Peter Heil is an internationally respected expert on the European Union's development funds. Having served for 15 years in the Hungarian civil service, 13 of them in leading management positions. He has vast experience with the EU's Phare and ISPA pre-accession programmes and the the EU structural and cohesion funds. He currently works as the Director of ConsAlt, the Consulting Division of the ALTUS Group. Dr. Heil graduated and obtained a Ph.D. at the Budapest University of Economic Sciences. He also studied EU integration at the Universities of Heidelberg and Oxford.*

The attentive newspaper reader has surely not missed the recent turmoil around Hungary's economic fortunes. The country that has been considered for decades as one of the pioneers of liberal economic reforms in Central and Eastern Europe (CEE), is nowadays regarded as one of the leading contenders for the doubtful honour of becoming "the next Greece". Its fate may have an unlikely influence on the development of CEE as a whole. And, indeed, it may offer a number of important lessons for economic policy-makers across Europe.

What can explain that a relatively small country with only 10 million inhabitants and a comparatively small economy – that is not even a member of the euro area – is creating so much apprehension? Who and why should care about what happens to Hungarians? Do they really matter to anyone?

The Magyars like to think of themselves as a small nation with a proud heritage – despite the fact that not many of them would consider their history as particularly fortunate. The last war that Hungarians managed to win dates back to the 15th century. For almost half of its 1000 year old history, the Hungarian state was ruled or occupied by foreigners: Turks, Austrians, Germans, and Russians. Despite that, during most of the last two decades, Hungary was a prime example of peaceful and successful transition from oppression to freedom, from the failed communist model to modern capitalism. Indeed, it was one of the symbols of the reunification of Europe, and living evidence that the European Union had a potential for stabilising and elevating the less developed countries of the Central and Eastern European region. Paradoxically, it is exactly these last 20 years of their history that many Hungarians want to forget, rather looking for inspiration in their more distant past, however controversial – and often tragic – it may have been.

"We had it too good under Kádár" – one of the country's leading liberal dailies wrote recently. Accordingly, the inhabitants of the former "merriest barrack of communism" never warmed for any radical economic reform policies. Indeed, at every occasion they voted for the parties that promised "easy dreams", and the few attempts at any meaningful, sustainable reform of the welfare system are, at least by the majority of members of parliament, nowadays thought of as acts of violence against the people. Which is the exact opposite of what has happened in, say, Estonia or Slovakia – two countries where voters accepted to be put into the dentist's chair, and where the levels of per capita GDP are now higher than in Hungary. Subsequently, both countries managed to introduce the euro, and they are also enjoying consistently higher growth rates. Even if the social costs of transition (such as the levels of unemployment or the cutbacks of state welfare spending) were far higher, not many would argue that, overall, Hungary had made the better choices. Even in terms of foreign investment, a discipline where Hungary has had a leading status for many years in Central and Eastern Europe, it is by now losing ground.

Indeed, the relationship to the outside world is a particularly touchy point nowadays. Prime Minister Viktor Orbán is blaming the world economy for the recent bad performance of the Forint, as well as falling growth levels, just as Kádár had blamed "the infiltration of outside factors" back in the eighties. At the same time he still insists that his "unorthodox" economic policies – the introduction of a single-tier tax system, painful "crisis taxes" on the better performing economic sectors, such as banks and telecom operators, the forced *de facto* nationalisation of private pension funds, and the also forced reconversion of foreign currency denominated mortgages – were the right way out of the recent crisis, and that Hungary would be pointing the way for others in the region, too. He boasts that "for the first time since joining the EU" the state budget was sporting a deficit below 3% of GDP, and that state debt was being consistently reduced – unlike any other country in the European Union.

Unfortunately, the EU, the IMF, foreign investors in general, or the National Bank of Hungary (MNB), for that matter, do not seem to agree.

Brussels was particularly angered by a recent law that would enable the government to depose the head of the National Bank through a merger of MNB with the state Financial Services Supervisory Authority – in which case the new body would "obviously" require a new president. The enlargement of MNB's Monetary Council through new members nominated by the governing majority is a further "hair in the soup". In any case, the latter move already seems to show an effect.

It is the likely explanation behind MNB's recent decision not to raise interest rates further – a major surprise for most analysts. The head of the National Bank himself – fearing a rise in inflation – seemed "not amused" either.

The EU is also investigating the regularity of the recent banking and telecom taxes, as well as the forced reconversion of EUR and CHF-based mortgages into Forints, which has caused severe losses for the country's foreign-owned banks. As it is widely feared, the destabilisation of the Hungarian banking sector could have serious knock-on effects on banks in Austria and other EU countries. This is clearly the last thing that the Union, fighting with the consequences of the Greek crisis, nowadays needs. As an immediate result, commercial banks are already reducing their lending activity in Hungary – again, the worst possible news for growth.

As to the budget deficit, the EU Commission as well as the Council of Economic and Finance Ministers (ECFIN) have officially concluded that Hungary was failing to comply with the Maastricht deficit criterion, as the low deficit figure Orbán is so proud about was a product of one-off effects, while the structural deficit was much worse than in 2010, when the current right-wing populist government took over. A possible consequence of this decision could be the suspension of 2 billion euro of financial aid from the EU's Cohesion Fund to Hungary, threatening much-needed investments into the transport, environmental and energy sectors.

The overall state debt – said to be declining according to the Prime Minister – reached an all-time-high of 82.9% of GDP according to the National Bank's statistics. Partly an effect of the recent fall of the Forint (in January, the Hungarian currency plummeted to ca. 84% of its value of 2010), but also a sign that not all of Orbán's unorthodox policies seem to be working that well.

In parallel to the EU, the International Monetary Fund is also arming itself for a battle with the Hungarian government. While the previous socialist-led administration successfully sought IMF assistance in 2008 to avert the risk of state default – due to the government's inability to finance the national debt from the free market – Orbán proudly kicked out the IMF from Hungary in 2010, unwilling to comply with their economic policy demands. Ever since he has proclaimed that Hungary did not need an IMF loan. However, following a number of unsuccessful government bond auctions, international observers were already counting the time until Hungary's money was running out. Accordingly, in late 2011, faced with continued currency fluctuations, and increasing international discontent, the government restarted talks with the Monetary Fund.

Again, unwilling to compromise, preliminary negotiations spectacularly failed in December. When rumours started that all the theatre about the National Bank's leadership was essentially an indication of the prime minister's immediate plans to get his hands on the reserves of MNB in order to continue financing his unorthodox Orbánomics, the Forint fell into the abyss, and bond yields rose to record heights.

In recent weeks, Orbán seems to be backtracking. According to recent polls, 84% of voters think that "things in Hungary are going into a wrong direction", and popular support for the governing coalition is, for the first time in many years, lower than that for the opposition. The EU Commission is playing hard, and the IMF is not even ready to open official talks until the government undertakes concrete structural adjustment steps. Simultaneously, thousands of doctors threatened to quit their jobs, and planned spending cuts for university education led to outrage well beyond academic circles. Pressure from the EU's conservative parties also seems to increase. The house is burning on all corners.

> *Small and open economies, especially those in a precarious macro-economic situation are not likely to succeed with "economic freedom fights".*

Whose fault is it then? Can Orbán blame the Greeks? Or previous governments? Predictably, a bit of both. The main lesson, however, is that small and open economies, especially those in a precarious macro-economic situation are not likely to succeed with "economic freedom fights". The Prime Minister's declared "right hand", economics and finance minister György Matolcsy, is an unlikely candidate for the Nobel prize for economics any time soon. When he proudly proclaimed that he was implementing "*economic policies from textbooks that are not yet written*", his targeted readership did not seem to be very keen. Ultimately, as perhaps as the first minister of finance ever, he even had to be withdrawn from the Hungarian delegation for the IMF talks. While Orbánomics was, for a remarkably long time, pretty much ignored by the outside world, by the end of 2011, markets, and the EU, and the IMF, had obviously lost their patience with Hungary. So have most influential economists at home.

Nevertheless, whether or not Orbán will ultimately give in, is still in doubt. He still is a man on a mission – even if on an increasingly dangerous one.

# GUEST COMMENT

## THE WHIGS VERSUS THE SCHOOLBOYS

PROF. STEVE HANKE

*Steve Hanke is an American economist specializing in international economics, particularly monetary policy, named to be the father of the currency boards. He is a Professor of Applied Economics at The Johns Hopkins University in Baltimore and a Senior Fellow at the Cato Institute in Washington, D.C.*

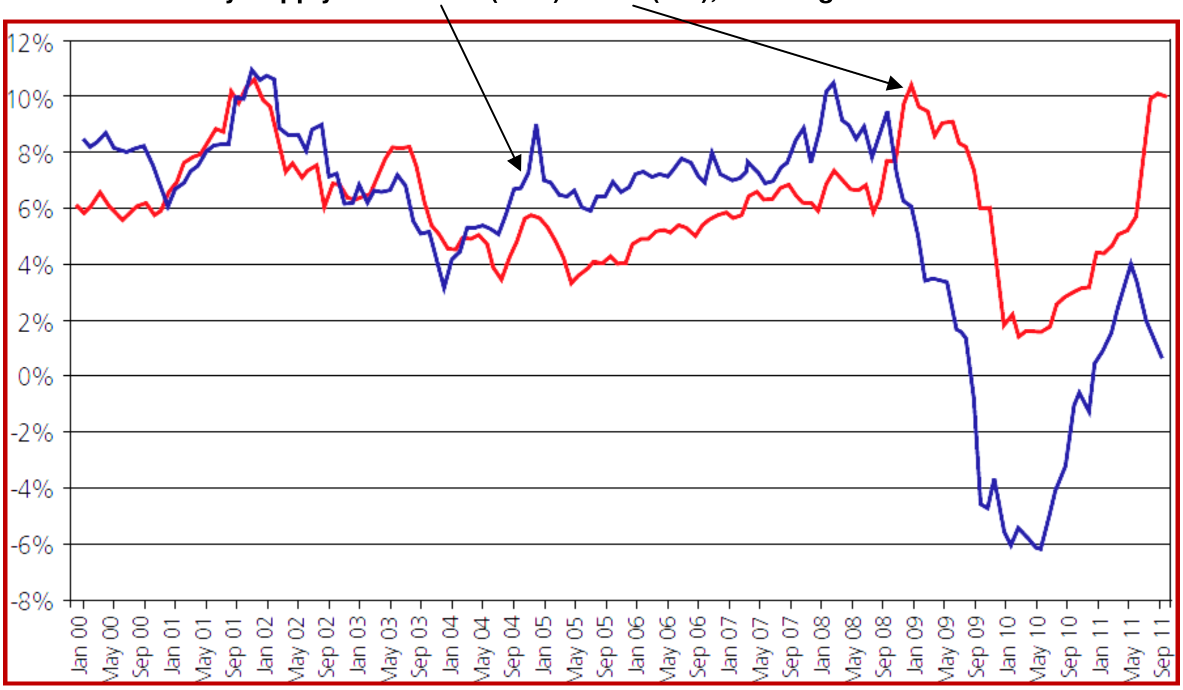
The Whig interpretation of history is captured by the phrase "onward and upward." The course of recent financial and economic events in the United States and Europe throws that notion into doubt. With each passing day, something new – and negative – pops up. This pattern fits the schoolboys' interpretation: "it's just one damn thing after another."

Just take a look at the money supply growth data for the U.S. The broadest measure of money published by the Board of Governors of the Federal Reserve System in Washington, D.C. is M2. This measure is widely used by analysts. It has been rapidly accelerating. At present, M2 is growing at an annual rate of 10%, lending credence to the onward and upward phrase (see the accompanying chart).

But, the M2 money supply figure has short-comings. It represents a simple sum of the components that make up that metric. In short, each component carries the same weight. A much superior measure of the money supply is the so-called Divisia metric. With this measure, each component of the money supply is assigned a weight, depending on its usefulness as a medium of exchange. So, currency, traveler's checks, and demand deposits receive a relatively "high" weight; whereas, institutional money market funds receive a relatively "low" weight.

In addition to weighing the components of the money supply to produce a Divisia metric, it is important to include the broadest range of components possible. The broader the measure of the money supply, the better. Prof. Bill Barnett has done just that with a broad money measure: Divisia M4. Unlike M2, the broader Divisia M4 has been falling rapidly and is now flat.

**Chart 1. US Money Supply: Divisia M4 (blue) vs M2 (red), annual growth rates**

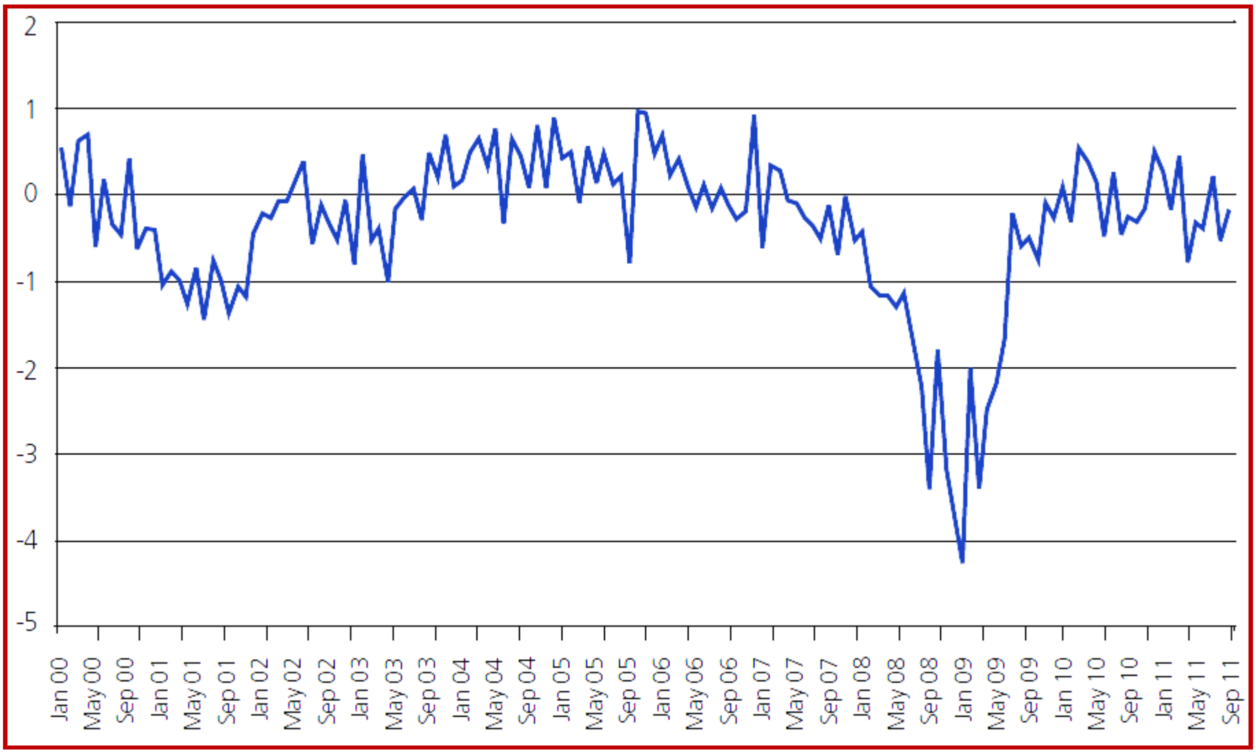



*Source: Federal Reserve Bank of St. Louis and Prof. William A. Barnett*

This contraction of the money supply spells trouble, leaving us with a schoolboys' interpretation. The U.S. economy is most likely headed for a recession by the middle of 2012.

We can be rather confident about this gloomy conclusion because of the following combination: no money supply (Divisia M4) growth and a very "weak" economy. One reliable measure that tells us what is happening today in the U.S. economy is the Federal Reserve Bank of Chicago's National Activity Index. The index is a weighted average of eighty five monthly indicators. A value of zero signals that the economy is growing in line with long-term trends. Positive and negative readings signal above and below trend growth rates, respectively. As the accompanying chart shows, the U.S. economy is struggling – unable to even reach its long-run trend rate of growth.

**Chart 2. Chicago Fed National Activity Index, Jan 2000 – Sept 2011**




*Source: Federal Reserve Bank of Chicago*

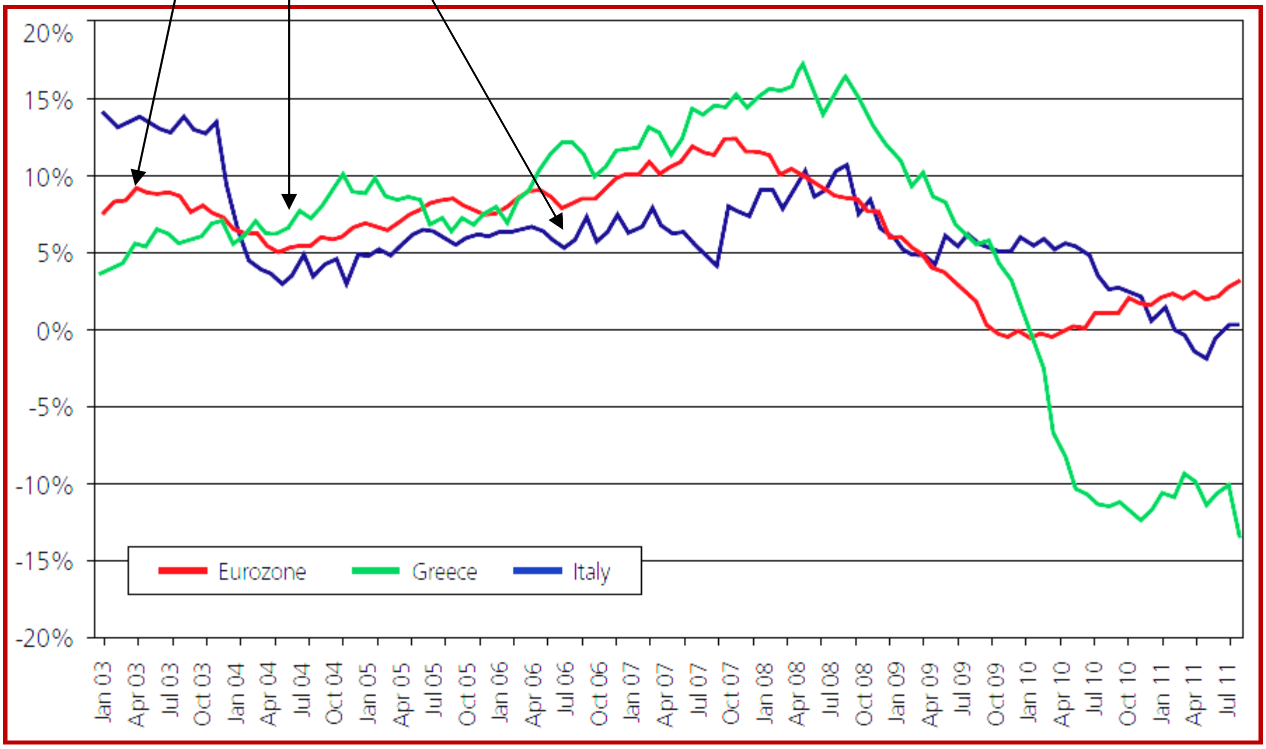
When we turn to Europe, the schoolboys are riding high. Events in Greece aren't a surprise. Ever since 1832, when that Balkan nation was recognized as a modern state, it has been a serial deadbeat. During most of the 19th century, Greece was under varying degrees of foreign creditor control. First, the country was under French administration. Then, after its defeat at the hands of Turkey in 1897, an International Financial Commission of Control, comprised of representatives from the major powers, took over Greece's fiscal affairs.

After concocting a series of economic statistics that never added up, Greece was allowed to join the European Monetary Union on 1 January 2001, a full two years after the eleven original participating members. Now that Greece is imploding and unable to deliver on promised reforms and service its debts, Greece has landed where it's been for much of its modern history.

As a task force of Eurocrats arrived from Brussels to dispense "expert" advice, a Greek newspaper printed the following headline: "The Prison Guards Have Arrived." If space would have permitted, the headline could have included the following additional words: "They Have Come Often, But The Prisoners Always Escaped."

To appreciate just how desperate things are in Greece, we only have to look at the accompanying chart of broad money supply (M3) growth rates for the Eurozone. In September 2011, the M3 metric was contracting at an annual rate of 13.6% in Greece. (Note: the M3 data for the Eurozone are a simple sum of the M3 components, not a Divisia metric, because the Eurozone does not report Divisia data). Given that the broad money measure (M3) in Greece has been contracting for 20 months, Greece's new prime minister, Loukas Papadimos, will have trouble finding the "light switch".

**Chart 3. Eurozone, Greece and Italy Broad Money (M3), annual growth rates**




*Source: European Central Bank, Bank of Greece, Banca d'Italia and Author's calculations*

In Italy, where the markets finally did what the political system was unable to do – dump Silvio Berlusconi – the new prime minister, Mario Monti, will also find it difficult to stabilize and then turn the economy around. The annual growth rate of broad money (M3) in Italy has been declining and now is registering "no growth."

Prime Minister Monti will be fighting a huge headwind. Italian banks are scrambling to raise more capital, as well as their capital asset ratios. With banks' share prices trading below book value, this means that banks will be forced to reduce their risk assets (loans). Indeed, UniCredit, Italy's largest bank, has announced that it will shed 11% of its risk-weighted assets, the bulk coming from its corporate and investment banking operations.

While the Italian bank recapitalizations might be just what the bank regulators ordered, they will deliver a blow to the already non-existent growth of Italian broad money (M3), pushing that metric into negative territory and perhaps delivering a crippling punch to the economy.

The bank recapitalization exercises and balance sheet contractions visiting Europe and most other parts of the globe promise to have wide-ranging negative economic consequences. It really is one damn thing after another.

*For those who want to delve into the intricacies of Divisia indexes, the best place to start is Prof. Barnett's new book – Getting It Wrong: How Faulty Monetary Statistics Undermine the Fed, the Financial System, and the Economy.*

*The article was published in GlobeAsia, December 2011*

## FINANCING THE ECONOMY – THE MAIN PROBLEM OF THE ROMANIAN ECONOMY

ADRIAN NĂSTASE

*Adrian Năstase is a former Prime Minister of Romania (2001-2004). He graduated from the University of Bucharest, receiving degrees from both the Department of Law and the Department of Sociology. From 1990 till 1992, Mr. Năstase served as Minister of Foreign Affairs. In 1992, he was re-elected to the Chamber of Deputies as a member of the Democratic National Salvation Front (FDSN). Between 1993 and 1997, he was also executive president of the Party of Social Democracy in Romania (PDSR, formerly the FDSN). After the victory of the PDSR in 2000, Mr. Năstase was elected president of the party (soon renamed to Social Democratic Party). After his mandate as a Prime Minister, between 2004-2006, he was President of the Chamber of Deputies.*

The Romanian economy is facing a difficult time in 2012. The economic crisis inflicted a heavy toll in 2009 and 2010 (a cumulative drop in GDP above 8%; a brutal fiscal adjustment program – adjustment of almost 4 percentage points of structural deficit between 2008 and 2010), and now the economy is facing a common European dilemma – the choice between fostering growth-friendly economic policies and the necessity of a fiscal adjustment which is *per se* recessionary. At the core of the economic problem of choosing between Scylla and Charybdis is securing the financing of the economy and in particular the external financing.

The underpinnings of the financing needs of the economy are as follows:

- The Romanian economy is forecasted to post current account deficits of around 4% of GDP (around EUR 5 bln) in the following years, which are much lower than in the past (the biggest current account deficit was recorded in 2007 – 13.4% of GDP, equivalent to almost EUR 17 bln), but still render finding financing important.
- The FDI is lately on a downward path determined by the heightened risk aversion around the word and the less appealing internal economic performances. In 2010, the FDI level was EUR 2.2 bln, down from almost EUR 10 bln in 2008. The January – November figures for 2011 compared with the corresponding 2010 data indicate a 36% drop. As the economic crisis unfolds, especially the European sovereign crisis – with a direct impact on the whole EU, the coverage of the current account deficit by FDI is poised to decrease in the following years (in the past the rate decreased from a level of 100.5% in 2004 towards less than 50% of the current account deficit in 2010 and around 40% in the first 11 months of 2011). This slowing trend in FDI is determined by both the lower mother-daughter loans and the lower capital participations in local companies.
- The banking sector, almost 90% foreign-owned, is reducing its financing to the Romanian economy. On the one hand, the behavior is determined by the compliance with European regulations which will require a higher-quality capital adequacy ratio (of 9%) in risky assets from mid-2012. On the other hand, the Greek banks have reduced their exposure (share of bank financing) to the Romanian economy (from around 25% to around 20% of the external funds), and the National Bank of Austria has required that the flow of new credit be limited to 110% of the flow of new domestic deposits in the banks that are under its jurisdiction. Overall, in the first 9 months of the previous year, the European banks' exposures to Romania have decreased by USD 11 bln according to data published by the BIS.
- The latest efforts of the Ministry of Public Finance to attract foreign investors for its bond issuance programme (e.g. lately in the USA), have not been successful, as its timing has not been the most favourable. Recent attempts have been more fruitful (issuance of USD 1.5 bln at a relatively high interest rate of 6.85%), as the risk aversion is more subdued by positive dynamics in the global economy, and risk factors that influenced the regional risk perception slowly fade away (e.g. the recent events in Hungary). These funds could temporarily alleviate some of the financing demands for the public sector.
- A different pattern of economic growth in the following years will require an inward turn, toward a sustainable development strategy based on domestic savings and an accelerated pace of EU funds absorption, as the actual EU funds absorption rate is at a very low level (around 5%), and the European budgetary exercise 2007-2013 is almost at its end.

  A change in the economic policies is also a necessity. The most widely accepted measures could envisage new industrial and sectorial policies combined with fiscal deductions, a streamlining of the legislation in order to reduce the red tape that could also reduce corruption. These changes should obey the current obligations that Romania assumed under the IMF-EC-WB arrangement (valid until March next year).

- The precautionary agreement with the IMF covers the eventual shortfall in external financing giving Romania access to financial liquidity and at the same time is an important instrument in regaining credibility and access to external private markets. Moreover, this accord should prevent any spillovers of the European crisis.
- The economic adjustment programme with the IMF has been successful, reducing the external financing needs, but the measures have been unevenly distributed. Among these mesures we could mention: a 25% cut in public sector wages, mass outlays in the budgetary sector, raising the VAT rate by 5 percentage points, hiking the medical contribution rate for pensioners by 5.5%, cutting various social programmes – such as the heating subsidies – which increased the heating prices by more than 25%. The tax breaks applied in the boom years, materialized mainly in a flat tax of 16%, which benefited the biggest income earners, have been reversed, in bust years, by broad based austerity measures mainly aimed at medium and low income earners (e.g. VAT is a regressive tax, and wage cuts in the public sector affected the medium/low income deciles).

So at the macro level, on average, the equilibrium is almost restored, but at the micro level, the inequities of the measures taken have generated discontent and restlessness – so the economic disequilibrium was translated to the social sphere due to the ideological blindness of the current right-wing government.

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The problems presented above will be addressed, and the solutions sketched will be most likely implemented as a new coalition government will probably be in power after the upcoming elections. The resolute and timely introduction of the necessary changes of the economic policies should solve the difficult challenges posed by the current crisis, fostering sustainable growth and consolidating the public finances. These accomplishments should reinitiate a virtuous economic cycle that could heal the social rift presently unfolding.

## BOŽIDAR ĐELIĆ: PEOPLE WILL SUPPORT DIFFICULT REFORMS, IF THEY SEE COURAGE AND TRUTH IN THE DECISION MAKERS

*Božidar Đelić is a Serbian economist and politician. He was Minister of Finance and Economy in 2001-2004, and Deputy Prime Minister for European Integration from 2007 till 2011, as well as Minister for Science and Technological Development from 2008 till 2011. Before going back to Serbia, Božidar Đelić was a Partner in McKinsey (1993-2000) in the Paris and Silicon Valley offices of the company. Mr. Đelić holds three Master's degrees – in Business Administration from Harvard Business School, in Public Administration from J.F. Kennedy School of Government, and in Economics from Ecole des Hautes Etudes en Sciences Sociales in Paris. For more information: www.djelic.net*

**How do you evaluate the economic situation in Serbia at the moment?**

The situation is challenging, as everywhere else. There are good things, in particular foreign direct investments (FDI) are going strong – over three billion dollars last year. Serbia is increasingly the destination of choice for export minded, cost conscious manufacturers. Simply put, from Michelin to Siemens, from Jura to Panasonic, from Swarovski to Bosch, they all appreciate the top productivity they consistently reach in Serbia. The Fiat factory in Kragujevac is in line to produce more than 200,000 cars of the new model to be unveiled at the Geneva show this Spring. On the other hand, unemployment, at 23%, has grown significantly over the last four years and remains stubbornly high. The figure is much higher in the South of the country and for the young.

**Has the current crisis hurt your country more than other countries?**

Comparisons are not so easy because countries were at different levels of development when the crisis hit. A 10% drop in real wages does not mean the same thing to people if you are in a 5,000 euro or a 20,000 euro per capita society. One can say that Serbia, overall, was relatively better at maintaining the macroeconomic stability, the soundness of its financial system, and at attracting FDI, and relatively worse in the increase of unemployment and inflation.

**Is Serbia suffering from the proximity to Greece?**

More in the minds of investors than in reality, but impressions matter. Our entire region is again perceived as risky. The Austrian central bank governor recently asked their banks to reduce the exposure everywhere in our region, not making differences between countries. Greece successfully invested over two billion euro in Serbia over the last decade. Here too, things are starting to be more balanced. Last month our Telekom bought back OTE's 20% stake in it for 380 million euro. A Serbian company might well purchase Hellenic Sugar. We hope for a successful recovery of Greece.

**What are the most serious risks for your economy? Please comment specifically on the budget deficit, the current account, and the health of the banking system.**

The biggest threat would be some continuing turmoil in our main market, the EU. We are above all linked through investments and trade with the regions of Southern Germany, Northern Italy, Austria, and Slovenia. So far, the budget deficit is kept below 4.5% of GDP, the current account deficit has gone from 21% to 7% of GDP under a three-year-old, quite successful programme with the IMF. We were actually upgraded by S&P last March, from BB- to BB, not such a bad rating these days. We also placed a first ever one billion dollar Eurobond last September with a 7.25% coupon. The health of the banking system, with a 21% capital adequacy ratio, has helped. But if the crisis continues in Europe and the world, the current liquidity and NPL (non-performing loans) problems will escalate.

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**Do you think a currency board regime might be appropriate for Serbia and why?**

I know that most people in Bulgaria think that the currency board has served it well and, indeed, it would be a bad idea to abandon it now. But the crisis has shown that those who use responsibly the currency flexibility at their disposal have fared better. Look at Sweden, even the UK. There is a currency debate, not to call it war, between the US, China, Brazil and the Eurozone for a reason. The smooth depreciation of the dinar over the last three years has helped us boost significantly our exports, by more than 25% last year.

**Do you see any chance that a fixed exchange rate regime might be introduced in Serbia in the future? If yes, to which currency?**

No, not in the forseeable future. But we are de facto in a dual currency regime, with the euro playing a leading role in transactions for durables or real estate. Unfortunately, some 70% of the loans issued are still linked to the euro. If anything, we need a continued dinarization policy in the years to come.

**How do you feel after a decade in politics? With hindsight, would you have done anything differently?**

When I quit my comfortable French life as Partner at McKinsey in 2001 to become the first democratically elected finance minister of Serbia after WWII, I knew that there will be many problems. But the achievements of my eight years in four cabinets are here, too. From the fiscal reform to the visa liberalisation and the signing of a SAA (Stabilization and Accession Agreement) with the EU, from investments in scientific infrastructure to the support of the Roma minority. There is no point in having regrets. If I have learned one lesson, it is that people are willing to support significant change, even if it is difficult, if they see courage, truth, and passion in the people who are conducting the reforms. Too often, people unnecessarily hesitate, calculate, delay.

**Which of the many posts in the government was your favourite?**

It migh susprise you, but my favourite time was as science and technological development minister. I wanted that job because, with our ageing society, the brain drain of the best and brightest is in fact our biggest problem. We doubled the budgets, launched a portfolio of investments worth 450 million euro, created the first public venture capital fund. By 2009, Serbia was recognized as the world's "rising science star" by Thomson Reuters as measured by the growth of the citation and impact factors of our scientists. A very strong nano and materials center will be finished by 2013 in Belgrade. We are creating a stem cells center in Kragujevac. Much remains to be done but this January, symbolically, we also rejoined CERN.

**What are your plans for the future?**

We have national, regional and local elections in May 2012. I might be back in government. If not, I will go back to the private sector – it would not be the first time.

**When do you think Serbia will join the EU?**

I would not like to give an answer precisely to this question anymore, because of the turmoil within the EU. Joining the EU still makes sense, both politically and economically, but it is not as good a prospect as it used to be. Serbia is busy, like many others, diversifying its economic ties. A bridge on the Danube and a thermal power plant are being built with the Chinese. We do more and more with Turkey, Japan, Russia, Azerbaijan. Small nations should seek opportunities opened by this seemingly unstoppable globalization.

## BULGARIA'S SLUMBER

ANGELOS PARASCHAKIS

*Angelos Paraschakis is a New York University graduate. He has been working in adverting since 1994. Angelos started his career in JWT Athens and became Business Development Director of the Communications Group of the advertising agency DDB Athens in 1999. From 2000 till 2001, he was CEO of DDB Bucharest, and since 2002 he has been CEO of DDB Sofia. He is also acting as Vice President of DDB South Eastern Europe. Since 2009, he has been a member of the Board of Directors of the Hellenic Business Council in Bulgaria and as of 2011 he has been elected Secretary General of the Council. Angelos has been living in Bulgaria for the last 11 years.*

There is this show on the Discovery Channel called "World's Toughest Jobs" where the host travels around the globe meeting dedicated workers who put themselves in harm's way on a daily basis. It is a typical high-budget, high-speed show with lots and lots of close-ups on impossible tasks, performed by brave men and women. Watching the show the other day, I couldn't help but think who would never appear on the show. The answer is closer and simpler then I initially thought. It is, indeed, in front of our very eyes – the people less likely to feature on the Discovery Channel's "World's Toughest Jobs" are Bulgarian politicians.

Let me go a step further – allow me to claim that if ever there was a show called "World's Safest Workplaces", Bulgarian politicians will be among the first ones shown. See, the job of a politician is to be responsible for his or her actions, and to serve the people's interest for the fear of being voted out or, worse, of provoking street action against his or her decisions. I have lived nearly a third of my life in Bulgaria, and I have witnessed only a handful of street protests. I have lived almost half of my life in Greece, and I have seen way too many street protests. The truth, in life in general, as well as in this case, should be somewhere in the middle.

I will be honest – when I started living here, it felt weird that Bulgarians do not rise up for anything and everything. Then it became weird they do not rise at all. Maybe they were used to being crushed by someone else's will, or just thought it plain useless, but Bulgarians, by and large avoid making their voices heard. Sure, there are anonymous keyboard-warriors in internet forums, but policymakers rarely have their ears full of disgruntled average people – a proof that Bulgarian politicians enjoy an easy pass.

There is a certain threshold Bulgarians employ when it comes to crisis talk. From Smolyan through Satovcha to Svilengrad, Bulgarians are used of having it rough. They have, in a way, surrendered. They are detached from the process of making this country a better place for both investment and living. They could not care less who is in the driver's seat – in the words of Ivan Krastev: 'people vote for entertainers, not fixers'.

But all is not bad. When people constantly moan (and protest), often only taking their own problems into account, a politician has to sacrifice his or her time in order to address individual issues, rather than concentrate on policymaking. In my opinion, the Bulgarians' reluctance to rise up is not a curse, it is a blessing in disguise – it provides Bulgaria's men and women the power of a safeway towards measures other politicians are quite terrified of.

Bulgarians simply believe a politician's job is impossible, and the key word is, indeed, 'impossible'. As one of the brightest intellectuals of our times, the conductor Daniel Barenboim writes: 'the impossible – if there is some sense behind it – has not only a feeling of adventure, but a feeling of activity which is found highly attractive. It has the added advantage that failure is not only tolerated but expected.' So, while Bulgarian politicians face the impossible task of steering Bulgaria in this rather harsh climate, their actions are susceptible to quite some tolerance. The only remaining ingredient is "sense", and that is one tough gig for anyone in power right now. 'Sense', everywhere in the world, and even more so in Bulgaria, should bring tough decisions to the ground – in other words – it should make lives even harder. But if ever there was a chance for "Sense" to shine, grow and succeed, it will be here, helped by this weird, rare, inexplicable slumber of Bulgaria's population.

There is a simple formula to success in business: 'under-promise, and over-achieve'. Bulgarian politicians have under-promised in the sense that no one expects them to deliver. Here is to them over-achieving and making use of the unique situation they find themselves in.

H.B.C.B Hellenic Business Council in Bulgaria

*The Hellenic Business Council in Bulgaria was formed for the purpose of promoting and strengthening the economic and cultural ties between Bulgaria and Greece. The main purpose of the Council is to provoke the mutual dialogue between key government and business figures in a way that encourages progressive economic policies in the two countries. This is a private, non-government, non-profit organization founded in 2005, which offers its own network of contacts, mutual assistance and information exchange. Today HBCB represents over 200 members/companies.*

# INVESTMENT MANAGEMENT IN A VOLATILE INTERNATIONAL ENVIRONMENT – A BRIEF CASE STUDY

NICOLA YANKOV

*Nicola Yankov is Managing Partner and Chairman of the Board of Expat Capital. Between 2003 and 2005, he was Deputy Minister of Transport and Communications. Concurrently he was Chairman of the Board of Directors of the National Port Authority. Prior to that Mr. Yankov served as Deputy Minister of Economy (2001-2003). He has held a number of senior private sector management positions, such as Member of the Supervisory Board of Lukoil Neftochim AD, Chief Executive Officer at Naftex Petrol AD, Finance Director at Solvay Sodi AD, etc. He currently sits on the Board of Hild Asset – the biggest life annuity business in Central and Eastern Europe and on the Management Board of Eurohold Bulgaria – a large publicly listed business conglomerate, focused on insurance, leasing and auto sales. Mr. Yankov has a BS degree in Consumer Economics from Cornell University, US.*

Today's international business news is rife with staggering announcements and speculations that would have been unthinkable only a few years ago – talk of sovereign default in Eurozone countries, massive reduction in the equity capital of major international financial institutions, bankruptcies of household names synonymous until very recently with prudent corporate governance and blue-chip market status. The dynamics of the situation and the generally acknowledged failure to predict the developments create unprecedented uncertainty in the marketplace. This uncertainty naturally leads to decreased investment activity and greater return expectations in certain classes of assets, while other classes, perceived as "safe havens", experience significant price appreciation and drop in yields. Such price appreciations (seen in precious metals and certain currencies such as the Swiss franc) are often expected, but never guaranteed though.

This general uncertainty leads to dramatically changed risk perceptions for many securities. Sometimes, the risk perceptions have deviated from the fundamentals in ways that create speculative opportunities. This is more evident in the fixed income securities segment, where price volatility is traditionally much lower than in the equities segment.

Professional asset managers are able to spot the discrepancies between the changes in risk fundamentals and risk perceptions, and are consequently well-positioned to take advantage of the situations on behalf of their clients on a case-by-case basis. At Expat, we have identified several such cases in the past year, which have resulted in substantial above-average returns for many of our clients who acted on our advice and invested.

**Chart 4. Gold, Silver and Platinum Price Movements, 01.02.2010 Levels Used as Base**

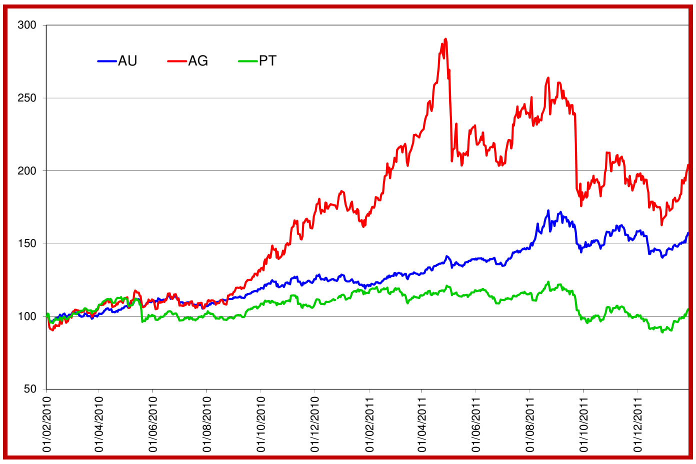



**Chart 5. Non-Eurozone Currency Movements against the Euro, 01.02.2010 Levels Used as Base**

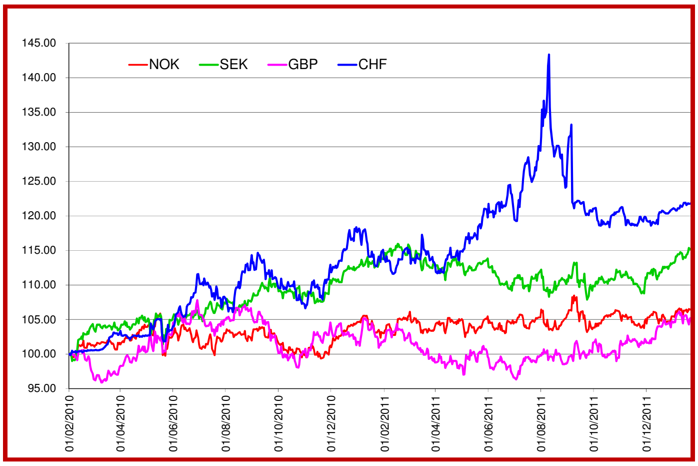


**Chart 6.** **FTSE 100, CAC-40, S&P 100 and DAX Performance Index, Feb 2011 – Feb 2012**


## Case-in-point 1: The 5-year corporate Bond of Eurobank EFG Bulgaria

Sometime around the middle of 2011, the Greek sovereign risk increased exponentially over a very short period of time, with yields topping 25%. The Greek sovereign rating plummeted to all-time lows, and institutional investors such as pension funds and other strictly regulated entities either decided or were forced to dump Greek assets en masse. This self-fueled sell frenzy created a maelstrom which quickly started sucking in all kinds of assets, in some cases completely detached from Greek sovereign risk. Greek bank bonds were affected heavily because of the notion that the Greek banking system held a substantial portion of the Greek sovereign debt on its books. Subsidiaries of Greek banks in other countries (such as Bulgaria) also got hit because they were presumed to either hold Greek risk on their balance sheets, or were seen as utterly dependent on their Greek parent companies for liquidity. Pension funds all over Europe started selling Greek bank bonds and the bonds of any banks that had anything remotely Greek in their name along with them, regardless of the domicile and the fundamental risks involved. Few portfolio managers cared to go into the financial details of each bank whose bonds they were dumping as fast as they could. Of all Greek-owned banks operating in Bulgaria, Eurobank EFG Bulgaria was the only one with an outstanding bond issue at the time. And it got hit. The yield-to-maturity (YTM) on its 5-year BGN-denominated bond maturing on March 21st 2012 reached 17-25% (annualized) as the price dropped to levels around 85-90% of the nominal value. At the same time, an annual deposit in BGN in the same bank carried an interest rate of 6%. As far as we were able to find out, the bank had no Greek sovereign debt or loans to its parent on its books, was not depending on its parent company for liquidity, was profitable and had over BGN 6 billion in assets, financed primarily from its local retail deposit base. The total outstanding amount of its bond, maturing in less than nine months, was BGN 40 million, which compared with over BGN 600 million in cash the bank had. The opportunity was there. The markets had miscalculated the risk of that security. We managed to purchase about BGN 4 million in such bonds over the course of several weeks, starting at annual yields to maturity close to 17% and gradually dropping to a little over 10% as the price steadily appreciated, at which point we stopped buying. Many of our clients withdrew term deposits from other banks to get a piece of the action. Some of them, who were among the first to invest at the lowest prices, sold the bonds in the market a couple of months later, making a quick 10% return on their investment.

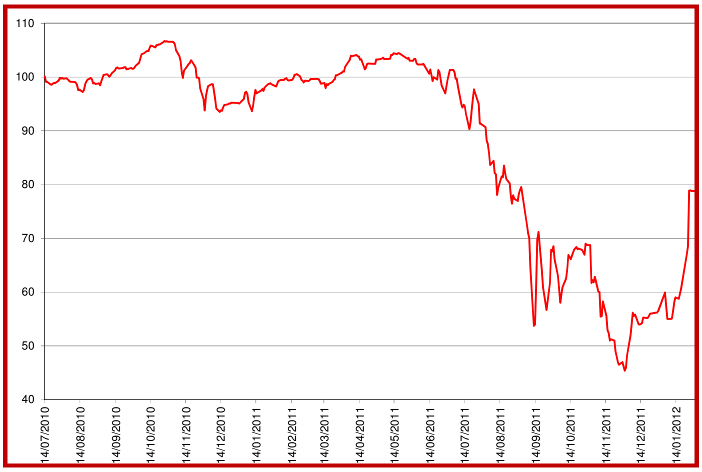
## Case-in-point 2: The Corporate Perpetuity Bond of UniCredit Italia

After the September meltdown in the stock markets and the mounting uncertainty over the Greek crisis, Italy became the centre of attention for most people in the investment community. Speculations about a pending sovereign default in Italy put the markets on the edge, and the yield on the 10-year Italian sovereign bonds jumped over the 7% benchmark. The sheer size of the problem with the Italian debt excluded a Greek-style solution, and many analysts announced gloomy projections about the fate of major Italian banks holding substantial amounts of Italian sovereign debt on their books, the pan-European banking giant UniCredit among them. Its perpetuity bond carrying a 9.375% fixed annual interest rate dropped from price levels above 100% to a range between 60 and 69%. The current yield jumped to the mind-boggling 15-17%. Similar developments were happening with the bonds of major French banks such as Societe Generale. We started taking note. Both UniCredit and Societe Generale were, and still are, classified as “systemic” institutions for the international banking system, the former being number 9 and the latter number 8 in the European Union by asset size, respectively. This meant that the “too-big-to-fail” rule would apply to them if they ever needed bailout packages from the ECB, regardless of any developments with the Italian or French sovereign debts.

The shares of the same banks dropped sharply in trading as well, but while shareholder value could be destroyed completely in a potential bail-out situation, the rights of the creditors – depositors and bondholders among them – would not be affected without going through a bankruptcy procedure, which a bailout is meant to avoid in the first place.

We issued a “buy” recommendation to our clients. In the course of the next few weeks the “Italian crisis” worsened, and the prices of the UniCredit bonds dropped to an all-time low around 55%. At the same time the bank initiated a EUR 2.5 billion capital increase, which was successfully completed on 21 December 2011, and got an additional EUR 7.5 billion from shareholders in January 2012.

**Chart 7. UniCredit Perpetuity Bond Price (% of Nominal Value)**




We acquired UniCredit bonds at prices between 55% and 65% of the nominal value. With favourable political developments in Italy, the price of the bonds gradually passed 70% and on 25 January 2012 the bank, flush with new cash from shareholders and the ECB, announced a call-back offer for the bonds at a price of 79.9%. We decided to sell everything. Our clients made between 20% and 40% on their investment in four months.

## A brief conclusion – the role of asset managers

Sometimes, especially in a prolonged period of economic prosperity and record-high stock market growth, it may seem as if managing one’s own investment portfolio is a good idea. After all, why should one pay a professional asset management firm when the price of everything one touches grows “magically” ever higher and higher, providing a sense of self-content and confidence in one’s investment abilities and logic? As all private bankers and asset managers will tell you, this is always the short-term perspective. Making money from the markets may seem easy when the sun is always shining; things usually get nasty when the rain comes. And, unfortunately, the rain always comes. A professional asset management firm is likely to warn you when the bad times are just around the corner and will know how to shield you from the worst of the crisis. It will also know much better than the average individual investor how to squeeze handsome returns for its clients from opportunistic situations in a period of economic downturn, global economic uncertainty, and great price volatility. Opportunity arises when the markets misprice risk, no matter what part of the economic cycle we are in. The deviation of the risk perceptions from the fundamental risk-determining factors is not immediately obvious and lasts only for a brief period of time. One is better positioned to take advantage of such opportunities when one relies on professional asset managers. Not surprisingly, Expat Capital’s business, measured by the assets under management, has increased about 10 times in the course of the last 2-3 years. Many of our clients, who had tried to manage their own investment portfolios previously, turned to us after suffering serious losses in the current market turmoil. New clients came to us for the same reason.

Opportunities to make money from the present economic conditions exist, perhaps more so than in a period of growing, relatively quiet and less volatile markets. Volumes of market data must be scanned constantly and assessed thoroughly in order to find the right deal though. The right way to go about it is to open an investment account with a professional asset management firm. Sitting on cash in the bank may not always be the best strategy, especially when the downturn and volatility continue for a long time and when the health of the banking sector internationally may also be at risk. Professionally managed pro-active investment strategies will bring much better risk-adjusted returns.

# TWO QESTIONS FOR A TRILLION EURO

NIKOLAY VASSILEV, CFA

1) Does higher budget spending lead to higher growth and wealthier citizens?

2) Do lower interest rates and higher money supply lead to higher growth and wealthier citizens?

**Why am I asking exactly these questions?**

We have heard many, as if logically sounding comments:

- 'Why should fiscal numbers be more important than the fate of the people?'
- 'Budget discipline should not be a goal for its own sake'
- 'Should we, in EU's poorest country, be bigger saints than the Pope?'
- 'We should raise incomes so that consumption increases'

However, I believe in a different logic. The currency board and budget surpluses have created the conditions for Bulgaria to achieve its biggest economic success (till 2008) in its modern history. Without budget and currency discipline, we will quickly go back to the crisis of 1996-7. Some of the developed countries are now heading that way.

**Why are these questions worth 1 trillion euro?**

A) This is the size of the annual budget deficits in the US, as well as in the EU. I do not support deficits at all

B) This is more or less the amount necessary to save the Eurozone countries from bankruptcy – at least for a few more months

C) This is the magnitude of the periodic printing of money which in the US is called *Quantitative Easing.* So far, it has only brought partial results

D) Probably, this is how much humanity would pay a genius who could show a non-standard way out of the current crisis. However, we have not found him yet

## THE EFFECTS OF BUDGET DEFICITS

| + They might increase aggregate demand in the short term, but under the following conditions: | – Chronic deficits unavoidably lead to: |
|---|---|
| • The countries should not be over-indebted. It is not like this today.<br>• There should be enormous confidence in the solvency of the governments, which should also be confirmed by the high ratings of the credit rating agencies. Now, the trend is the opposite.<br>• The demographic situation should be positive, so that future generations are able to easily repay today's debts. Nowadays, this is categorically not true – both growth and the pension models are threatened by the ageing population.<br>• This cure should be temporary and should carry a surprise element for the economy. During the last years, however, deficits in many countries have become chronic and enormous. One energy drink before an exam might help, but five energy drinks every day will eventually kill the student. | • Increasing public debt<br>• Falling credit ratings<br>• An exponential rise of interest expenses for servicing the debt – first, due to its larger size; second, due to the higher risk premium required by investors<br>• In turn, these expenses lead either to lower opportunities for non-interest expenses (pensions, investments, etc.) or, more likely, to even higher deficits, because no one enjoys belt-tightening. The avalanche has started and is as difficult to be stopped as for a drug addict to stop cocaine.<br>• The very important *crowding-out* effect is completely ignored by Keynesians. Private investment is crowded out by public spending. For example, a bank can choose whether to finance a new factory or with the same money to buy government securities. Then the factory which would have created growth and employment might not be built at all. A pension fund can invest in the IPO of a growing company or buy T-bills.<br>• Higher interest rates<br>• Higher inflation<br>• Currency depreciation<br>• Evapourating confidence in the country, a lack of investments<br>• Capital flight |

Does this not sound familiar? This is exactly what has happened in Europe in the last years. Has anyone invested to the south of Bulgaria lately?

### Why is the reasonable deficits formula not working?

Because the governments and the public opinion are not like good doctors who cold-bloodedly prescribe a dose, but are rather like kids who always want one more chocolate bar. There is no politician who would not be tempted to spend more before elections. Look at the history of the last decade. During some of the golden years for the global economy, the countries should have had surpluses and lowered their debts – just like Bulgaria did. The US, Hungary, Greece, Italy, and dozens of others did exactly the opposite. Why? Let the deficit fans answer that. I believe in the theory of kids and chocolate. And did those countries achieve higher growth and attract more investment than us? No, they just caused the world economy to crash.

### My conclusion about the budget deficit

As the gains are small and the harms and risks are large, in the current situation budget deficits should be limited or even directly banned. The best would be to write this in the constitutions so that it will be difficult to breach the discipline. Until the debt crisis is overcome, and the confidence in the solvency of the states comes back, nothing else would matter. There would be no growth and investment at all.

If someone disagrees, let him/her find an example of at least one country during the last decade, which has flourished due to deficits.

### What do the populists answer?

They say, we see that for several years the policy of budget restrictions has not worked in all of Europe. It is time to spend more so that we stimulate growth.

### My counter-reply

Which budget restrictions have not worked? There would have been such, if the countries *en masse* had had surpluses, while they still have record high deficits. Does Greece's 10% deficit for 2011, or the US's 9% sound restrictive? Most countries are still sliding down the spiral mentioned above. We will need years with real restrictions and with debt reductions in order to reinstore confidence. The trouble is that the next election cycle might bring new governments with lower affinity for fiscal discipline.

## THE EFFECTS OF MONEY SUPPLY

The question whether in this situation the printing of large amounts of money is useful or infinitely harmful is also interesting.

**The basic monetary equation**

$$Y*P=M*V$$

Y – nominal GDP
P – price level
M – amount of money in circulation
V – velocity of money (the speed of money circulation)

Monetarists can explain most processes in the economy with the changes in these 4 parameters. *Ceteris paribus,* a rise in M would mostly lead to an increase of P, i.e. to inflation.

### The confidence crisis has made the velocity of money collapse

At the moment, however, the situation is not standard. The sequence of crises after 2007 has lead to an unprecedented 'drought' in money circulation. Banks do not lend – households do not spend – sales and production are low – companies do not invest – everyone holds on to the cash and does not spend it on anything. This has caused a heavy recession in Europe and the US.

I do not have exact data about the changes in the velocity of money in the different countries – if reliable data exist at all. My feeling is that, in the US, this indicator has fallen almost by half, while in Europe – by less, but still significantly. In such a situation, some moderate growth of the money supply might not necessarily lead to inflation. Rather, the lack of money has lead to deflation (first, in asset prices) and a recession.

Prof. Steve Hanke has a similar opinion (see his article on page 8). Currently, in his opinion, the broad money supply indicator, M4, is not showing a danger of inflation in the US, but of a recession.

### My conclusion about the printing of money

I might surprise you with this opinion, but I think that until we restore the confidence in the currencies, in the countries' solvency, and in the stability of the financial systems, the large-scale printing of money and inflation are not the big problem. In the short term, I would suggest that the ECB and the US Federal Reserve continue the policy of low interest rates and large money supply. When the velocity of money rises, and there is a danger of inflation, they could change course. However, this velocity will only rise when confidence is restored. Confidence is currently negative as it is primarily affected by the budget policy.

For Bulgaria, however, the conclusions are not the same. We are a small economy with a currency board which has imposed restrictions on the monetary policy. We have to follow a balanced budget policy, and the future global recovery will pull us upwards, too.

It is a different question that, with or without a crisis, at the moment Bulgaria is not moving anywhere and is missing opportunities for attracting domestic and foreign investment; the development of capital markets; the privatization of the energy sector; concessions of airports, ports, highways, the water sector; a deep reform of the pension model, healthcare, and the judicial system.

Structural reforms will take us out of the crisis, not spending.

# EXPRESS IDEAS FOR AVOIDING INSOLVENCY AND REDUCING INTER-COMPANY INDEBTEDNESS

NIKOLAY VASSILEV, CFA

Before the economic crisis began three years ago, the Bulgarian corporate sector had enjoyed a decade of economic growth. The period was characterized by abundant credit, low interest rates, and significant investments – even excessive in construction and real estate. Many companies borrowed more than it seems reasonable today.

The recession which followed has resulted in:

- a severe lack of cash in the whole economy
- sharply falling prices of shares, real estate, and other assets
- too many bad loans at the banks – officially over 20% of the total, more in reality
- a rising pile of delinquent payables to utilities, suppliers, employees, the state
- an overleveraged corporate sector

As I have argued before, most companies do not need debt but equity (see the article "Is It Good for Credits to Stimulate the Economy" in Issue 8 of Expat Compass). There is certainly no magical solution for these problems, but the hide-and-do-nothing approach is also useless.

**Five ideas**

1. Allow all creditors to transform their receivables which are delayed by 3+ months into **tradable bonds.** These bonds can then be automatically listed and traded on the stock exchange, creating a liquid market for corporate debt. *The Ministry of Economy made such suggestions in 2003.*
2. Allow all creditors to transform their receivables which are delayed by 12+ months into shareholders' equity of the indebted company. This would be a **debt-for-equity swap.** The process would facilitate the change of ownership without bankruptcy procedures. The key question is at what ratio to execute the swap. Two possible although imperfect solutions are: a) at nominal value (worse), b) at net asset value per share (better).
3. The issuance of special **bad debt certificates (BDCs)** by the Ministry of Finance (MoF). These BDCs can be used as a payment method similar to the ZUNK-bonds:a) by the MoF to clear delayed payments from the state to the private sector, b) by companies to clear delinquent payments to suppliers accumulated prior to, say, 31 Dec 2011, c) by companies to clear delinquent payments to the state budget. Magically, most of these certificates will find their way back to the MoF, clearing mountains of debt along their way. A pilot project of BGN 10 mln can be tried, which could then be raised to BGN 1 bln.
4. Dramatically fasten the **bankruptcy and liquidation procedures in the Company Act.** These procedures should be the fastest in Europe. *Similar changes were made in 2002, but were later partially reversed.*
5. Stimulate the development of **capital markets.** Many companies might be able to raise the necessary equity capital through IPOs.

While these ideas might sound logical, they are not being realized. They may be imperfect, but there should be a discussion resulting in more and better solutions of the abovementioned problems.

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