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Business in Bulgaria

An Overview for Investors and Managers in 2010

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About the Author

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Introduction

In the summer of 2009, the head of a prominent public relations consulting firm in Brussels told me that he had once tried to work with Bulgaria in the 1990s. After two years, however, the leadership of the firm concluded that Bulgaria was not yet ready to seriously engage with Europe, and they abandoned their attempts to work with the country. Since that time, Bulgaria has gained European Union membership while the same public relations head has gone on to successfully represent government-level interests of other Eastern European states that are not EU members to this day. I was curious about this disconnect. Was this a function of the time that had passed and the progress that Bulgaria had made since the 1990s? Had this firm simply failed to read the tea leaves properly on Bulgaria? As I looked more deeply into the issue, however, it became clear that the story of Bulgaria in the late 20th and early 21st centuries is not so straightforward. Transitioning politically, geographically prone to conflict, new to capitalism and rife with corruption and organized crime, post-communist Bulgaria seemed to be a new Wild West – with all the same risk, but perhaps the same rewards, too.

I headed to Bulgaria in the fall of 2009 to carry out an assessment of the country as an investment destination and to explore some of the many contradictions that Bulgaria seemed to present. The real effects of the global economic crisis were just reaching Bulgaria at about the same time that I arrived in August 2009. Bulgaria was just coming off of about five years of unprecedented economic growth as cash that was piling up in leading economies from Western Europe, Russia, the United States, Japan and beyond looked for places to go. Bulgaria's trusted currency peg (to the euro), low corporate taxes and permissive operating environment attracted billions of dollars in new investment throughout this period. By the fall of 2008, however, the party was over in America, and most of the rest of the world was soon to follow. The socialist party in power in Bulgaria at the time repeatedly assured their voting public that Bulgaria, somehow, was "immune" to the crisis, so not to worry. The writing was on the wall, however, as exports began to fall, liquidity began to dry up and Bulgaria's expanding middle class began to recognize – acutely – that the crisis had reached their shores. The socialists fell from power on July 5, 2009, bringing the pro-Europe and self-styled reformist "GERB" party to power. It would now be their job to manage the crisis while fulfilling campaign promises to route out corruption and tackle crime in the Balkan nation.

Yet as Warren Buffet once said, "It's only when the tide goes out that you learn who's been swimming naked."[1] Likewise, the macro economic picture in late 2009 and early 2010 – while disastrous for businesses and individuals in the country – presented a rare opportunity to look under the hood of Bulgaria's political and economic systems during a painful moment of truth, as the effects of the crisis forced a level of transparency not seen in Bulgaria for years. It was in this environment that I set out to explore the contradictions between the Bulgaria that was "not yet ready to talk to Europe" and the Bulgaria that was already formally integrating into Europe's political and economic structures; between the Bulgaria deemed by various development watchdogs and corruption-watchers as an average, at best, place to do business and the Bulgaria that made the unofficial short-list of "it" places to invest your money during the go-go days between 2003 and 2008. In the process, I hoped to uncover a narrative that might serve to clarify the country's profile as a destination for investment and to iron out at least some of the contradictions that persisted.

I began this process, before and after arriving in Bulgaria, with a series of interviews with high-level professionals with business in, or pertaining to, Bulgaria: CEOs and country managers at firms investing in Bulgaria; EU staff involved with Bulgaria's accession and integration processes; consultants working with European and Bulgarian interests in Sofia, Brussels, Washington and elsewhere; Bulgarian think tank personnel, academics and policy practitioners; Bulgarian industrialists and entrepreneurs; and various Bulgarian professionals involved in the process of securing and applying EU funds in the country. From these interviews, I was able to establish a baseline of what the biggest issues are today for business in Bulgaria. I stress-tested these findings with the necessary research and plowed through current and archival news coverage of events to flesh out the broader themes uncovered during my interviews. The resulting report examines Bulgaria as a business destination by dividing the country into three broad categories: culture, climate and outlook. Within these categories, I attempt to comprehensively cover the themes that I have come to understand as vital considerations for anyone thinking of investing their money in Bulgaria.

If you are reading this introduction, it is likely because you are someone who is either already invested in Bulgaria, is considering investing in Bulgaria or is at least interested in the notion of Bulgaria as an investment destination. As such, this report is intended to serve as a primer on what you have ahead of you, should you choose to move forward. This report looks at where Bulgaria is today – and how it got there – as well as some of the key challenges that the country will face ahead. Driven by journalistic recounting of events, enhanced with first-hand anecdotes and supported by the relevant data, the following sections seek a narrative intended to facilitate a relaxed read for the actively interested audience. The aim of this report is to leave the reader with a more *inherent* understanding of the realties and challenges that investors should expect to face when placing their money in Bulgaria, and with a stronger framework for tackling the important decisions that lie ahead.

Part 1 > Culture > The Issue of Endemic Corruption

Commentary on the business environment in Bulgaria must begin with a discussion of corruption. For the bulk of Bulgaria's short post-communist history since 1989, corruption has been an important defining context of doing business in the country. Compared to other post-communist states, such as the Baltics, which summarily dismissed and banned their erstwhile communist leadership after the fall of the Soviet Union, as well as Romania, which scuttled its communist strongman Nicolae Ceausescu with particularly violent resolution, Bulgaria's transition from communism to true democracy has been slower. Bulgaria's communist nomenclature continued to officially hold the reins of power in Bulgaria for years after the official expulsion of Bulgaria's communist strongman, Todor Zhivkov.

During these final few years in power, members of the communist political elite, including personnel from the security services, were able to consolidate gains, taking favored positions in the privatization of state assets and shoring up relationships that would serve them lucratively going forward. By maintaining control over various aspects of politics, law enforcement, customs agencies and other state apparatuses, a continuum of personal straddling both legitimate and illicit institutions arose in an unpredictable new order, assuming positions of power in the wreckage and confusion that followed the collapse of communism. This continuity of personnel would play a major role in slowing the development of the country in the years since, as Bulgaria continues to struggle with a culture of corruption, inconsistent economic growth and the consistent threat of political isolation within Europe.

An analysis of corruption is therefore appropriate for any prognosis on the business climate in Bulgaria. This section of the report seeks to paint a useful picture of corruption in Bulgaria as well as provide a discussion of progress in the fight against corruption in Bulgaria to date.

Past is Prolog: from Communism to Present

A former EU bureaucrat who was actively engaged in Bulgaria's accession process commented to the author of this report that Bulgaria had missed a good opportunity, in the early 1990s, to purge its government of communist-era personnel just after the fall of communism. As a consequence, the old nomenclature was able to hold onto power, plaguing the system right up through the accession process and beyond. The bureaucrat offered the case of the Baltic States, Lithuania in particular, as an example of a clean purge that freed the state from its past in a clean and decisive way. And while this meant that early democratic Baltic governments were peopled largely by ex-patriots in their mid-20s, it also meant that these emerging states were free to build their new democratic systems on a more forward-looking model, without having to incorporate the lingering interference of parasitic forces from the past.

Today, however, Bulgaria suffers perhaps as much from the middle as it does from the top. It is, in fact, mid-level bureaucrats and functionaries who have been consistently spotlighted in recent years as clogging up and dragging down Bulgaria's government apparatuses. From ministerial staff to customs officials to traffic police, concerns remain that personnel who have been in place since the mid-1990s, or longer, have maintained "communist-era" modus operandi, believing that "back door" channels can be pursued without any true harm being done to the system as a whole. From petty €5 bribes to avoid traffic and other small violations to collusion with organized crime groups, these activities and the seeming inability to purge them from the system (to date) exacts real costs on society and the economy and should be considered a concern for anyone considering investment in the country.

A lack of resources to combat low- and mid-level corruption remains a major concern as well. While monitoring and oversight are costly and time-consuming, something as simple as compensation for government positions – at all levels – continues to present one of the biggest cost challenges in the effort to battle corruption. Alexander Boshkov, Bulgaria's industry minister in 1999, complained that "bright youngsters would much rather go into private business than 'work for peanuts' in the civil service."[2] The issue persists today: As of March 2010, the salary for an adviser to the prime minister stood at BGN 800 (€400) per month. And as a European official familiar with Bulgaria's corruption reform process told the author, "You cannot pay someone 800 leva and expect them to be careful with 200 million euros."

Border Corruption and the Role of International Crime

In late 2009, the Bulgarian association of Duty Free and Travel Retail Trade (ABTRT) announced that contraband fuels and tobacco products in Bulgaria amounted to BGN 2.3 billion each year.[3] Much of the cigarette smuggling is actually in the form of Bulgarian cigarettes exported legally at wholesale export prices, then smuggled back into the country illegally for resale on the "gray" market. A roundtrip through Turkey with re-entry at a Bulgarian Black Sea port has become perhaps the most popular route, and there is strong evidence that such activity has increased in early 2010 after an increase in the excise duty on cigarettes took effect in Bulgaria, increasing the standing duty of €53 for 1000 cigarettes to €76 for 1000 cigarettes as of January 2010.[4] At this time, Deputy Prime Minister and Finance Minister Simeon Dyankov estimated that illegal imports comprised 40% of this market, which translated into government losses of at least BGN 920 million from cigarette contraband per year.[5] In an interview with BBC, Dyankov stated that when he assumed office in mid-2009, one in four employees in the Customs Agency did not even know how to fill out a customs form. "They weren't there to do their work, but to extract bribes," Dyankov explained.[6]

Other accusations have gone further: In early 2010, Customs Director General Vanyo Tanov stated in an interview that during the preceding 20 years the Bulgarian Custom Agency was ruled by organized criminal groups, adding that there was murky business both at the Customs Agency and the Interior Ministry. Tanov explained that there were several such groups, which had recently stopped fighting between each other after managing to divide the country in zones of influence. Tanov explained further that those groups had even lobbied the government for legislation that would serve their interests, and added that tighter control over the Customs Agency could bring an additional BGN 700 million to state coffers. According to Tanov, BGN 200 million alone was currently being lost to the so-called "alcohol mafia."[7]

By early 2010, however, the Finance Ministry was touting improvements. In early March 2010, Dyankov announced that BGN 1.77 billion had been collected in 2009 in revenue raised from the cigarette excise tax, a 3.1% rise year-on-year, while the actual consumption of cigarettes had declined by 14%. Dyankov also announced that the government was involved in talks with the World Bank to secure funding for the purchase of new technical equipment for intercepting contraband goods.[8]

According to a U.S. State Department report, however, corruption in its various forms in the Bulgarian government still remained a serious problem in 2009. During the year, the Ministry of the Interior's reputation, for example, suffered after a series of high-profile scandals culminating with the interior minister's forced resignation. And, despite reforms in the Prosecution Service, the judiciary as a whole (which included prosecutors, investigators and judges) consistently received poor scores in the area of public confidence, while some senior officials in the Customs Agency maintained known ties to notorious public figures with criminal connections.[9]

Bulgaria is also a transit point for heroin and cocaine, as well as a minor producer of illicit narcotics, and is vulnerable to illegal flows of drugs, people, other contraband and money across its borders and through its territory. Heroin distributed in Europe moves through Bulgaria from Southwest Asia and via the Northern Balkan route, while chemicals used for making heroin move through Bulgaria to Turkey and the Middle East. According to the 2009 U.S. State Department International Narcotic Control Strategy, corruption and effective implementation of legal and structural reforms remained major challenges in Bulgaria's fight against the smuggling of contraband during 2009:

> Bulgarian law enforcement agencies, investigators, prosecutors and judges suffer from public mistrust, and require widespread reforms, much more reliable political and public support, and strong leadership to develop the capacity to investigate, prosecute, and adjudicate illicit narcotics trafficking cases and other serious crimes effectively…The Government of Bulgaria…continues to face many challenges in its enforcement efforts…In addition, lack of financing and inadequate equipment to facilitate narcotics searches; widespread corruption, especially in the Customs offices and among the judiciary; and excessively formalistic judicial procedures continue to hamper counternarcotics efforts.[10]

In the summer of 2009, after winning open elections in July of that year, the incoming GERB finance minister, Simeon Dyankov, stated that one of the first priorities of the Finance Ministry would be to link the information databases of the Customs Agency and the National Revenue Agency. According to Dyankov, "the quickest and easiest reform, which can be accomplished within a month to a month and a half, is linking the customs and tax authorities, which will ensure a decrease in smuggling and annual revenues of about BGN 800 million from excise duties and taxes that are now not being collected."[11]

The Role of Foreign Investment in Promoting Corruption in Bulgaria

A lesser-discussed, yet important, factor in Bulgaria's culture of corruption is the role played by foreign investment. The general manager of a London-based real estate developer heavily invested in Bulgaria advised the author in late 2009 that, "real estate development is completely haphazard, barely thought out and driven really only by greed: for a few extra euros you can get a higher density allowance on your site – not a big deal downtown, but this has completely [screwed] up [suburbs] like Simeonovo ad Dragelevtsi. What's more is that big-box stores have had a hard time coming in because of these juiced density allowances."

The investor added that while such a permissive environment is great for investors, Bulgarians "have completely [screwed] it up [for themselves] in terms of what they could have done to develop this country in the past three to five years." The sentiment is a common one, and was echoed consistently throughout the interviews conducted in support of this report. The issue is largely one of government personnel who – whether appointed or elected – seem to view state and municipal positions as a means to personal wealth, allowing those who control potential investment dollars to set the rules – or to avoid them completely. With no oversight mechanisms or true planning structures in place, Bulgaria's biggest boom – real estate – was sewn early with the seeds of catastrophe.

As a wall of money from the West flowed east, Bulgaria's lax operating environment made it a perfect destination for short-sighted, quick-turnaround construction projects. When the bubble burst in late

2008/early 2009, the country's major cities, its seaside and its mountain resorts were littered with poorly planned and quickly devaluing structures. A large number of these properties were sold to or ultimately held by Bulgarian citizens who were now stuck with negative equity in properties purchased with less-than-favorable loans from an increasingly uncertain banking system. This topic will be covered in greater detail in Part 2 of this report.

Part of the problem is that the government left development issues largely to the developers themselves. There has been a tendency, therefore, for hospitals, local access roads and other important public infrastructures to be planned and executed in the cheapest manner possible. In other words, according to sources involved with such large projects in Bulgaria, where the developers' interests are not aligned with those of the general public, it has been the public who loses out.

A proper permitting structure with high levels of transparency and sound oversight is often suggested as a remedy to many of these ills. In Croatia, for example – a country that has seen a similar boom in property during the course of the past decade – heavy permitting fees are applied up front on large projects. These fees are meant to pay for the roads and other urban necessities that accompany large developments, freeing the developers of the full responsibility and intended to protect the public from unseemly cost saving techniques from the private sector. Developers who have operated in both Bulgaria and Croatia explained to the author that the Croatian model is vastly superior if the goal is to take the long view in developing the country. With hands-on public involvement in the urban planning process and with adequate transparency and oversight of how the permitting fees are used once drawn, Croatia has, by many accounts, created a system that renders bribes difficult and unlawful re-zoning practices impractical.

Under Bulgarian law, by contrast, registry and permitting requirements are much lower, on paper. With some limitations and exceptions, the acquisition and registry of property follows as such:

> Real property in private ownership is acquired through an acquisition agreement in form of a notary deed. The deed is signed between the parties before a notary public. State or municipal real property is acquired by virtue of a written contract. The respective title documents (being a notary deed or written contract) are subject to registration with the recordation office at the recordation agency.[12]

Meanwhile, associated initial fees for the purchase of land are similarly straightforward:

- Notary fee: The amount of the notary fee is calculated on the basis of the transaction value. The maximum notary fee cannot exceed BGN 3,000 (approximately EUR 1,500)
- Land registry fee: The charge for registration into the land registry held by the recordation office is 0.1% fee based on the purchase price agreed between the parties or estimated according to the tax evaluation of the property, whichever is higher[13]

The problem with this seemingly investor-friendly, even foreign-investor-friendly system is twofold: First, low registry and permitting costs upfront provide no mechanism for collecting needed revenues for the infrastructure developments that must accompany property and real estate development. Second, because these costs are not incurred in a transparent manner at the beginning of the process, circumstances are created in which public officials are given a window of opportunity to extract those monies from developers in a manner that serves no public good to the rest of the community.

Corruption and Ineffectiveness in the Judicial System

Pierre Guislain, a lawyer by training, was a private sector development specialist with the World Bank during the 1980s and worked closely with Eastern European states on legal reform issues. In a 1997 paper, Guislain laid out six principals that were necessary to guarantee the rule of law in a given state:

- Publicity of laws
- Clear and unambiguous legal framework
- Predictability in applying laws
- Nondiscrimination in the application of laws
- Means of legal redress and respect for due process
- Stability of the legal, political and decision-making systems[14]

As of early 2010, with the help of the international community, Bulgaria has seen progress in building out a legal framework with guarantees and processes in line with advanced democracies to the West. However, function does not always follow form. While law are now public, frameworks are more or less clear and means of legal redress and due process are in place, Bulgaria still faces challenges in terms of predictability, nondiscrimination and stability in the functioning of its justice system.

The USAID Bulgaria Judicial Strengthening Initiative states as its goals: "An independent judiciary that protects the rights of individuals and private institutions, attracts foreign investment, guarantees the efficiency of the market system [and] enforces the legal and regulatory environment necessary for sustainable economic growth."[15] As of early 2010, these goals had yet to be fully realized, with an under-functioning judiciary remaining a significant concern for business in Bulgaria. Three main issues continued to dominate concerns about the Bulgarian judicial system in early 2010: structural deficiencies, corrupt actors and inefficiencies born largely of a lack of proper funding.

One major structural difference between the Bulgarian justice system and the Anglo-American system is the division of labor among the police, the prosecutor and the courts. In Bulgaria, police do all of the investigating while it is at the discretion of the prosecutor to bring charges – or not. The ability to "pocket" cases has created concerns with regard to criminal prosecutions – a corrupt prosecutor has the power to forestall the prosecution of any individual he or she would prefer not to charge, for whatever or no reason. The structure of the system, therefore, creates circumstances in which impunity for those close to a given prosecutor becomes a real concern, and the blind application of justice is called into question. A U.S. judge studying the Bulgarian justice system in Sofia during late 2009 told the author that the prosecutor is too much a part of the court system to perform his or her role in an appropriately impartial fashion. Noting that prosecutors "walk around the court in red robes, even outside of the courtroom," the same judge asserted that the relative pomp and power of the prosecutor in Bulgaria presented a significant structural challenge to the proper functioning of the judiciary in the country.

In September 2009, Konstantin Penchev, chair of the Supreme Administrative Court, publically opposed a spate of high-level judicial system personnel appointments. During a September 17, 2009 meeting of the Supreme Judicial Council, Penchev further called for immediate changes in Bulgaria's legislation guiding the judicial appointment process. Penchev's concerns centered on his fear that close-knit circles of friends had established themselves in the judicial system, and that these circles of influence could hamper access to justice in Bulgaria's courts. In his words, "each dubious appointment is like introducing a cancer cell in a healthy organism…The parliament must take measures, because apparently the judicial system cannot deal with the issue on its own. This is a national concern, and a matter of national security."[16]

In early 2010, staffing and funding remained serious concerns as well, with Bulgarian courts remaining notoriously underfunded and short on resources – and cases seeing consistent and prolonged delays. This becomes a serious concern for businesses operating in Bulgaria, and especially for foreign investment. Foreign parties can find the Bulgarian court system onerous, costly and unpredictable, and will often contract for outside forums in the event of a contract dispute. However, while two parties may select, for example, New York as forum for dispute, the foreign party still faces the real risk of getting dragged into court in Bulgaria, based on any number of vacating tactics and mechanisms that might be employed to his or her disadvantage. Should such an instance occur, the case could then take years in the Bulgarian court system, and now the foreign party is operating in a forum other than that which was decided upon at the time the contract was made. As a result, Bulgarian parties can – and have – used the Bulgarian court system as a tool of extortion: The foreign counterparty will likely opt to settle the case to save time and money.

Some improvements have been made in recent years, and there are early indications that further integration into EU infrastructures after accession in 2007 will play a positive role. The state has harmonized the majority of its legislation with EU norms and recent improvements have included a more investor-friendly labor law, better intellectual property legislation and a more effective competition law. Meanwhile, lagging judicial reform has finally been set in motion after pressure from the EU. Analysis by Global Insight in early 2010 concludes that these reforms "should work towards increasing transparency, reducing judicial immunity and demarcating the separation of the judicial branch. It also promises to combat corruption further through harsher punishment for economic crime."[17] However, the situation continues to require close monitoring and vigilance, and will remain a key concern for business interests in Bulgarian until clear, transparent and reliable processes begin to yield more consistent outcomes.

EU Demands and Bulgaria's Meandering Path toward Compliance

Bulgaria was invited to start formal EU accession talks in 1999. By 2004, the Bulgarian government had successfully completed all chapters of the European Union *acquis communautaire* and in December 2004, accession talks were formally closed. In April 2005, the accession treaty with Bulgaria was signed and was passed to the parliaments of the 25 member states for ratification in 2006.[18] Between 2001 and 2004, significant progress was made to move Bulgaria toward the EU. However, according to one U.S.-based analyst dealing with Eastern European issues in Washington, once the chapters were closed, the relationship began to deteriorate, with Bulgaria coming under increasing EU scrutiny during the final two years heading into 2007 accession.

Brussels' posture toward Bulgaria on the topics of corruption and organized crime, which has traditionally ranged from paternalistic to hostile, is the result of a long and difficult relationship between EU bureaucrats and Bulgarian leadership. At the beginning of the accession process for Romania and Bulgaria, Bulgaria was the favored sibling, considered significantly ahead of Romania in its progress toward reform and compliance with EU standards. By the time the two neighbors received their EU membership cards in 2007, however, Bulgaria and Romania had traded places. EU officials with whom the author spoke in late 2009 complained that, heading into 2007, there was a certain counterproductive dedication in Brussels to brining both Bulgaria and Romania into the EU together. Bulgarian politicians, they claimed, became acutely aware of these sentiments, thus reducing the leverage that would-be hardliners at the EU level might have otherwise had in the final two years of negotiations. The progress of reform in the Bulgarian government during these final years, therefore, ground to a near halt as the Bulgarian cabinet's posture moved ever more boldly toward an understood *fait accompli* with regard to their future in Europe. In the final months heading up to the accession date, the U.S., Dutch and German ambassadors all warned against too-quick Bulgarian accession and many in Europe argued that Bulgaria was not ready to join the club alongside Romania.

In an executive report issued on July 22, 2009, the EU asserted that Bulgaria was still not doing enough to tackle corruption and organized crime, and so would have to accept European Union monitoring for at least another year. Under the oversight of the EU Cooperation and Verification Mechanism, there are 21 fields in which Bulgaria is to improve its performance, including the implementation of anti-corruption laws and the strengthening of judges' independence. At a Foreign Ministers Council in Brussels in September 2009, the ministers further insisted that the monitoring system should be extended until all criteria are met. The next possibility for Bulgaria to close the oversight mechanism will come with the release of the next report of the European Commission, due out in the summer of 2010.[19]

Europe's Weak Position and an Arrested Reform Process

One of the major impediments to reform was ambivalence in Bulgarian political circles about moving closer to Europe in the first place. While EU accession had remained popular among majorities of the Bulgarian population, the ruling socialist party also maintained strong ties with Russia, which has traditionally sought to discourage the southern Slavic states from joining Western institutions such NATO and the EU. In a February 2010 interview, Bulgarian Finance Minister Simeon Dyankov stated that the "oligarchs" and political imposters who had preceded the GERB party in government wanted to see Bulgaria get out of the currency peg and slip away from the eurozone. This would serve the interests, he said, of those with close ties to Russia who "want to live in the past."[20]

Nonetheless, on Wednesday, April 13th, 2005 the European Union's parliament in Strasbourg voted by large majorities to allow both Bulgaria and Romania into the club.[21] The vote was seen by many as anything from a tentative show of confidence to a serious gamble that integration into EU structures and institutions would help to bring the new member states – particularly Bulgaria – up to the unmet standards that some argued should have been treated as hard prerequisites to membership. A number of diplomats and politicians in Brussels have since expressed the opinion that Bulgaria, and Romania along with it for that matter, were admitted too soon, arguing that once "problematic" countries get into the club, the EU immediately loses key leverages.

Under pressure from the European Union, for example, socialist Interior Minister Roumen Petkov resigned in April 2008 after a leaked intelligence report said a drug gang had received top-secret internal documents from officials in his ministry and illegal alcohol producers had given money to a senior investigative official in return for the destruction of incriminating evidence. EU officials had long worried that anything they shared with Bulgarian counterparts would be leaked to members of organized crime syndicates. Eurocrats had also expressed displeasure over what they regarded as Petkov's bullying attitude: One EU source stated that Petkov enjoyed "rubbing our noses in the fact that Bulgaria is now a member state,"[22] the implication being that Petkov felt a certain degree of freedom from consequence in his pursuits, now that the accession process had been concluded.

The counter-argument is that admitting countries like Romania and Bulgaria is the best way to protect and encourage internal reformists who are the best hope for the future. According analysis by The Economist in the summer of 2009, the decision by the European Commission to freeze funds for

Bulgaria, for example, was not simply a technical measure, but a deeply political experiment – nothing less than an attempt to claw back leverage over the government after it had entered the union.[23]

Increasing Capital Inflows and Corruption

The case of Roumen Petkov and the Interior Ministry, discussed above, was but one of numerous very public examples of official corruption in Bulgaria during the first decade of the 21st century. Reaching its crescendo during the rule of the socialist party under Sergei Stanishev from August 2005 to July 2009, corrupt tendencies were further fueled by an influx of EU structural funds after accession. Over the course of several years, Bulgaria saw hundreds of millions of euros in structural funds suspended due to scandals in the awarding, reporting and execution of contracts based on EU aid. A few representative cases are detailed below.

The National Road and Railway Scandals

In January 2008, Vesselin Georgiev, then head of the state-owned National Road Infrastructure Fund, was charged with illegally awarding contracts worth BGN 120 million for the repair of Bulgaria's roads to companies run by two of his brothers.[24] While Mr. Georgiev resigned, the controversy led the EU to freeze €144 million meant for farming and road improvements. This, of course, only created further funding delays and additional challenges for a country in dire need of infrastructure repairs and improvements. The affair also meant greater uncertainties for Bulgaria's agricultural community, which was relying on the funds to make equipment upgrades necessary to bring operations in line with EU standards.[25]

Meanwhile, a probe of the Transport Ministry during 2009-2010 revealed serious violations committed at the Bulgarian State Railroad Company, BDZ, between 2007 and 2009. Transport Minister Alexander Tsvetkov reported that over BGN 127 million were lost due to the fraud, calling the waste of resources a "total disgrace."[26] Among the allegations in the case was a public order signed in 2008 by former BDZ head Hristo Monov for the delivery of 30 sleeping cars from Switzerland. Eighteen of the cars, for which €14 million had been paid, went missing.[27] Other violations at BDZ included the failure to collect BGN 35 million in VAT as well as improper public tenders for the purchase of computers, consumables and uniforms at highly inflated prices. Meanwhile, as of spring 2010, BDZ carried a debt of BGN 700 million and, it was believed, would not be able to stabilize without state assistance.[28]

The SAPARD Draining Case

Another high-profile scandal involved monies earmarked for the modernization of Bulgaria's agricultural sector. The EU SAPARD (Special Accession Program for Agricultural and Rural Development) program was launched in Bulgaria in 2001 and expired at the end of 2009. The State Fund Agricultural (SFA) was the EU paying agency set up to implement all EU measures in the agricultural sectors, which also acted as the country's SAPARD Executive Agency. In 2008, Bulgaria saw the blocking of millions of euros under the SAPARD program over violations in the SFA. According to prosecutors, an eight-person organized crime group drained €7.5 million of SAPARD money through document fraud from 2002 to 2005 by presenting old equipment as new for the purpose of sale. A legal inquiry began in Bulgaria after the EU Anti-Fraud Office, OLAF, published a report in 2008 describing the "Nikolov-Stoykov" business group's alleged involvement in the fraud scheme.[29]

Registered irregularities and fraud under SAPARD during the life of the project amounted to 419, of which 288 had financial consequences. Meanwhile annulled funds amounted to BGN 374 million, which remained unabsorbed and were permanently lost to Bulgaria at the expiration of the EU program at the conclusion of 2009.[30] The program was unblocked, however, at the beginning of September 2009, and since then 197 projects have been paid with subsidies of BGN 83.7 million.

Boyko Borisov and the GERB Party

On July 5, 2009, parliamentary elections brought the GERB party to power after four years of socialist rule. The GERB (or "CEDB" by other translations) party, an acronym for the Bulgarian "Citizens for European Development of Bulgaria," built an election platform around the promise to move the country closer to Europe and step up efforts to fight corruption and organized crime. The party's flamboyant leader, Boyko Borisov, came to power after one term as the mayor of Sofia, during which time he founded and built the young GERB party.

Borisov began his career in state service as a member of the Ministry of Interior from 1982 to 1990. While some worried about Borisov's erstwhile position in a notoriously corrupt state security apparatus, others believed that such experience could serve as an asset, should Borisov prove to be a true reformer and serious about combating Bulgaria's underworld.

While mayor of Sofia, Borisov went to the United States to discuss the possibility of the FBI establishing an office in Bulgaria, which became a reality with the announcement of a permanent FBI office in Sofia in June 2004.[31] And through a series of brash confrontations with organized crime groups and public attacks on high-profile politicians and state employees over corruption, Borisov became somewhat of a media darling – and the public began to trust him as someone who might follow through on promises to fight corruption. While still mayor of Sofia, in preparation for his eventual cabinet at the national level, Borisov likewise began using trips to Washington and Western European capitals to establish contacts with Bulgarian ex-patriot intelligentsia. During this period, the fledgling GERB began to build its credentials as a meritocratic and Westward-looking party.

However, others remained suspicious of the GERB party and the new government precisely because it was so centered on one personality. As a new party, GERB came to office lacking sophistication in platform and structure. Likewise, because the GERB party had won an outright victory in the summer 2009 elections, and would therefore not need to form a coalition government, there was also early concern that the new leadership would not be up to significant task of ruling alone.

While GERB is generally considered center-right and is a member of the European Peoples Party in the Euro Parliament, it is also perceived to have populist elements, with Borisov's "man of the people" image only fueling such perceptions. This presents a mixed bag for the business community and has caused alarm in some quarters. A former VP-level manager at the American Chamber of Commerce in Bulgaria told the author in October 2009 that the business community in Bulgaria finds the GERB party "unpredictable" and continues to take a "wait-and-see" approach. As of late spring 2010, there is little evidence that the relationship between the business community and the ruling government has grown any less tentative.

Recent Trends and Attitudes in the Fight against Corruption

A late 2009 report by Eurobarometer showed that newer EU member states (post 2004) are more positive about the EU's role in fighting corruption, with 40% agreeing that an EU role helps reduce corruption in their own country – compared to 27% of respondents in the pre-2004 member states. This opinion was most widely held in Bulgaria, where 64% agreed that the EU helps to reduce local corruption.[32]

However, three years after Bulgaria's accession to the European Union, a 2009 ASSA-M poll showed that 40% of Bulgarians felt that entry into the European family had made no difference. While EU membership is widely associated in Bulgaria with high living standards, order and safety, the rule of law and free travel, respondents said that these benefits had accrued primarily to the capital city, Sofia, and its inhabitants, while life in other parts of the country had remained largely unchanged. Meanwhile, respondents pointed to high prices, inflation, crime, prostitution and persistent drug problems in the country as evidence that EU accession has not been the panacea for which some Bulgarians had hoped.[33]

Lingering Perceptions of Corruption in Bulgaria

According the global corruption tracker Transparency International, Bulgaria ranked 71 out 180 states monitored in its 2009 "Corruption Perceptions Index." This ranking places Bulgaria slightly ahead of regional states Serbia, Bosnia-Herzegovina, Romania, Greece and FYR Macedonia, yet well behind Western Europe, North America and advanced East Asian and Pacific states, which cluster near the top of the index.[34]

In late 2009, the Center for the Study of Democracy in Sofia published the results of its annual Corruption Perception Index, showing that one in four Bulgarians had paid brides for a favor during the course of that year.[35] Meanwhile, a 2009 poll by Eurobarometer showed that respondents in Bulgaria believed that corruption was widespread in their police, judiciary and customs service – which was the most mentioned of all the government organs, at 87%. Meanwhile, eight out of 10 Bulgarians believed there was widespread police corruption, well above the EU average of 39%. Bulgaria also ranked first among all EU states in percentage of the population who perceive corruption by people working in the judicial services, at 82%.[36]

According to the same Eurobarometer data, Bulgarians were also the most likely in Europe to agree that corruption is widespread amongst their national politicians, with 76% holding this opinion. Since 2007, Bulgarians' faith in their politicians at all levels had decreased dramatically, with increases of 20 to 24 percentage points in the proportion believing that there is widespread corruption.[37] The study also showed that Bulgarians' belief that corruption existed amongst officials awarding public tenders had increased by 30 percentage points over 2007 levels. Perception of corruption in Bulgaria practiced by officials issuing building permits had increased by 26 points over 2007 levels, while perception of corruption practiced by officials issuing business permits jumped by 22 points over the same period.[38]

Part 2 > Climate > The Economics of Boom and Bust

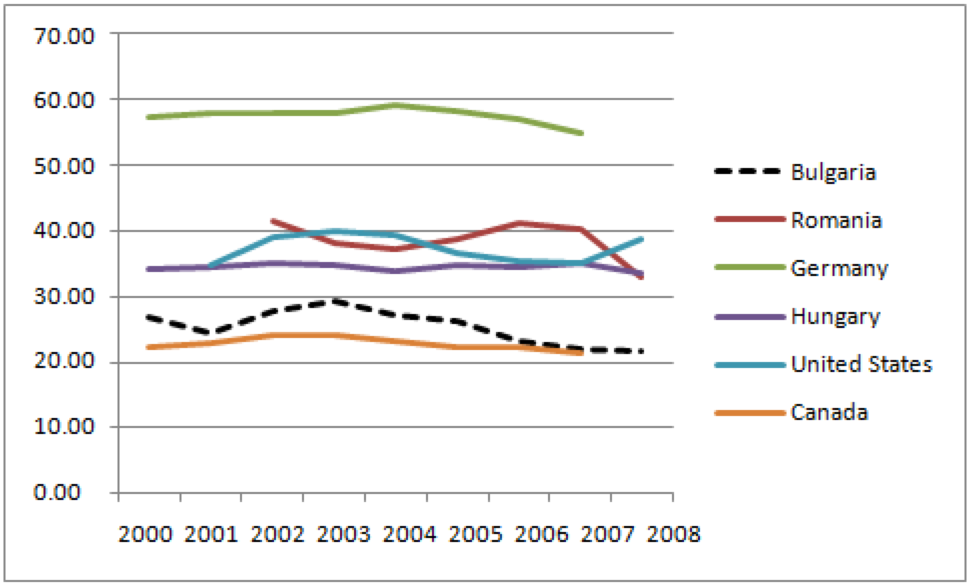
Eastern Lure and the Western Wall of Money

During the summer of 2008, the U.S. Dow Jones Industrial Average breached the 14,000 mark for the first time in history. Western and developed markets were nearing the end of about five years of strong growth in capital. As private industry sought expansion at a fever pitch and banks sought new locations to invest capital, emerging markets around the world eagerly sought to capture investment through pro-business incentives that would attract capital away from competitor states and to their shores. A 10% flat tax and easy access to EU markets were at the center of Bulgaria's investment pitch. In 2008, the Socialist Party ushered in a 10% flat tax regime, giving Bulgaria the lowest personal income rate of all EU states. Along with the lowest social security rates of any EU state, the flat tax was meant to attract employers and potential investors, as well as to help increase tax collection (curb tax avoidance).[39] Coupled with tax holidays and a famously permissive operating environment, Bulgaria was able to offer investors a package that most states in the region could not match.

Figure 1: Dow Jones Industrial Average, 1999 - 2008

Source: Google Finance

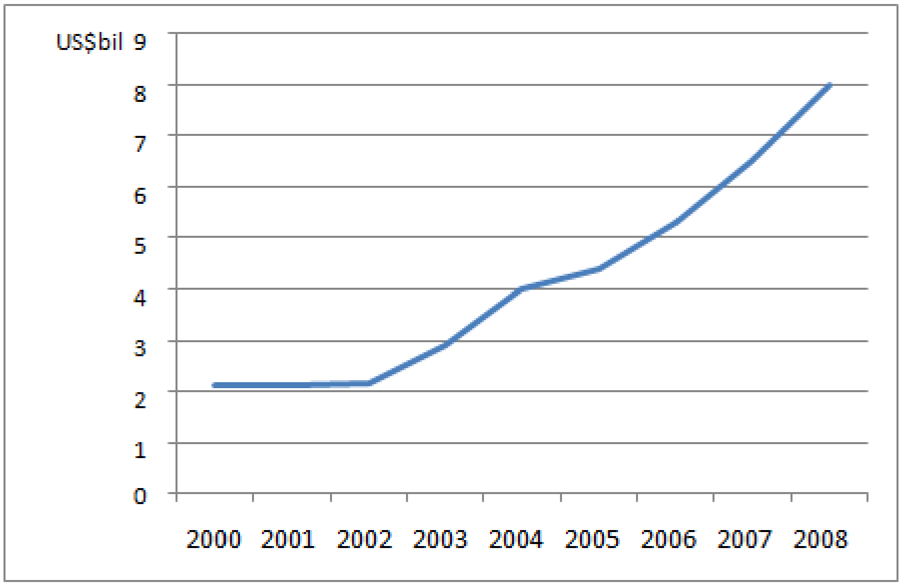
Figure 2: Comparison of Social Contributions (% of revenue)



Source: Adapted from the World Development Indicators, The World Bank, data accessed April 26, 2010, available at: http://data.worldbank.org/data-catalog

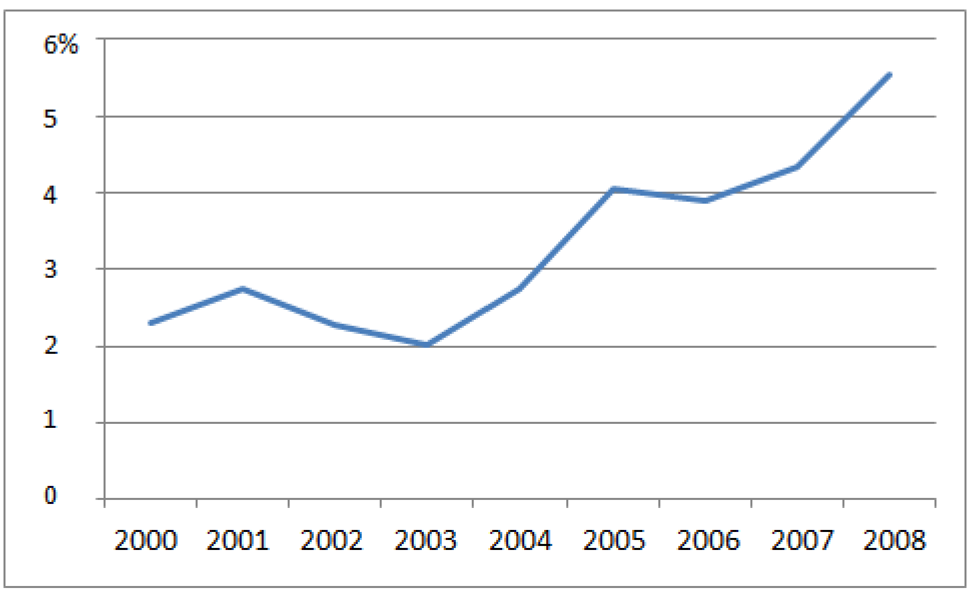
Arguments were made that Bulgaria's exceptional, educated – and low-wage – workforce, would accrue economic benefits to high-productivity industries seeking a regional base. And indeed, the country did see significant development in high-tech, logistical and other advanced service sector employment. Significantly, in 2007, IBM chose Bulgaria to locate its regional business process outsourcing (BPO) center, which was estimated to create 100 jobs in the capital city of Sofia.[40] Meanwhile, McKinsey & Co. opened an office in Sofia during this period (which has since closed its doors) and energy firm AES took significant stakes in wind energy, with €1.5 billion in total investments making the firm the single largest foreign investor in Bulgaria.[41] Yet perhaps the largest non-government sector beneficiaries from the decade-long influx of FDI were real estate and tourism. These industries would, in fact, expand to bubble proportions, the popping of which would play a major role in the subsequent congealing of the Bulgarian financial system after 2008.

Figure 3: Growth in Commercial Exports in Bulgaria (current US$, in billions)



Source: Adapted from the World Development Indicators, The World Bank, data accessed April 26, 2010, available at: http://data.worldbank.org/data-catalog

Figure 4: Growth in ICT Service Exports in Bulgaria (% of service exports, BoP)



Source: Adapted from the World Development Indicators, The World Bank, data accessed April 26, 2010, available at: http://data.worldbank.org/data-catalog

Yet as early as 2008 there arose strong concerns that the economy was growing too quickly. According to figures from the National Statistical Institute (NSI), Bulgarian real GDP grew by 7.1% year on year in the second quarter of 2008. Meanwhile, the expenditure breakdown of GDP showed that domestic demand continued to race ahead, powered by rapid growth in fixed investment (up by nearly 30% year on year in the second quarter on 2008) and very rapid increases in stocks. This surge in expenditure was in turn sucking in imports, which were up by 13.7% year on year in the second quarter, far outpacing growth in exports. Net trade, therefore, had begun to represent a large net drag on economic performance,[42] and Bulgaria's over-reliance on foreign investment was beginning to be cause real concern.

This section of the report discusses how a confluence of external and internal factors – among them, governmental economic policies and responses – set the stage for the particular challenges that Bulgaria would face after the boom had ended.

The Currency Board

The Bulgarian currency (BGN), the "lev," is linked to the euro through a currency board that keeps the nations currency pegged at BGN 1.9558: €1. The currency board, in place since an economic crisis in 1997 led to hyperinflation and the lev's collapse, compels Bulgarian policymakers to preside over a tight fiscal policy.[43] Bulgaria therefore must maintain fiscal prudence and aim for balanced budgets or small deficits as the currency board regime significantly limits monetary operations, leaving fiscal policy as the key tool to influence the economy.[44]

The peg was also a key driver of growth for the decade-plus following the crisis of 1997. Driven largely by inflows of foreign investment throughout the first decade of the 21st century, the Bulgaria economy benefitted greatly from investors' ability to plan Bulgarian projects on euro terms as well as investor confidence in the management and stability of the peg through the currency board. With the fear of Greek contagion hanging over Europe's collective head in the spring of 2010, however, the peg has taken on renewed significance as the ruling GERB party strives to manage Bulgaria's economy through the crisis. This will be discussed in further detail in Part 3 of this report.

The Uncertain Role of Foreign Commercial Banks

Lacking a well-developed local banking infrastructure, 85% of banks operating in Bulgaria are foreign-owned – Unicredit, Raiffeissen, Pireaus Bank and Alpha Bank are all major players with significant presence, while both Citibank and BNP Paribas have played key financial services roles for large investments.[45] This reality facilitated growth in the Bulgarian economy during the boom of the early 2000s. Primarily Greek-, Italian- and Austrian-owned, euro-dominated foreign banks provided attractive financing to Western investors seeking euro-denominated lines of credit in Bulgaria. Meanwhile, smaller Bulgarian entrepreneurs were given a variety of lending options that would not exist in the absence of foreign bank presence, and larger Bulgarian business interests could deal directly with Athens, Vienna or Milan with banking establishments already familiar with the Bulgarian market.

However, when the liquidity crisis hit in late 2008, the domination of foreign banks in Bulgaria would prove to have a serious downside as well. In tighter times, foreign banks faced fewer political pressures outside of their home markets to operate fairly. Rather, facing political pressures at home, there exists a strong temptation to use foreign markets to shore up accounts while striving to maintain more lenient policies at home. In September 2009, European Bank for Reconstruction and Development (EBRD) Chief Economist Erik Berglof stated that a lack of transparency in the banking industry in Eastern Europe continued to undermine confidence and impede interbank lending. The EBRD had been working to limit the impact of the financial crisis on eastern Europe, persuading western banks to stay invested in the region. However, Berglof pointed out, there remained "big questions about western European banks' portfolios and a lot of those uncertainties are tied to investments in eastern Europe…When banks don't trust each other, the interbank market doesn't work and they are cautious about on-lending to clients. When there are pressures at the center of these banks, it's typically in the periphery that they withdraw."[46]

Meanwhile, the liquidity situation in Bulgaria would be compounded by the repatriation of reserves by commercial banks to home institutions. In December 2008, in a series of moves designed to address liquidity shortages, the Bulgarian National Bank decided to lower its requirements on mandatory reserves on deposits from 12% to 10%, halved the reserve requirements on foreign deposits to 5% and scrapped the minimum reserves on government and municipal deposits.[47] However, no proper system of ensuring that the freed-up capital would be used to lend in the Bulgarian market was – or legally could have been – put in place to accompany to the new, lower reserve requirements. The result was that much of that capital was pulled out of the Bulgarian banking system, thereby only compounding liquidity concerns.

Greek Banks, the Greece Crisis and the Risk of Contagion

In early 2010, rating agency Fitch lowered the long-term and short-term issuer default ratings of United Bulgarian Bank (UBB) and Eurobank EFG Bulgaria to BBB- from BBB, and to F2 from F3, respectively, with a "negative" outlook. UBB and Eurobank EFG Bulgaria are the third and fifth largest in the country, respectively, and are both Bulgarian subsidiaries of Greek Banks (National Bank of Greece is parent of UBB, EFG Eurobank is parent of Eurobank EFG Bulgaria). The move came shortly after Greece's four largest lenders, including National Bank of Greece SA and EFG Eurobank Ergasias SA, also had their credit ratings lowered at Fitch, which said the country's economic crisis would hurt asset quality. According to the agency, the required fiscal tightening that needed to be made by the Greek government would have a significant effect on the real economy, affecting loan demand and putting additional pressure on asset quality.[48]

Early January 2010 analysis by the Sofia Echo describes the previous year's economic meltdown:

> The chickens came home to roost in 2009, as more than a decade of economic growth came crashing down with a bang and the excesses that fuelled the boom, their potential drawbacks being paid little heed, could not be ignored any longer... the year 2009 brought further proof, if any was needed, that Bulgaria's economy was not an island, of stability or otherwise. The same opening of borders that led to strong growth after the 1997 crash has left the country's economy vulnerable to the current recession, but also will be largely responsible for the recovery.[49]

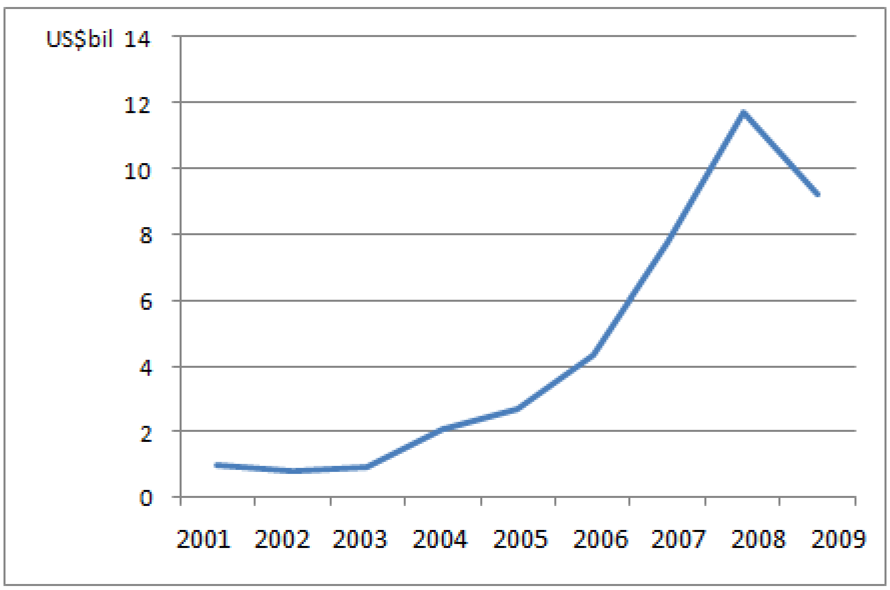
Bulgarian policymakers could no longer afford to simply declare themselves immune (as the socialist party had done at the beginning of the crisis) and hope for the best. Rather, the country that had relied so heavily on its peg to the euro for its development during the previous decade would now have to confront the reality that currency contagion from its Greek neighbors could seriously undermine stability and recovery going forward.

As of late spring 2010, however, Greek contagion and currency risk remain real concerns. While the direct threat posed by Greek banks in Bulgaria remains an issue under debate, larger currency fears over the possible effects of the "Greek crisis" on the euro continue to grow in Brussels, in capitals throughout Europe and in the global currency markets. With so much riding on the success of the euro, Bulgaria once again finds itself undeniably exposed and vulnerable to the wider challenges the EU is now grappling to address.

The Collapse in Real Estate and Building

As discussed earlier in this report, Bulgaria's permissive operating environment, coupled with almost unlimited "green field" building opportunities and a strong public desire for development provided builders with ample opportunities to cash in on everything from a boom in Black Sea tourism (fueled by the proliferation of discount airlines operating in Eastern Europe's secondary markets) to cheap skiing in Bulgaria's two mountain ranges, to resort and spa villages to be populated by British holiday-makers, Japanese retirees and others. The problem was that, as with all bubbles, real estate and tourism in Bulgaria became a dangerous game of "hot potato." And when the game was over, too many times it was Bulgarian investors and entrepreneurs left holding the potato, with no options for unloading.

Figure 5: Foreign Direct Investment in Bulgaria, Net Inflows (BoP, current US$, in billions)



Source: Adapted from the World Development Indicators, The World Bank, data accessed April 21, 2010, available at: http://data.worldbank.org/data-catalog

Foreign investment in Bulgarian real estate between 2006 and 2008 accounted for more than €2 billion, compared with €300 million in the previous three years.[50] In early February 2010, however, real estate investors polled by Reuters said that Bulgaria was no longer even on their radar screens as a destination for investment. In an analysis of whether investors were ready to go back to Bulgaria's property sector, Richard Peterson of real estate services company Cushman & Wakefield said investors were now put off by Bulgaria's threadbare infrastructure, which he claimed would take at least 20 years to develop.[51]

This would become a significant contributing factor in the swelling of Bulgaria's inter-company debt (discussed in greater detail in Part 3). As Bulgarian real estate owners and investors saw equity in highly leveraged properties turn sharply negative, lines of credit were cut or rates were increased, leaving private persons and businesses increasingly unable to meet obligations further down the chain. The author of this report was availed of multiple first-hand accounts of business owners offering, or being offered, property as a means of payment for services and goods delivered. Yet for any practical purposes, the immediate value of many of these properties approached zero. By this point, even vulture investors, who could have provided some cash flow to property owners, were largely absent.

Budgetary Management during 2008-2009

Early 2010 analysis by the Sofia Echo argued that Bulgaria's economic woes during the crisis have been exacerbated by poor planning at the end of 2008:

> Despite a hasty redrawing of the 2009 Budget, it still set unattainable goals for economic growth and revenue collection. The tripartite government of socialist prime minister Sergei Stanishev envisaged 4.7 per cent economic growth in its 2009 Budget and was roundly criticised for being unrealistic both at home and abroad. Somewhat incongruously, however, that was not the figure used to draft the Budget spending, a more cautious 2.1 per cent estimate being used instead. The use of this conservative figure won the government a small amount of praise from the International Monetary Fund (IMF) and the European Commission, both of which were moderately optimistic early in the year that Bulgaria would avoid a recession and post mild economic growth. The ruling coalition, however, gave no satisfactory answer to why it had used two figures in the first place.[52]

At the end of a week-long visit to Bulgaria on April 22, 2009, IMF mission head Bas Bakker insisted that the 2009 budget, which was drafted in September 2008, was unrealistic and had to be altered. The IMF called on Bulgaria to revise the budget, insisting that existing plans to curb spending would not be sufficient to avoid a deficit, or even to meet targeted surplus of 3% of GDP. The 2009 budget targeted a surplus equivalent to 3% of GDP, but gave the government leeway to run this surplus down to 1% of GDP in order to support the economy during the economic slowdown. However, with budget revenue starting to come under pressure, the prospect of a budget deficit began to loom large. At the same time, however, it was seen as imperative that the government avoid a budget deficit in order not to exacerbate the country's financing needs or dent investor confidence, which was particularly sensitive given that Bulgaria operates a currency board, and the euro pegs of other east European states, such as Latvia, had been in question.[53] Key policy findings from the April 22, 2009 IMF mission report included the following:

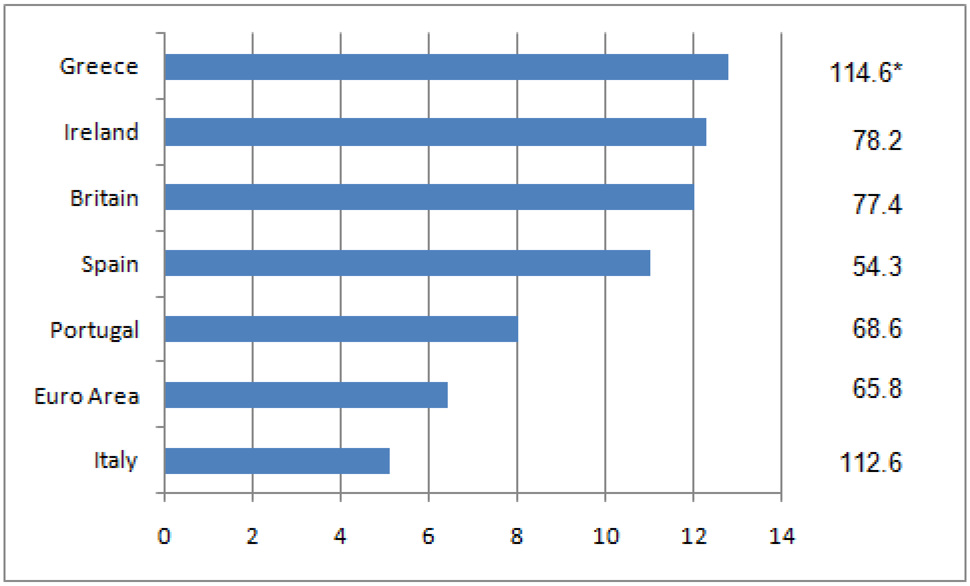
- The original budget, which envisaged 16% tax revenue growth, was too optimistic
- Ideally, the budget should be adjusted to reflect the new revenue realities
- It is desirable and should be feasible to maintain a small surplus in 2009
- To sustain a future recovery, private sector resources will need to be shifted to export-oriented sectors
- It is important to have strong legal and institutional frameworks in place that support corporate workouts, restructuring and bankruptcy procedures
- EU funds can play an important role in Bulgaria's development, and it is important that available resources be utilized[54]

Bulgaria's cabinet again invited an IMF mission to review the government's economic stimulus plans in the fall of 2009. In a statement, a mission representative summed up the review:

> Bulgaria started the downturn with considerable public sector buffers, including a large fiscal surplus and sizeable reserves in the fiscal reserve account…These buffers were important given its large private sector vulnerabilities – after years of large capital inflows, private sector external debt had increased to about 100 percent of gross domestic product. Capital inflows fuelling consumption generated robust tax revenue in previous years, allowing Bulgaria to maintain a Budget surplus even as government spending increased. But the revenue boom is now over and unless the Cabinet stemmed the spending increase, the fiscal surplus could soon turn into a large deficit.[55]

Accordingly, in early 2010, the Ministry of Finance reported that Bulgaria had finished 2009 with a budget deficit of BGN 500 million. However, this figure was not unmanageable, and was in fact the lowest budget deficit of any EU country. At the time the figures were released, the ministry cited reforms in the customs and tax administrations – as well as measures against trafficking and the fight against schemes for VAT draining – as key contributing factors to the low deficit figure.[56] In February 2010, the 2009 budget deficit was revised upward to BGN 530 million due to increases in December 2009 that were unaccounted for in the initial estimates.[57]

Figure 6: EU Budget Balances as % of GDP (2009 estimates)



Source: Adapted from The Economist, *A Very European Crisis,* February 4, 2010; *indicates debt as % of GDP

Progress Since 2008

Enterprise profitability, export performance, strong business and consumer confidence and rising real incomes boosted growth in Bulgaria through the first three quarters of 2008. However, the turmoil in global financial markets and an unfolding global recession dampened confidence, reduced the flow of new export orders and eroded domestic demand in 2009.[58] In January-November 2009 general budget revenue declined by around 11% year on year and expenditure increased by around 12%. The GERB cabinet has stated aims to keep expenditure tight in 2010, both through cost savings at the ministries and lower state investment spending, particularly in the energy sector. The number of public-sector workers has also been reduced and will likely be reduced further in 2010.[59]

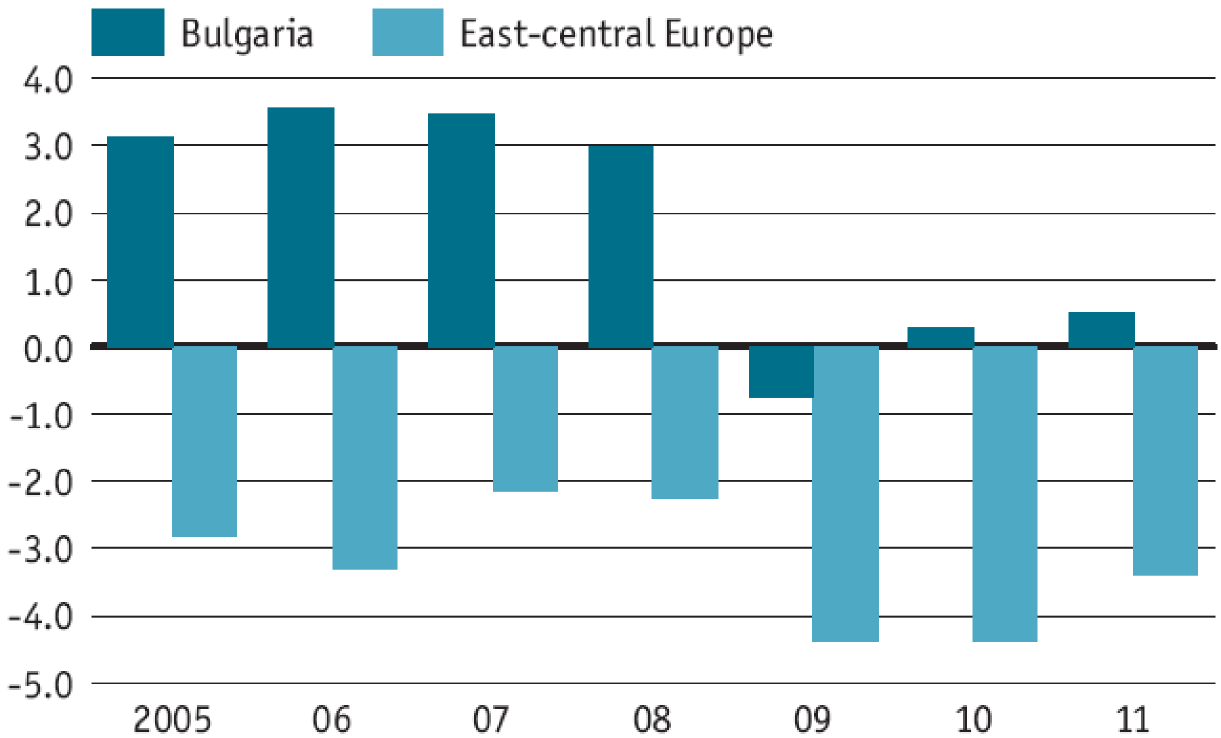
While Bulgaria's tax environment remains fluid, according to early 2010 analysis by Global Insight recent reforms have been moving the tax system in the right direction. Putting a lid on widespread tax evasion is high on the governmental agenda and in January 2010 the Bulgarian National Revenue Agency announced a higher number of companies to be taxed in one of the highest tax brackets in the country. Criteria for companies to qualify for this bracket include revenues of over BGN 20 million in 2008, 120 or more employees, tax and insurance payments of more than BGN 2 million in 2008 and refunds of more than BGN 2 million. Almost 1,500 companies will fall into this category once the decision is implemented. Yet, while the measure may be a means to boost the funds of the financially stricken state, to be a resounding success in the eyes of the European Commission, it would also need to be accompanied by readily applied anti-corruption measures and greater transparency in the recording and managing of the received taxes.[60] As of spring 2010, no such planned accompanying measures had been made public.

The national draft budget for 2010 was designed to be balanced, although the EU funds component leads to a deficit equivalent to 0.7% of GDP. However, this budget was predicated on a further 2% contraction of GDP in 2010 and economic forecasts are not in agreement that GDP will continue to contract throughout 2010. A 2010 report by the Economist Intelligence Unit forecasts GDP growth of 0.6% in 2010, before a return to stronger growth in 2011. Under these assumptions, Bulgaria should return to small surpluses in 2010 and 2011.[61]

Meanwhile, signals from the IMF after officials visited Sofia in late February 2010 were mixed: "The global recovery is now boosting Bulgaria's exports," IMF Mission Chief Bas Bakker said, continuing: "Domestic demand is expected to decline further and the investment boom continues to unwind and consumption suffers from the decrease in employment." Bakker warned that meeting the 0.7% deficit target in 2010 would be "challenging" and was cautious in his comments on plans to reduce the valued-added tax rate from 20% to 18%. Rather, the IMF estimated Bulgaria's budget deficit to stand at a higher figure of 1.8% of gross domestic product for 2010, totaling nearly BGN 1.2 billion.[62]

Nonetheless, by early 2010, the Wall Street Journal had declared that Bulgaria, the newest and poorest member of the European Union, was emerging as a fiscal model for a number of EU countries struggling to fend off debt crises. Officials in Sofia had frozen government wages and pensions, mothballed costly state investment projects, raised taxes on tobacco and slashed government spending by 15%.[63] This cut in public spending was the biggest fiscal limitation in the European Union.[64] In the race to the euro, the Journal further predicted, Bulgaria was also in position as of mid-January 2010 potentially to outpace Poland, where policymakers have been cautious about entering the currency club.[65] Bulgaria's future progress toward the euro is covered in greater detail later in this report.

Figure 7: Budget Balance - Bulgaria versus East Europe, 2005-2011



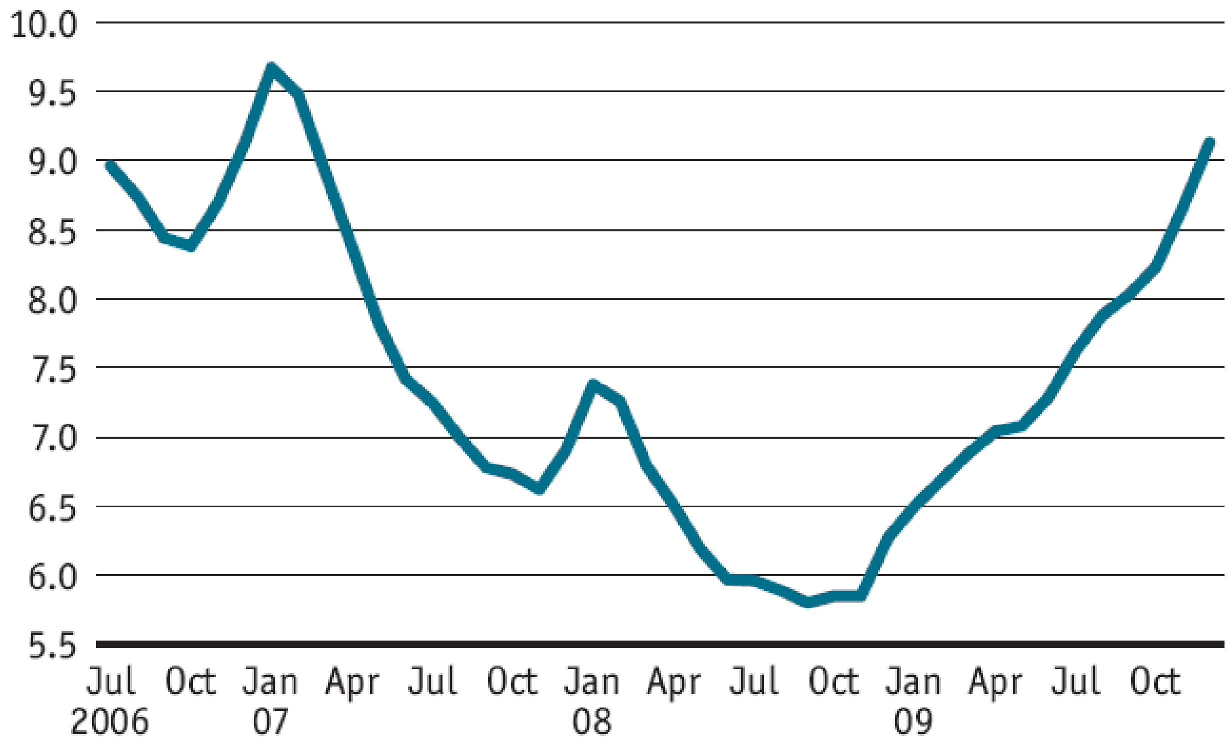
Source: Economist Intelligence Unit, Country Report: Bulgaria, February 2010

Welfare Expenditures

Since July 2009, expenditure growth has fallen markedly across most categories of spending. Social expenditure, which accounts for around 40% of total expenditure, came down moderately. Meanwhile, spending on maintenance costs, which accounted for 16.8% of total expenditure, was significantly lower in year-on-year terms, as was spending on wages, which accounted for 16.3% of the total, and capital expenditure, which made up 14.5% of total spending. This tightening of the purse strings was deemed necessary, as the performance of tax revenue continued to deteriorate in August and September of 2009, and a look at the absolute numbers reveals that expenditure cuts were an important factor in stabilizing the budget: Tax revenue averaged BGN 1.7 billion per month in March-July and BGN 1.6 billion in August-November, whereas average monthly expenditure dropped from BGN 2.2 billion a month in March-July to BGN 1.9b billion in August-November.[66]

In late 2009, Bulgaria's Labor Ministry announced pans to invest more than BGN 1 billion in the labor market in 2010 in order to tackle unemployment: BGN 250 million from the EU funds under the "Development of Human Resources" Operational Program, BGN 400 million from the state budget and BGN 400 million to be retained by Bulgarian businesses upon reduction of social security payments by 2% starting January 1, 2010.[67]

Figure 8: Unemployment in Bulgaria, July 2006-October 2009



Source: Economist Intelligence Unit, Country Report: Bulgaria, February 2010

Government Debts to the Private Sector

According to early January 2010 analysis by the Sofia Echo, "early in 2009, reports surfaced claiming that as much as half of the BGN 900 million national budget surplus recorded in January, which appeared to vindicate the cabinet's Budget calculations, was due to delayed value-added tax (VAT) refunds. The money boosted the budget revenues and bottom line, masking the deficit, but also made it increasingly difficult for businesses to meet their business plans."[68] By the end of June 2009, the analysis continues, with tax authorities reportedly putting no stop to the practice, the budget surplus shrank to BGN 173 million, while delayed VAT refunds had reached BGN 700 million, according to then-new Finance Minister Simeon Dyankov.[69]

> [Finance Minister Simeon] Dyankov took office saying that Bulgaria faced a Budget deficit of 2.5 billion leva at the end of 2009. He immediately cut 15 per cent of the ministries' budgets to save 1.16 billion leva and targeted 1.2 billion leva in additional revenue from improving excise duties collection…By the end of the year, the Cabinet managed to halt the slide, posting small surpluses in October and November…to reduce the consolidated Budget deficit below the 500 million leva target the new Government set…Just like the numbers announced by Dyankov's predecessor, Plamen Oresharski, this figure tells only part of the story. The Government's short-term debt to the private sector has ballooned over the second half of the year, with different estimates placing the figure at between one billion and two billion leva, a debt that Borisov vowed to begin repaying in January and February 2010.[70]

As of early 2010, however, Dyankov had refused repeatedly to use even a small amount of the BGN 8.1 billion accumulated in the country's fiscal reserve to inject cash into the economy by paying off some of the government's debts to the private sector. Dyankov said in December 2009 that it would be the fastest way to pay back what the government owed companies, but he remained reluctant to do so, instead choosing to focus on finding other possible sources of financing, including the issuing of domestic bonds and foreign loans[71] (discussed in Part 3 of this report).

Yet while Bulgarian businesses would welcome any move that would boost cash flow, it was debatable how much a sum even as large as BGN 1 billion would help in unclogging the bottlenecks in the private sector. According to data from the Bulgarian Industrial Association, one of the biggest employer bodies in the country, inter-company debt outside the financial sector stood at BGN 90 billion at the end of 2008 and the figure was estimated to have increased by 30% in 2009. Meanwhile, firms owed a further BGN 70 billion to banks and other financial institutions, as well as outstanding payroll payments to staff, at the end of 2008.[72]

In early 2010, the Bulgarian cabinet offered a deal to private sector entities waiting to recoup money owned to them by the government: if firms gave up 10% of the sum owed to them by the state, they would receive monies owed sooner – i.e., in February-March 2010. Should they not agree to those terms, however, they would simply have to wait until funds became available, a period with no set parameters. Martin Dimitrov, one of the co-chairs of the rightist Blue Coalition (which, in principle, backs the Borisov cabinet) criticized the government for not having a clear program for repaying its debts to the private sector, labeling the deal on offer a "racketeering approach," and asking for a public register of all state debts.[73]

As of March 2010, the Bulgarian state continued to owe about BGN 600 million in VAT refunds to businesses, according to official information of the Finance Ministry. Ninety percent of the delayed payments are due to the construction sector.[74] In February 2010, Finance Minister Simeon Dyankov affirmed that the government would return all of the overdue VAT rebate payments to private companies by the start of April 2010. Dyankov said that BGN 160 million had so far been returned from the overdue payments, with an extra BGN 420 million still left to refund.[75] Meanwhile, Bulgaria's Minister of Regional Development and Public Works, Rosen Plevneliev, promised that all overdue payments to businesses would be made by the end of May 2010, admitting that payments could not be made by the end of March, as previously agreed with the Construction Chamber.[76]

The Role of Multilateral Institutions

In March 2010 The Economist offered praise for the role played by multilateral institutions in helping to stabilize Europe's newest member states during the economic crisis:

> International organizations…deserve some praise. The European Bank for Reconstruction and Development helped stabilise the region's banks, bringing foreign lenders together to ensure an orderly deleveraging instead of a rout. Both the European Commission and the European Central Bank realised that problems beyond the euro area could create headaches inside it. Their cheap loans helped foreign creditors and countries alike. And the IMF showed itself to be a collegial and flexible organisation, not the aloof, rigid outfit that EU leaders have foolishly rejected as a source of help for Greece and other troubled members of the euro.[77]

Bulgaria, however – the EU's poorest member, which relied on foreign funding for a quarter of its gross domestic product in 2009 – avoided the route taken by richer neighbors such as Romania and Hungary, both of which received IMF-led rescue packages. On September 21, after concluding its review of Bulgaria's finances, the IMF said that no negotiations concerning a possible bailout package were held during the visit.[78] Bulgaria's economic progress as of early 2010, rather, had some predicting that the country could leapfrog longtime euro aspirants, such as Romania and Hungary, where sharp downturns required bailouts from the International Monetary Fund.

Leading Bulgarian economists and financial experts who held a meeting with Deputy Finance Minister Ani Mihaylova in late 2009 expressed a uniform belief that the need for Bulgaria to access an IMF loan was diminishing. The group indicated that Bulgaria was increasingly unlikely to seek an emergency loan from the International Monetary Fund, favoring instead the launch a Eurobond in early 2010 to meet external financing needs (discussed in greater detail in Part 3 of this report).[79] Yet as of late 2009, the government had not ruled out the possibility of seeking aid from other international financial institutions, such as the World Bank, International Bank for Reconstruction and Development or the European Investment Bank.[80] According to Finance Minister Simeon Dyankov, the decision not to tap the IMF was based largely on the fact that Bulgaria would not qualify for the multilateral lender's new flexible credit lines, which offered loans without intrusive policy prescriptions.[81]

Part 3 > Outlook > The Future of Business in Bulgaria

In March 2010, The Economist captured the mix of surprise and relief that a crisis-gripped Europe felt regarding adept crisis management in the capitals of the EU's newest member states:

> In the depths of the financial crisis a year ago, it was easy to see how the woes of the ex-communist economies could cause huge problems for the rest of Europe. Western banks had lent recklessly in foreign currency to firms and households stricken by the downturn. If they all fled for the exit at once, dumping assets and stopping lending, the result would be carnage both at home and abroad…In the event, the ex-communist economies have so far ridden out the storm.[82]

According to analysis by IHS Global Insight, however, continued austere fiscal policy will be required through 2010 to prevent continued declines in FDI and negative repercussions among potential investors in Bulgaria. In 2009, shrinking external payments deficits were still entirely covered by dwindling foreign direct investment, but Bulgaria could face an even harder adjustment, according to IHS, "if foreign capital inflows shrink markedly further, as the country's trade and payments deficits—although significantly narrowed by slack domestic demand—would not be sustainable without support from multilateral financial institutions in that case."[83]

In December 2009 Bulgaria's gross external debt increased to €37.6 billion (111.1% of GDP) from €37.12 billion in the previous month. A year earlier, the gross debt stood at €36.97 billion. In these figures, general government external debt amounted to €2.81 billion, at 8.3% of GDP, marking an increase of €209.6 million on a year-over-year basis. Private non-guaranteed external debt, meanwhile, rose 1.4% to €33.46 billion in the last month of the year, while public and publicly guaranteed external debt increased to €4.14 billion in December.[84]

Meanwhile, as in most of emerging Europe, the economic downturn in the region dramatically reduced Bulgaria's external trade and payments imbalances for 2009. Although weakened external demand slashed exports, domestic demand and its substantial import component were even more drastically cut back in relative terms due to tight credit conditions, declining business confidence and rising unemployment. Moreover, the absolute size of the cut in imports was boosted by the higher statistical base. During this period, Bulgaria relied on a steady stream of FDI for non-debt financing of its current-account deficit.[85] The global recession took a toll on FDI in Bulgaria in 2009, slashing the 11-month figure for incoming FDI to €2.63 billion (down 56.5% y/y). However, thanks to the smaller payments imbalance, that FDI covered 102.9% of the current-account deficit in January-November 2009, compared with only 78.7% in the same period a year earlier.[86]

According to the preliminary estimate by the Bulgarian National Bank, the current-account deficit in the first 11 months of 2009 reached €2.556 billion, or 7.6% of GDP, down from €7.688 billion, or 22.5% of GDP, in the same period a year earlier. This marked an improvement in Bulgaria's external payments position by €5.132 billion, or 67.8% year-on-year. The improvement in the cumulative current-account balance throughout the first 11 months of 2009 was primarily explained by the dramatic reduction in the deficit on merchandise trade: merchandise exports were down by 24.3% y/y, to €10.803 billion. Other contributing factors included:

- Imports were even more significantly down, by 34.6% y/y, to €14.53 billion

- The merchandise trade deficit in January-November 2009 therefore came to €3.727 billion, €4.23 billion less than in the year-earlier period
- The remainder of the improvement in the January-October current-account balance can be ascribed to a larger surplus on non-factor services y/y, as well as a reduced deficit on income items
- The surplus on non-factor services in January-October 2009 amounted to €1.367 billion, a y/y improvement of €529.2 million
- The deficit on income items in the first 11 months of 2009 amounted to€ 657.6 million, a €414.0 million improvement.
- These improvements were modestly offset by a deterioration in net current transfers of €40.6 million y/y, to €461.5 million, as worker remittances reflected the unfavourable labour-market conditions in Europe[87]

Bulgaria's impressive comeback from the throes of the 1996-97 financial crisis, to achieve respectable annual growth levels in the range of 5-6% through the most recent period, turned it into one of the most attractive markets in the Balkans for foreign investors through much of the last decade. As of March 2010, however, the outlook for Bulgaria's recovery in early 2010 is more mixed.Real GDP is estimated to have contracted by 5% in 2009, because of limited external finance and the poor economic performance of the euro zone. Growth is forecast to rebound weakly, to 0.6%, in 2010, before trending up to 3.2% in 2011 as both private consumption and investment begin to grow again more strongly.[88]

As of April 2010, substantial fiscal reserves – BGN 8.2 billion left by the previous government – that had been built up during the period of rapid economic expansion are helping to stave off freefall in the current crisis. However, as discussed previously in this report, monetary policy is essentially unavailable, due to the currency board, and a cautious fiscal stance is required. As analysis by IHS Global Insight highlights, the restricted ability of the government to provide any stimulus leaves open the possibility of a weak economic recovery or even a relapse into stagnation or recession.[89]

Managing the Economy through Crisis

Bulgarians have their hands tied by a currency board that pegs the lev rigidly to the euro. That rules out devaluation to restore competitiveness, which is a concern as exports sag. It also removes a potential buffer, because the central bank cannot adjust interest rates.[90] In February 2010, the Economist Intelligence Unit summed up Bulgaria's economic policy outlook as such:[91]

> As monetary policy is constrained by the currency board, the emphasis falls on fiscal policy. Since coming to power in July, the CEDB (GERB) government has been tightening fiscal policy to try to avoid a deficit. Fiscal policy will remain tight in 2010-11, when the government plans to reduce the rate of social security tax in order to lower the tax burden on businesses to aid economic recovery. To offset this, the state will reduce its redistributive role and rationalise state holdings in the industrial sector in 2010-11…The government's recovery plan also includes better absorption of EU funds and improvements to the business environment. Better absorption of EU funds should slowly lead to infrastructural improvements.

One saving grace is that Bulgaria's fiscal position remains fairly strong. However, two bulwarks of fiscal planning just two years ago – little foreign debt and a budget surplus – are no longer givens.

Figure 9: Key Economic Indicators, Bulgaria

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Real GDP (% change)	6.3	6.2	6.0	-5.1	1.4	3.8	4.0	3.9	3.8
Nominal GDP (US$ bil.)	31.7	39.5	49.9	46.5	47.5	53.5	59.9	64.1	66.0
Nominal GDP Per Capita (US$)	4,117	5,174	6,573	6,164	6,330	7,180	8,088	8,716	9,029
Consumer Price Index (% change)	7.3	8.4	12.3	2.8	2.0	3.4	2.9	2.5	2.1
Policy Interest Rate (%)	3.26	4.58	5.77	0.55	1.50	3.75	3.75	3.75	3.75
Fiscal Balance (% of GDP)	3.6	3.7	3.0	-1.0	0.0	0.3	0.0	0.0	-1.0
Population (mil.)	7.69	7.64	7.59	7.54	7.50	7.45	7.40	7.36	7.31
Unemployment Rate (%)	9.0	6.9	5.6	7.6	7.3	6.9	6.6	6.2	5.7
Current Account Balance (% of GDP)	-18.5	-25.4	-25.2	-10.9	-12.5	-11.8	-11.1	-9.9	-8.4
BOP Exports of Goods US$bn	15.1	18.6	22.7	16.5	17.6	19.2	20.9	22.7	24.7
Exchange Rate (LCU/US$, end of period)	1.49	1.33	1.39	1.36	1.39	1.32	1.26	1.30	1.32

Source: IHS Global Insight, Country Report: Bulgaria, February 21, 2010

Figure 10: Snapshot of Doing Business in Bulgaria, IFC

BULGARIA		Eastern Europe & Central Asia		GNI per capita (US$)	5,487
Ease of doing business (rank)	44	Upper middle income		Population (m)	7.6
✔ **Starting a business** (rank)	50	✔ **Registering property** (rank)	56	**Trading across borders** (rank)	106
Procedures (number)	4	Procedures (number)	8	Documents to export (number)	5
Time (days)	18	Time (days)	15	Time to export (days)	23
Cost (% of income per capita)	1.7	Cost (% of property value)	2.3	Cost to export (US$ per container)	1,551
Minimum capital (% of income per capita)	20.7			Documents to import (number)	7
		Getting credit (rank)	4	Time to import (days)	21
Dealing with construction permits (rank)	119	Strength of legal rights index (0-10)	8	Cost to import (US$ per container)	1,666
Procedures (number)	24	Depth of credit information index (0-6)	6		
Time (days)	139	Public registry coverage (% of adults)	34.8	**Enforcing contracts** (rank)	87
Cost (% of income per capita)	436.5	Private bureau coverage (% of adults)	6.2	Procedures (number)	39
				Time (days)	564
Employing workers (rank)	53	**Protecting investors** (rank)	41	Cost (% of claim)	23.8
Difficulty of hiring index (0-100)	17	Extent of disclosure index (0-10)	10		
Rigidity of hours index (0-100)	40	Extent of director liability index (0-10)	1	**Closing a business** (rank)	78
Difficulty of redundancy index (0-100)	0	Ease of shareholder suits index (0-10)	7	Time (years)	3.3
Rigidity of employment index (0-100)	19	Strength of investor protection index (0-10)	6.0	Cost (% of estate)	9
Redundancy cost (weeks of salary)	9			Recovery rate (cents on the dollar)	32.1
		Paying taxes (rank)	95		
		Payments (number per year)	17		
		Time (hours per year)	616		
		Total tax rate (% of profit)	31.4		

Source: IFC Doing Business 2010 report

Private Debt

On December 16, 2009, Bulgarian National Bank figures showed that foreign direct investment in the country from January to October 2009 was €2.3 billion, substantially down from the €5.8 billion registered in the equivalent period in 2008.[92] Most predictions hold that FDI inflows in 2010-11 will be much lower than in 2006-08, with inter-company lending, although much diminished, remaining a key source of external financing for foreign-owned companies in Bulgaria.[93]

According to data from the Bulgarian Industrial Association, one of the biggest employer bodies in the country, inter-company debt outside the financial sector was BGN 90 billion at the end of 2008 and the figure was estimated to have increased by 30% in 2009. Analysis by the Sofia Echo describes the private sector debt picture heading into 2010:

> On top of [inter-company debt], firms owed a further 70 billion leva to banks and other financial institutions, as well as outstanding payroll payments to staff, at the end of 2008. The lack of efficient and quick debt collection procedures to settle disputes between creditors and insolvent companies has contributed to the swelling of the inter-company debt, while at the same time increasing the risk of chain bankruptcies, an outcome long predicted by some business associations that is yet to materialise.[94]

As discussed earlier in this report, the private debt picture will continue to be a drag on the economy moving forward, as chains of unpaid debts between businesses and individuals compound an already congealed liquidity scenario. Additionally, bankruptcies, lawsuits and other protection and legal workout procedures related to the bust will continue to overshadow business in Bulgaria for years to come, creating real costs in terms of further clogging an already overburdened court system and siphoning the resources and attention of much of the country's business and entrepreneurial base away from more constructive efforts in the mid-term.

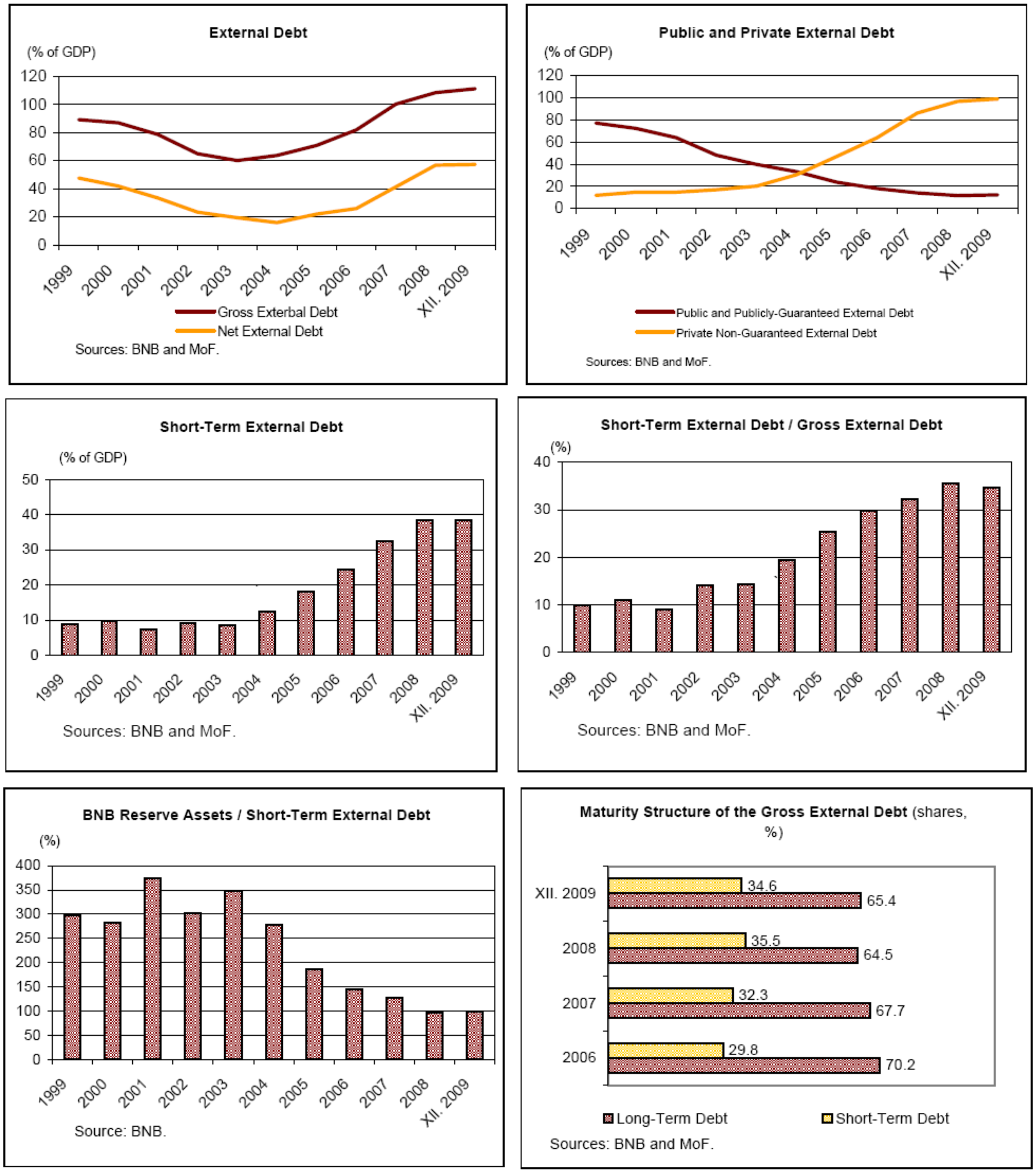
Managing Foreign Debt

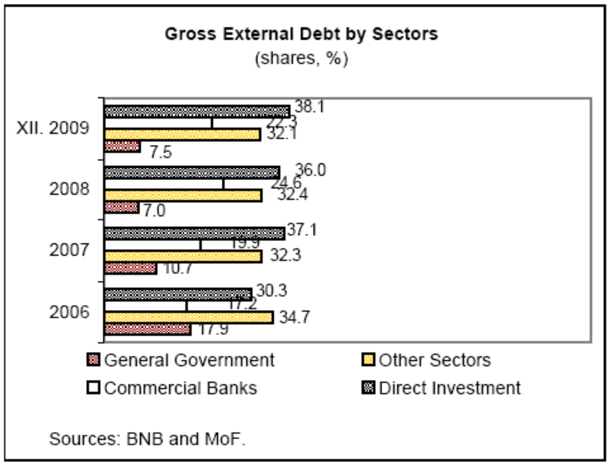
With the 2007 current-account deficit at over 21% of GDP, and at over 25% for 2008, financing the deficit became increasingly difficult toward the end of the boom, relying heavily on foreign capital. However, contracting domestic economic activity slashed import demand even more rapidly than exports, and from a higher base. Thus, as of early 2010, trade and payments deficits were narrowing.[95] The steep drop-off in net private capital inflows that accompanied the global financial crisis was therefore of particular concern for the Bulgarian economy during 2008-2009. At the time the crisis hit, Bulgaria had a double-digit current-account deficit, leaving the country vulnerable to the seemingly inevitable foreign capital reversals that would follow.

According to analysis by Roubini Global Economics in early 2009, another major concern was that a large part of recent investment has funded activities in the non-tradable sector, the productivity enhancing capacity of which was unclear. Meanwhile, the drop-off in FDI inflows over this period meant increased debt financing of the current account deficit. Citing economist Seppo Honkapohja on examination of the Nordic crises of the 1990s, Roubini explains that "a country may be able to withstand a relatively high level of international indebtedness, provided its economic growth remains solid, the debt is largely long-term, and the confidence of international investors remains intact."[96] However, given today's global risk sensitivity, sharply slowing economic growth and Eastern European countries' high external vulnerability indicators, such high external debt-to-GDP ratios became problematic as the crisis broadened.[97]

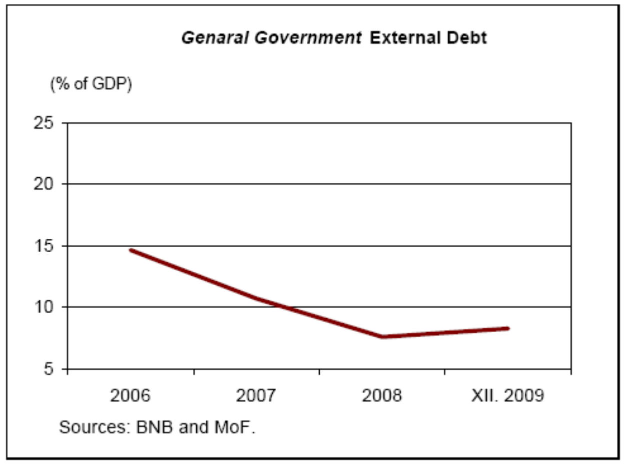
Bulgarian exports picked up at the end of 2009. Many attributed the results to a recovery in European economies, which accounted for 80% of Bulgaria's exports. Coupled with declining consumer spending at home, the increase in exports helped to halve the Bulgarian trade deficit, while the current account gap fell threefold from 2008 levels. Analysts point out, however, that this cuts both ways: The upside is that Bulgaria should dodge external debt trouble as FDI continued to cover the current account gap at the beginning of 2010. The downside is that weaker imports of investment products could lead to recession.[98]

Figure 11: Bulgarian External Debt Figures

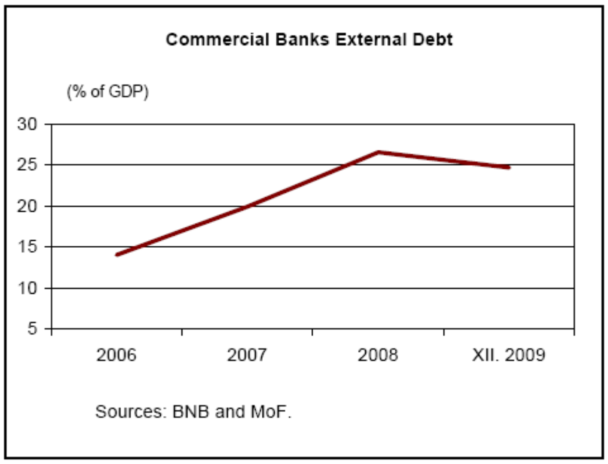




Sources: BNB and MoF.



Sources: BNB and MoF.



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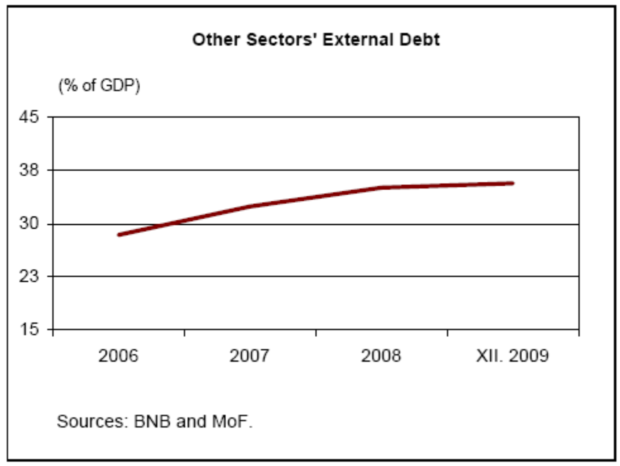
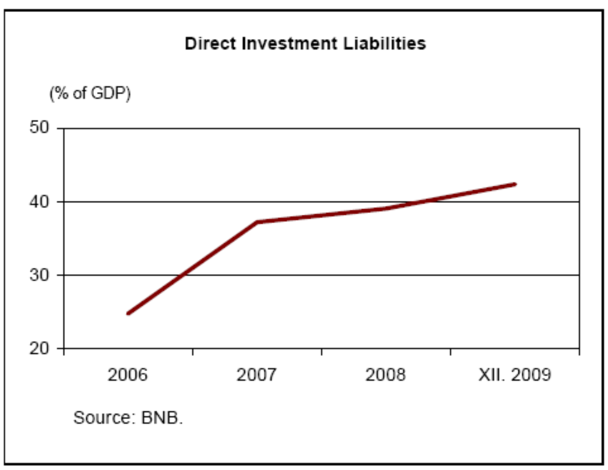
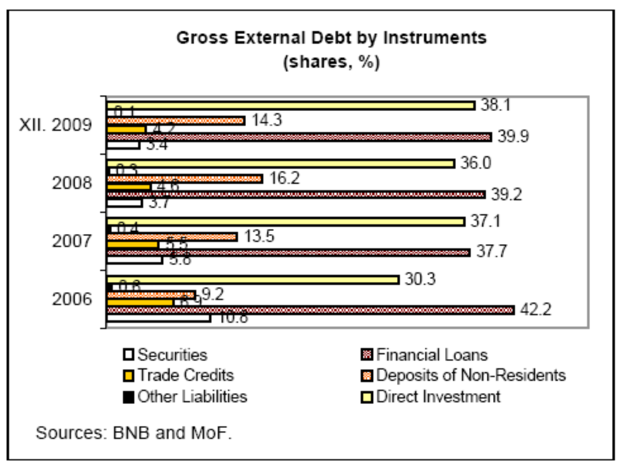


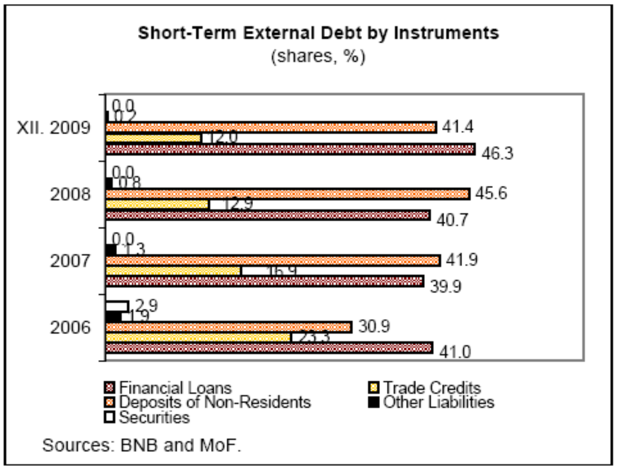
Sources: BNB and MoF.

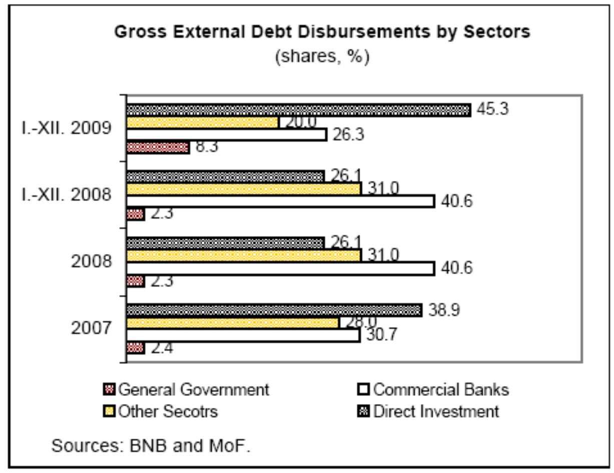


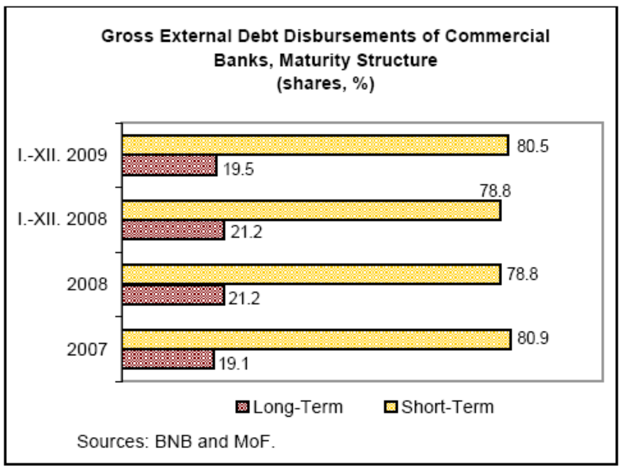
Source: BNB.

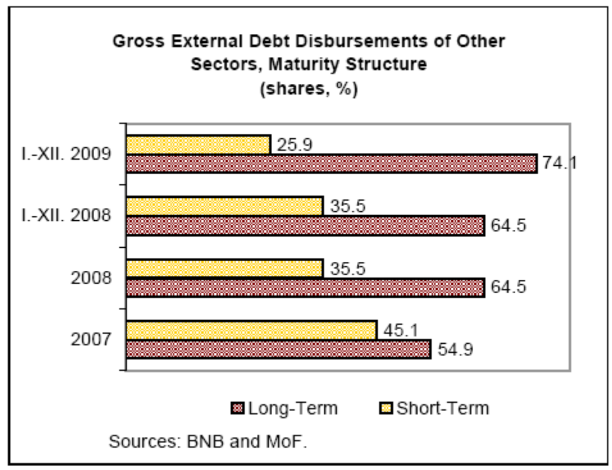


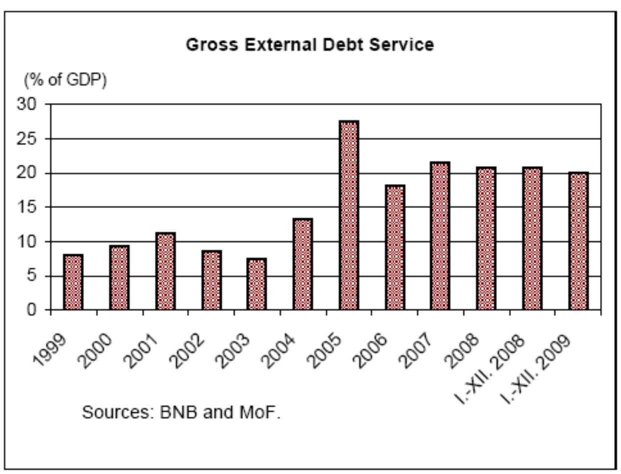
Sources: BNB and MoF.

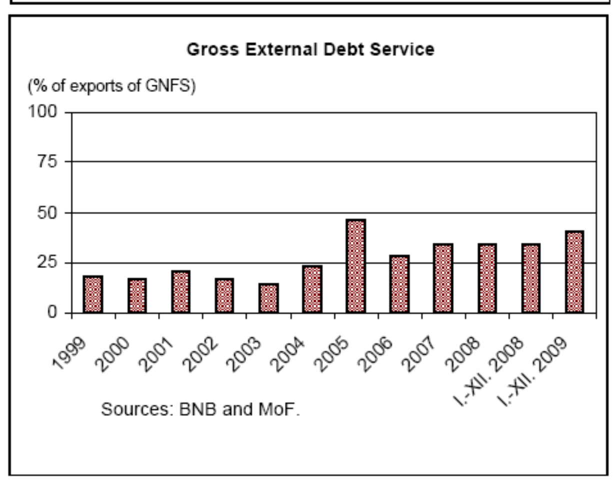












Source: Bulgarian National Bank, Gross External Debt of Bulgaria: December 2009, Publish date: February 23, 2010, p. 32-34, available at: www.bnb.bg

Consumption Trends

During 2009 and early 2010, private consumption was declining significantly in Bulgaria as a result of a poor outlook for jobs and wages, limited availability of borrowing, the repayment of debt and the negative wealth effect from lower house prices.[99] Owing to a sharp contraction in domestic demand, the

Economist Intelligence Unit estimated in February 2010 that the current account deficit narrowed from 25.2% of GDP in 2008 to 7.8% of GDP in 2009, and forecast that it will average about 6.2% of GDP in 2010-11.[100] The upside to this picture is that the decreased imports attributable to low domestic demand has helped to narrow the current account deficit. Low domestic consumer demand will also help to keep inflation in check, which is a positive for Bulgaria's peg to the euro. These figures also point to an economy that will likely continue to be dominated by export-oriented investment going forward.

Likewise, according to the concluding statement of the IMF's April 2009 mission to Bulgaria, to sustain a future recovery, private sector resources will need to be shifted to export-oriented sectors:

> The sectors that have contributed the bulk of the growth in recent years (financial sector, real estate, construction) were dependent on large capital inflows. With a prolonged drop in capital inflows, these sectors are likely to decline in the near future and may see little, if any, growth thereafter. A market driven reorientation toward the tradable sectors is needed. This will only be possible if the rapid rise in unit labor costs of recent years comes to an end. Anecdotal evidence suggests that wages are indeed slowing rapidly, but it will be important that wage moderation is sustained.[101]

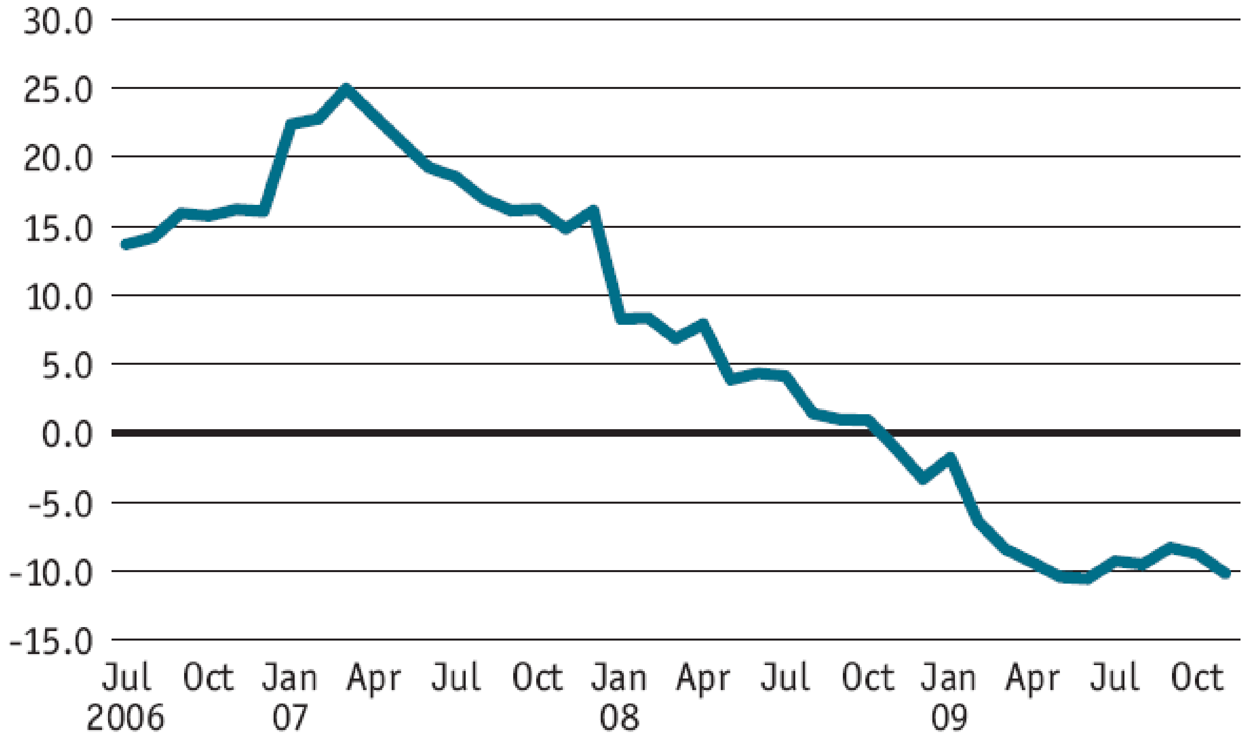
Analysts polled by Dnevnik news agency in early 2010, however, said that reviving exports will not be enough to ensure a sustained economic recovery in Bulgaria – a view that clashed with stated government expectations that exports would be the engine behind GDP growth in 2010. Unless depressed household and consumer demand perked up, analysts maintained, the economy could not be expected to do more than eke out a meager increase, and this would not be sufficient to lift it out of its current state. Christopher Pavlov, chief economist at UniCredit Bulbank, summarized the view:

> "Economic recovery in Bulgaria is underway and obviously it depends on exports. At the same time, going back to sustainable growth will be impossible without a rebound in household spending, which will be a more prolonged process…We believe sustainable recovery will be impossible before the economy has started to create jobs, lending has returned to normal growth rates and the property market has stabilized."[102]

In the fall of 2009, Moody's issued a report significantly pushing back predictions for when Central and Eastern European economies would achieve per-capita income parity with their EU counterparts. Pre-crisis predictions for Bulgaria to reach parity with Western nations initially stood at 15-20 years. The new guidance, however, pushed expectations of convergence to 40-45 years, following the effects of the crisis.[103]

Meanwhile, in the summer of 2009, management consulting firm A.T. Kearney ranked Bulgaria 21st among 30 global emerging markets in its Global Retail Development Index. The study, which gauges markets by factors such as saturation, attractiveness and country risks, placed Bulgaria five spots lower than the previous year, trailing Turkey but still ahead of Romania and Croatia. Global economic deterioration continues to take its toll on Bulgaria, hitting hardest at sectors heavily dependent on credit purchases, according to Jan Van der Oord, who ran the company's Bulgarian, Serbian and Hungarian operations. He added, however, that the Bulgarian market still offered a raft of modern retail format opportunities and was far from consolidation at the time the study was concluded, giving the market continuing appeal for foreign retailers.[104]

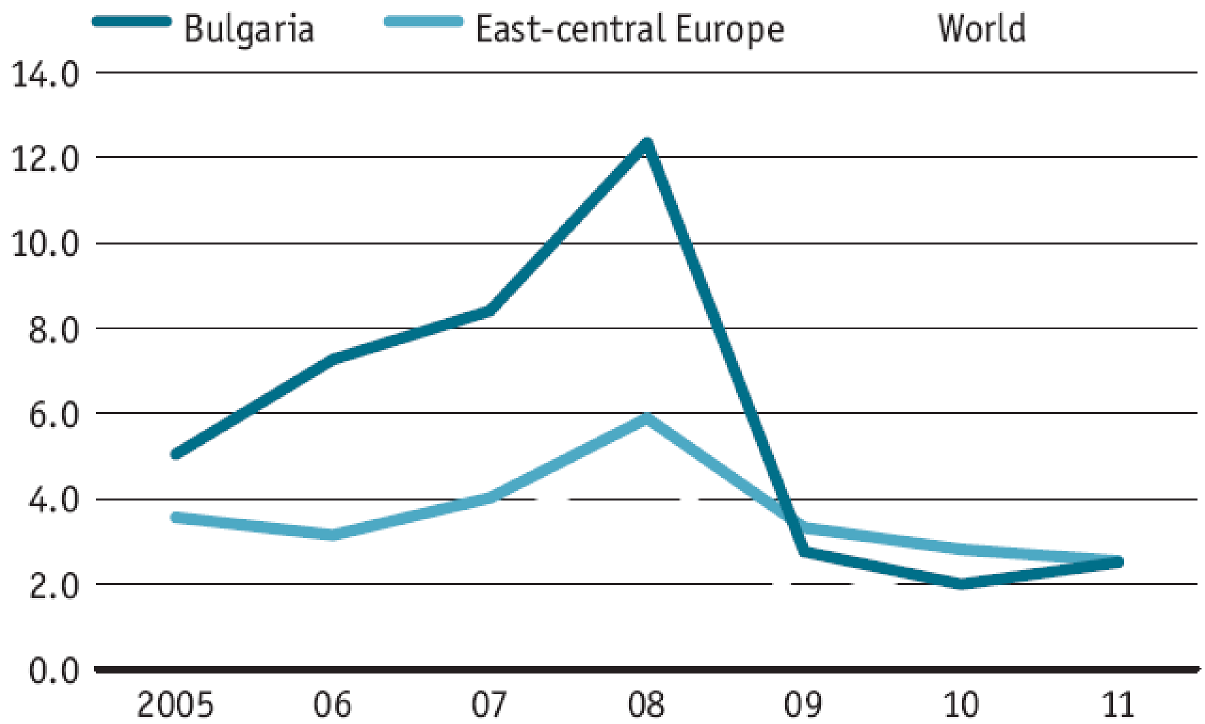
Figure 12: Retail Sales in Bulgaria, July 2006-October 2009



Source: Economist Intelligence Unit, Country Report: Bulgaria, February 2010

As late as January 2010 consumer confidence in Bulgaria decreased by 0.8 percentage points compared to October 2009, according to a report by Bulgaria's National Statistical Institute. At the time of the report, consumers' opinions about the current economic situation and expectations for the coming 12 months had worsened by 3.5% and 1.3%, respectively. Much of this decrease was due to a strong decline in confidence among the urban population, with drops of 6.4% and 2.4%. Meanwhile, as perhaps a small sign of better things to come, rural populations actually registered a small increase in confidence over previous polls.[105]

Figure 13: Consumer Price Inflation in Bulgaria



Source: Economist Intelligence Unit, Country Report: Bulgaria, February 2010

Access to Credit

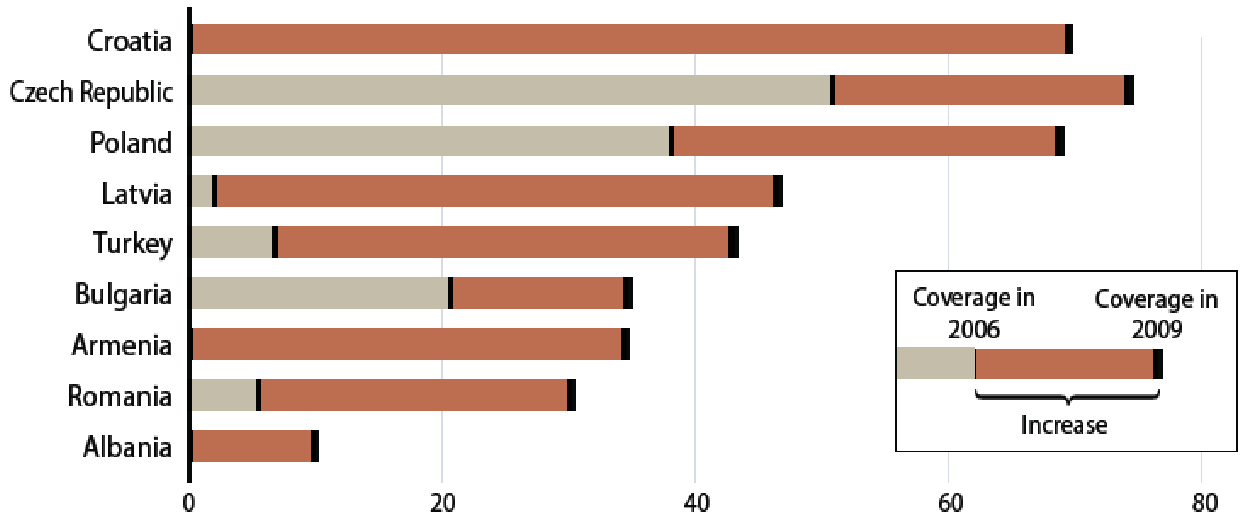
In December 2008, the Bulgarian National Bank (BNB) basic interest rate stood at 5.77%. Since the beginning of the crisis, however, the BNB began aggressively loosening, slashing interest rates dramatically in an effort to counter sharp drop-off in liquidity. In early 2010, the BNB announced the lowest basic interest rate since the index was first recorded in 1991. From March 1 2010, the basic interest rate would be set at a record low of 0.18%, down by 0.16 percentage points compared to the previous month. March marked the eighth month in a row during which the basic interest rate was under 2% and the fifth during which it was set below the 1% mark.[106]

In late 2009, Ivan Iskrov, head of the BNB, forecasted that the combined profit of the banks in Bulgaria would decline by 50% in 2009 compared to 2008, with total profits of Bulgarian banks expected come in at about BGN 700 million for 2009. The BNB forecasted that the number of non-performing loans would also be twice as high at the end of 2009 compared to 2008, reaching 6%, up from 2.4% the previous year. In the first ten months of 2009, the Bulgarian banking system registered a profit of BGN 656.5 million, 46% less than the same period for 2008.[107]

As of late spring 2010, obtaining credit in Bulgaria continued to be difficult, principally because of a lack of funding. According to an analysis of the sector carried out by Postbank (Eurobank EFG Bulgaria), the high proportion of bank deposits to loans – 120.5% as of December 2009 – served to restrict the granting of new loans. The Eurobank survey also noted that the annual growth rate of lending to the non-government sector decreased by 27.8%. At the end of 2009, it was at an annual level of 4.5%, compared with 32.3% one year earlier.[108]

Analysis by the Economist Intelligence Unit in early 2010 held that, provided foreign parent institutions of Bulgarian banks did not run into serious financial problems themselves, the steep slowdown in bank lending seen in 2009 should pick up slightly in 2010 and more strongly in 2011. This was expected, however, to be a gradual process, given the ongoing need for balance-sheet adjustments. The upward trend in non-performing loans was also predicted to prevent a quicker recovery of bank lending.[109]

Figure 14: Borrowers Covered by Credit Registries (% of adults)



Source: IFC Doing Business 2010

Europe and the Bulgarian Economy

As is discussed earlier in this report, the future of Bulgaria's economy will largely hang on its ability to increase exports to more mature (primarily European) markets over time. EU membership has already provided a boost to Bulgarian trade through the gradual integration of Bulgaria's economy into a market of free-moving goods and services. However, at the same time that consumption is slackening in Western European economies, Bulgaria's export-based model may find itself somewhat at loggerheads with larger export-oriented economies such as Germany, who have traditionally seen Europe's southern flank as its natural customers.[110] Economic policies crafted at the EU level and in other European capitals will therefore require vigilance by Bulgarian business concerns and policymakers going forward.

According to analysis by IHS Global Insight, continued economic malaise in Bulgaria's key markets in Western Europe points away from an export-driven recovery in 2010.[111] While Bulgaria's economy will develop as a producer of goods and services earlier in the value chain than higher-value-added producers in Europe's north and west, Bulgarian policymakers and investors nonetheless need to seriously consider Bulgaria's "place in Europe" and rank in the global hierarchy of low-cost producers when assessing Bulgaria's potential for an export-driven recovery.

Another significant Europe-centric issue on the horizon for Bulgaria will be the future of the flat tax. Much of the country's current appeal as a business destination rests on its simple 10% flat tax on business profits. Recently, however, there have been rumblings in the EU parliament that such a system of taxation might contravene EC competition policy. Should the flat tax run officially afoul of EU law, the resulting need to restructure could undermine a key selling point for attracting foreign investment to Bulgaria's shores. In the short term, at least, such a move could potentially persuade firms seeking a regional location for operations to invest in non-EU states such as Macedonia, which would remain free to maintain the flat tax and other incentives. Bulgarian will need to be nimble in its response to Europe during the integration process and investors in Bulgaria will need to remain alert to the accompanying challenges.

Rebuilding the Relationship with Brussels

In a report to the Bulgarian government in early 2010, the European Commission pointed out that only 1% of EU regional aid to Bulgaria had reached the intended beneficiaries since the country joined the EU.[112] As of early 2010, Bulgaria continued to rank last among EU member states in absorbing EU program funds, according to Jean Marie Seiler, director of Regional Policy at the European Commission. However, corruption was not the only factor in Bulgaria's record of low absorption. Seiler pointed out that Bulgaria, as a new EU member, has also lacked the necessary experience to absorb funds properly, adding that even older members lose funds due to inefficiency in the absorption process at national levels. "The EC has a strict rule – funds are granted with a firm deadline. If a country misses this deadline, we take the funds back," Seiler said.[113]

Speaking at the time of his first official visit to Brussels on September 9-10, 2009, Bulgarian Prime Minister Boyko Borisov declared that "it is an indisputable fact that Bulgaria has had a very bad image in Brussels. It is up to us now to change it. It is crucial that the people in Brussels have hopes [for] us."[114] Shortly after his visit, the European Commission announced the unblocking of €140 million of Bulgaria's SAPARD program funds, which had been frozen in 2008 over violations. Some took this as a goodwill gesture – if not a full-fledged vote of confidence – from Brussels to the new government in Sofia. And while there was little lingering hope that Bulgaria would be able to absorb the full amount of other, still-frozen EU funds before the expiration of the EU-set deadline, Borisov nonetheless pledged to work with Brussels to unfreeze the remaining monies.

As of early 2010, the Bulgarian Union for Auditors was calling for stricter regulations on the management of EU funds as a means to help absorb greater levels of the available aid. Previously, the EU had claimed that current Bulgarian absorption rules were insufficient and weak, and were a main reason for the frequent misuse of funds. The Bulgarian Finance Ministry, meanwhile, was envisaging a new auditing department at the ministry, which would oversee the management of funds.

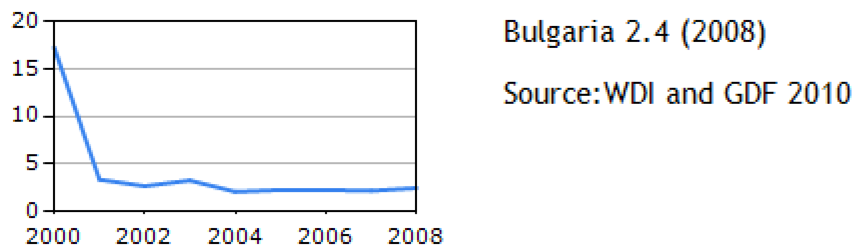
The drive for greater efficiencies and more effective oversight are steps in the right direction. Additionally, a more sophisticated private sector infrastructure has begun to develop to assist with the absorption of funds. In early 2010, the author spoke with a VP-level manager at a public relations firm with offices in Sofia and Brussels that works with the Bulgarian government to help private-sector interests apply for and secure EU structural funds. Having won the right to manage a line of funding through a state-run bidding process, the firm ran road shows throughout Bulgaria, spreading awareness of the availability of funds and educating the target audience on the procedures for securing EU monies for various development-oriented projects. Such efforts could prove greatly beneficial to meeting higher absorption targets moving forward, as well as matching available funds with more of the intended recipients for maximum positive impact.

In January 2010, the Bulgarian Finance Ministry announced that Bulgaria would absorb a [national] record BGN 700 million in EU funds for the month, adding that the money absorbed in January would be 15% higher compared to December 2009 and about 20 times higher compared to January 2009.[115]

The Importance of Continued Progress toward the Euro

In late September 2009, Unicredit Bank Director for Central and Eastern Europe, Federicco Ghizzoni, stated that the currency board in Bulgaria was functioning successfully, helping to keep default loans at low levels (around 2.4% according to World Bank data). Ghizzoni explained that the stability of the currency board had prevented the devaluation of the lev and thus, he claimed, prevented serious hardships for Bulgarian households and businesses. He continued that “the level of default loans will determine whether financial institutions are going to concentrate their efforts on risk control or will seek new business opportunities” moving forward.[116]

Figure 15: Bank Nonperforming Loans to Total Gross Loans in Bulgaria (%)



Source: World Development Indicators, The World Bank, accessed April 21, 2010, available at: http://data.worldbank.org/data-catalog

Early in its mandate, Bulgaria's center-right government made progress toward the euro a state priority. Shortly after assuming power, Boyko Borisov’s GERB party announced plans to apply to join the ERM-2 exchange-rate mechanism, the European Union's two-year currency stability test, which Bulgaria would need to pass before the country would be permitted to drop the lev and adopt the euro as its official currency. High inflation and a large current account deficit – exceeding 20% of GDP in recent years – had previously precluding Bulgaria from joining the mechanism. Yet although structural and institutional problems remained, with inflation having receded, Bulgaria had now met the Maastricht criteria, given its long record of cautious fiscal policy.[117]

Successfully joining the exchange-rate mechanism would bring Bulgaria closer to the umbrella of the euro region and the protection of the European Central Bank.[118] Expedient progress toward this goal must be understood as a central necessity in any Bulgarian formulation to attract investors back to the Bulgarian economy. After months of speculation over when the former communist state would formally apply to the bloc’s exchange-rate mechanism, the so-called Eurozone waiting room, the finance minister set a goal deadline of end-June 2010.[119]

As of mid-2010, most analysts agreed that the currency board remained an anchor of Bulgarian economic policy, and should not be considered at risk. (However, few also believed that the euro would be adopted before 2014.) Given the tightening of fiscal policy during the end of 2009 and beginning of 2010, and the significant correction of the current-account deficit, risks to the maintenance of the currency board were in fact diminished at this time. According an early 2010 Economist Intelligence Unit report, however, additional pressure could arise if Latvia, Estonia and Lithuania were to give up their currency pegs. Even if this were to happen, however, any government in Bulgaria would be unlikely to change or abandon the currency board arrangement, fearing a repeat of the currency crisis that occurred in 1997.[120]

Gauging the Local Bond Market: 2010 Issuances

As discussed earlier in this report, bond issuances figured largely into the GERB government's plans to avoid financial assistance from multilateral institutions in 2010. In early March 2010, Fitch Ratings said that Bulgaria may see its credit rating lowered to junk as an external debt burden bigger than total output threatens financial stability. "The jury is still very much out on the path of the macroeconomic adjustment," said Edward Parker, head of emerging Europe ratings at Fitch in London. "The fiscal position is a strong one. However, it faces risks from the private sector, which has high levels of external debt, which leaves it in a vulnerable financial position."[121] At the time, Fitch rated Bulgaria's foreign-currency debt BBB-, the lowest investment grade, and has kept a negative outlook on the rating since April, with commentary by Bloomberg at the time of the downgrade citing the following key factors:

- Bulgaria had a gross external debt of €37.6 billion ($51 billion), or 111% of the economy, at the end of last year. The poorest EU member may be facing pressure on its current account and currency peg

- An EU member since 2007, Bulgaria still has a substantial current account deficit and there's a lot of uncertainty about how that will be financed and what impact that's going to have on growth

- The current account, which was in surplus in the third quarter last year, turned to a deficit that swelled to €327 million ($444 million) in December, the widest since May, according to central bank data. The deficit was 8.6% of GDP in 2009, the government estimates

- The current account shortfall swelled to a quarter of gross domestic product in 2008, the largest in the emerging market universe that Fitch ranks

- Bulgaria's euro-denominated bond due January 2013 fell the most in more than a month, pushing its yield up five basis points, to 3.79% in Sofia. The lev-denominated benchmark bond due January 2015 also declined, with its yield rising 2 basis points, to 4.82%

- A large chunk of Bulgaria's foreign debt stems from the financial system. Bank industry debt last year was €8.4 billion, about a quarter of GDP, and private sector debt stood at €12.08 billion, or 37.6% of GDP, according to the central bank

- The economic contraction deepened every quarter last year, sending output down an annual 6.2% in the last period, the statistics institute said on Feb. 12. The economy probably shrank 4.1% in 2009 and may grow 0.3% in 2010, the government estimates

- Bulgaria, which pegs the lev to the euro, is among the countries in Eastern Europe that display "significant financial fragility," according to New York University Professor Nouriel Roubini

- With loans exceeding total deposits by about a third, banks in Bulgaria need to tap their parents to fund lending. Western banks are busy writing down bad debt and reducing their balance sheets, reducing funds available to sustain foreign units. That may be bad news for Bulgaria, whose banks have more than half their lending denominated in foreign currency, mainly euros…This could lead to pressures on the balance of payment, GDP growth and the currency board, with adverse consequences for the public finances[122]

Bond offerings in late 2009 and early 2010 have boasted strong showings: Issues of domestic bonds in late 2009 were oversubscribed, with high demand for the issues proving a boon to government spending needs. In late 2009, the Bulgarian Finance Ministry planned to issue another BGN 740 million worth of government securities on the domestic market in 2010, which would cover maturing bonds to the value of BGN 590 million and generate new financing of BGN 150 million. Three- and five-year bonds would not be issued, in order to avoid creating a maturity burden in 2013 and 2015, when Bulgaria's global bonds denominated in euros and U.S. dollars mature. Instead, the ministry planned to issue two- and four-year bonds, together with longer-term securities with seven- and 10-year maturity periods. The Finance Ministry planned to denominate some of the domestic securities in euros. It was hoped that domestic bonds denominated in euros would lower interest rates further, thus limiting the government's repayment burden.[123]

It was announced on February 1, 2010 that the euro-denominated issue made by the Bulgarian government had been three times over-subscribed. "The results of the auction correspond to favorable changes occurring in the market environment. As a direct consequence of ongoing government policy, government bonds are becoming an increasingly attractive investment," said Deputy Finance Minister Anna Mikhailova, describing the auction result as "extremely positive" for sector management of public debt.[124]

In January 2010, the first two auctions of five- and 10-year Bulgarian bonds were held, with the aim of raising BGN 65 million. On February 26, 2010, Bulgaria's second government securities auction within a week's time was oversubscribed by almost three times, as high interest rates attracted investors. The bonds carry a maturity of 10.5 years with a fixed interest rate of 5% payable every six months. The auction of government bonds matched the success of a previous auction held on February 22; both were over-subscribed, as investors scrambled to buy up the BGN 30 million worth of securities on offer.[125]

Meanwhile, in February 2010, the Bulgarian Ministry of Finance opened a tender for bond management in a bid to emit €25 million in euro denominated bonds with a maturity of 2.5 years to meet the internal demand for state securities. According to the Finance Ministry, "the decision for euro bonds has been prompted by the favorable trends that we have seen in the development of the domestic market in the last few months." The euro bonds issue, the ministry stated, reaffirmed the government's determination to keep the currency board in place and apply to join the exchange-rate mechanism, planned for 2013.[126]

It will be important to watch the bond market closely throughout the remainder of 2010, as sovereign bond action in Bulgaria – and throughout the eurozone – will serve as an indicator of investor confidence in the health of the euro and of the EU economies. With significant direct exposure to continuing economic uncertainty in Greece at the country level as well as Greece-related euro exposure through its currency peg, Bulgaria is now highly leveraged to Europe's challenges as well as its opportunities. Any decision to invest in Bulgaria must therefore take into account the risks as well as the opportunities implicit in Bulgaria's continuing integration into the EU's political and economic structures.

Epilogue

In the early summer of 2010, Bulgaria's economy is not out of the woods yet. However, there are some signs that are pointing in the right direction. With an austerity budget in place, the Bulgarian government has continued to pursue an agenda of efficiency within its own ranks, cutting 11% of state servants from a badly bloated bureaucracy[127] while raising salaries of well-performing staff members in the now leaner ministries[128] – a much needed reform to boost performance and potentially reduce incidences of corruption. In recognition of these efforts, ratings agency Moody's said in April 2010 that an upgrade of the country was possible in the coming 12-18 months, from a current rating of Baa3 with a positive outlook.[129] Meanwhile, the government has begun to pay back the some of the monies it owes to the private sector – largely in delayed VAT refunds – which should help to improve a government-private sector relationship that has suffered growing mistrust.

Meanwhile, Bulgaria's unemployment rate has remained fairly steady at about 10% throughout the first half of 2010, similar to that of the U.S. economy and well below unemployment figures for the worst-hit European economies. The country has decidedly cooled off as a go-to destination for foreign direct investment, however, and FDI levels should be watched closely, as foreign investment remains vital for covering external payments deficits. Major investment from companies such as IBM, GE and AES likewise play key roles in employment, job creation and growth. From a country level, it will be important not only to quantify FDI pullback over the coming year, but to qualify it as well. As long as the "smart money" remains invested, the economy can withstand – and society, perhaps, benefit – from an ebbing of other monies that once flooded into poorly managed real estate development and tourism schemes.

Finally, it must be mentioned that an important resource in Bulgaria remains its people. At the beginning of my research for this project, a real estate investor from London, who was managing a portfolio of commercial properties around Bulgaria, spent a good fifteen minutes outlining to me all of the ways in which the government had wasted the opportunities and the money that accompanied the economic boom. Once he concluded, I asked him, "So, what are the positives of doing business in Bulgaria?" Without hesitation, he replied, "The people. This country has the greatest people. They'll do anything for you." If Bulgaria is truly to compete in the global economy moving forward, more resources must be dedicated to developing its people through higher educational standards and practices and by focusing on proper training and incentives to bring more smart money to Bulgaria to employ well-qualified talent. After spending nine months in Bulgaria, I would warn any investor not to be naïve about the challenges of doing business in the country. However, I also believe that if Bulgaria can find a way to keep its best and its brightest in the country and to leverage their talents in the government and private sectors, reform is achievable, the future does hold promise and opportunities may well lie ahead.

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