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GLOBAL FINANCIAL CRISIS IMPACT ON BULGARIAN STOCK EXCHANGE²

Bulgarian stock market experienced sharp and continuous decline in 2008 causing this way a heavy pressure and turmoil among its investors. The decline hit the confidence in the prospects for its development raising a lot of concerns. This paper addresses some questions about the contingency of the Bulgarian stock market on the development of Global Financial Crisis (GFC), the channels and magnitude of negative influence, as well as of the necessary measures to be taken in order to smooth and balance GFC's negative impact
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Introduction

The global financial crisis (GFC) which developed rapidly in 2008 went very soon, beyond the immediate financial institutions which were involved in the particularly improper financial speculations. What started as more or less risky operations of some of American investment banks quickly spread out over the whole economic and business activity throughout the world. The global interconnection and mutual dependency made impossible for any country or sector to stay intact no matter how sound, itself, it was, and how remote and distant were its operations from the pure gambling with the subprime mortgage casino-type speculations.

In 2008, Bulgaria was experiencing, probably, a slight slow-down of its economic growth, but was in no way approaching any recession. The published preliminary data for the last year GDP shows more than 6% real growth, even under the conditions of unprecedented stress in the last quarter of the year. Bulgarian banking sector, having undergone in the disastrous hyperinflation storm in 2006-2007, has been quite cautious in the period preceding the crises, caring out a conservative and sound policy. In spite the running credit expansion in 2006-2008, both to the business and to individuals, the overwhelming majority of the exposure is considered sound and safe. Practically Bulgarian banks, even being overwhelmingly

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EU subsidiaries, do not have exposure toward unsafe derivatives and financial instruments, which caused the biggest deal of concern for the world financial system.

That policy, combined with already more than 10 years of successful history of Bulgarian Currency Board is considered a major pillar for expecting that the GFC impact over the Bulgarian economy might be not that sharp as it already revealed in some of the other East European economies.

At the same time, Bulgaria has quite controversial and even risky values of some of the key-factor macroeconomic indicators, including a deficit on current account of almost 25% to the GDP. That includes, a strongly negative trade-balance, decreasing FDI, which will lead in very short time to a negative balance of payments, stagnating real-estate market etc.

Taken together, the positive and negative dynamics of the current economic situation make quite welcome a discussion about the influence of GFC over the different branches of Bulgarian economy. While this influence in many of the branches of Bulgarian real sector economy is still considered ambivalent and debatable, its impact over the financial sector and the Bulgarian Stock Exchange (BSE) is quite clear. There is an undoubted downturn during the past months of 2009 which was particularly sharp in October and November.

Channels of influence

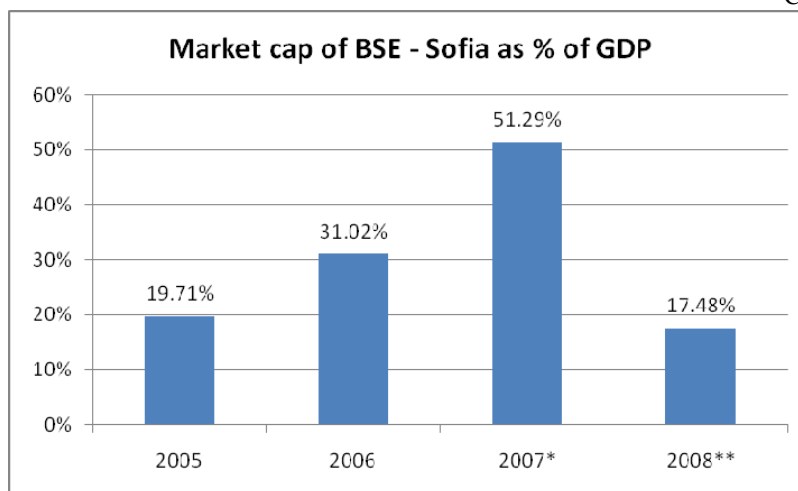
The crises influence stems through several different channels. First of all, the crisis ceased the positive development of the trade itself. If we compare the values of SOFIX, the BSE index with longest history – created in October 2000 and because of that, best fit for our analysis, we will see this dramatic turn. For a little longer than a year, from the pick of index in October 2007 till the plunge in mid-November 2008, the index has lost more than 80% of its value reaching the levels of July 2003, after an unprecedented week of everyday drops. Later, after the end of the year, the drop continued again, but in the mid-November were the most dramatic sell offs when the 5% drops happened in many consecutive days and in some days the drop was even above 10% ensuring the crash of index at 319.04 points on November 20th. The drama was particularly shocking since the 2007 rally was long-delayed in Bulgaria and when it was eventually achieved it was abruptly slashed by the unfolding GFC.

The second channel of influence goes through the decrease of market capitalization of the BSE-Sofia, both in absolute and relative (% of GDP) figures. The drop of capitalization from 30.098 ban Bulgarian Leva (BGN) in 2007 to 11.552 ban BGN (November 2008) was more than 60%. Chart 1 is showing the development of the BSE market capitalization against the GDP of the country. As a result of the GFC impact, the decrease of the market capitalization combined with still rising GDP in 2008, caused an almost three times fall of that index as compared to its 2007 value. And if one considers that in the countries with emerging capital markets this index

keeps traditionally lower values than those in the developed market economies, and this is particularly true for Bulgaria, where the level of corporate financing through the SE is low, then she must admit that even this only aspect of GFC influence has a pronounced negative significance for our economy. That is because it blocks an important source of financing which especially in the environment of stagnated credit market becomes badly needed.

Next aspect of negative influence: after a prolonged and delayed transition, Bulgarian capital market experienced a strong push up by the Accession of the country to the EU. In 2007 the number of deals almost doubled and their volume tripled – up to 9.9 ban BGN. The BSE-Sofia experienced also, a jump in the new listed issues of securities – total nominal reached 970 ban BGN, which presented a 65% growth compared to 2006. In the core of that jump were the issues of public companies equity which went from 195 to 480 ban BGN, revealing the most important event going on the SE – a bust in the investors' trust; attraction of many new investors and capitals and eventually – the increased role and importance of the Stock Exchange for the country. All those positive tendencies were abruptly broken. Thus, Bulgarian stock market could not fully take use from the rise of positive expectations connected to the so long awaited EU accession. Moreover, the slump which emerged caused not just break in the trade itself, but also a fall in the confidence and the capabilities of the SE to raise a capital. According to the data from the BSE, the nominal value of the new issues is just 216.8 ban BGN as of October 2008 of which 29.8 ban are of investment societies with a special purpose as to invest in arable land, real estate etc. The situation deepened further, and practically, all the potential issuers went in a process of waiting and postponing of the planned issues because of the strong negative trends on the market.

Chart 1



* the data for market cap is by 31 Dec

** market cap is as of 20 November 2008 (figures for 2007 and 2008 GDP are preliminary)

Source: calculated from BSE data

Factors of influence

The negative trends raise the issue about the degree of interconnection between Bulgarian and world markets; to what extent one can attribute them to the internal dynamics of Bulgarian stock Exchange, which experienced an unprecedented upswing in the months immediately preceding the crisis. The question is of serious importance since a part of observers tend to blame the same very upsurge for the following crash; pointing out the would-be causes as groundless optimism, unrealistic forecasts, plain greed etc. In that sense, those observers see a natural upturn of the dynamics, which is probably more or less exaggerated as a result of the external influence.

Another group of scholars, pointing out that couple of years ago there was no significant correlation between national and world markets is more prepared to see the events even more dramatically emphasizing that the current Bulgarian market not just repeat, but also amplify the negative waves coming outside within the world financial crisis framework.

This *ad hoc* and also ambivalent reflection of the rapidly developing events on Bulgarian capital market require an attempt for more objective tracing into the facts.

Chart 2 is showing the dynamics of BG SOFIX index juxtaposed to the most familiar world index today – Dow Jones Industrial – both taken for a 2-year period, which is covering practically all the most interesting movements of the BG market. The data shows a daily percentage change in the values of both indexes normalized to a common origin in order to make their movements easily comparable. Additionally, the values are taken off on dates when one of the exchanges has been closed for specific holidays or so. That way, the charts are running through identical periods (21.11.06-20.11.08) and could be used to find out to what extent both indexes follow a common pattern. For the sake of the *hot trace paper* presented here, the analysis was just striving to capture the general trend and thus not required to go into a precise regression analysis which might be followed in detail as a next step.

Thus, the more stable and less volatile movements of the US index are assumed as a benchmark to plot against the movements of Bulgarian market and to make conclusions. It is clear enough, that the BG movements were generally following the trend of the world-wide economy though with an emphasized national specific. That specific is due to the overall lower level of development of the Bulgarian market, from one hand, and due to the presence of such a powerful and important event for the nation – as EU accession (01.01.2007), from the other. This way, a long-time suppressed rise of the BG market unfolded powerfully in the late 2006, when the news for Bulgarian acceptance in the EU structures became a process without alternative.

That way, after the mid-January, the BG index reaches a moment maximum values, getting 25% ahead of much flatter movement of the US index. Gradually, the post-

accession euphoria passes away and the BG markets experience a relatively calm correction in the next months, within the framework of still advancing world market trend, represented by the Dow. During the second half of April the two indices almost equalize their growths and go in good correlation for more than two months until mid-June 2007. By this point, there is no any evidence which might be regarded as exceptional, absorption, risk underestimation etc.

Chart 2



Source: calculations based on Yahoo Finance and BSE-Sofia data.

Gradually, the distresses caused by the US markets of sub-prime mortgages get speed and the world bourses indices slow down. This is the first instance when one may talk about a break between the trends of the Bulgarian and world market. And the Bulgarian Stock Exchange starts a busting expansion, reaching peak values in October 2007, when the BG SOFIX breaks through and leaves behind the growth of its American counterpart with more than 60 percentage points. Precisely, this is the period considered to be most controversial, and which provides the grounds for assumption, that Bulgarian speculative investment went beyond the limits of the reasonable risk. Although, one needs to consider that the country's economic development, and especially, that one of its capital market, was suppressed for so long period, at a so low level, that none of the reached levels of rapid growth could be interpreted as too high. In fact this growth encompassed a relatively small number of public companies and just when it started to spread wide and to attract more and more new issuers on the market its expansion was put on hold.

In the next period, it occurs a more or less rapid correction, which, by the end of 2007, brings down the speculative peaks of the growth pace and keeps it at about 25-30 percentage points higher levels than those of US Dow John's. This differential is quite understandable provided the existing potential for growth – the real GDP was growing for the last recent years at a pace of above 6%, the positive outlook to the

BG economy expecting 7 ban Euros in the following period from the EU funds, and finally and the positive results of the real sector. Within this framework, the bigger growth of Bulgarian markets seemed justified.

During the next period, SOFIX follows closely the DJI and though the movement is on the negative side, it could not be interpreted as accumulating, and by no means amplifying the external trends of the world markets. Yet in September and the first days of October 2008, when the panic swept all over the world, with the record, from the times of Great Depression, daily slide-downs, causing breaks of the trade in big centers as Moscow and Paris, just then the data for Bulgarian trade worsened substantially. And the Bulgarian index started to produce 2-digit negative results, compared to the level of growth of DJI. In November it marked several times about 34 percentage points lower levels and eventually achieved the already mentioned 80% devaluation against its best score.

Those are the dynamics determining the understanding that the present situation of the Bulgarian Stock Exchange has nothing to do with the internal developments and is result from negative tendencies, attitudes and expectations conveyed from the world economy.

Apart of that, not less detrimental is also the draining out channel of foreign investments. The interest to them is determined by the fact, that unlike the other outflows of financial resources, which eventually may settle in other areas of Bulgarian economy (in banking sector for example), the foreign outflow is terminal. The shrunk liabilities of foreign portfolio investors or decreased size of attracted share capital directly erode the basis for development of the Bulgarian capital market. Limit the business activity and hinder the growth of national economy.

As a result, during the 12 consecutive months before 30 September 2008, the decrease of the foreign portfolio investments is 343.3 millions of euro as opposed to the analogical 12 month period in 2007, which actually showed an increase by 48.1 euro. This is about a 30 million average monthly decrease, leading eventually to a peculiar “peak” in September of 116.5 millions. At the same time the newly attracted share capital from January till September 2008 is more than 500 million euro less as compared to the same period in 2007. Apparently the both groups of figures have a direct influence over the situation on the BSE-Sofia, though this influence is difficult to quantify, since the data in Balance of payments do not differentiate between public and private companies. It is virtually impossible as well to estimate the amount of the remaining foreign investments, since the observed value is just the flow and not the value of the investment itself. Another imperfection comes about the data for the direct investments which show as an aggregate not just the changes in the capital and reserves, but also the investment in the real estate, which do not affect the situation of the capital market directly.

Nevertheless, it is clear that the both groups of investments reveal withdrawals of capital from the Bulgarian stock market. It is also interesting that the process itself has been started yet in 2007, as the withdrawals in that year total at 389 millions of euro.

Summarizing the situation

- The vigorous expansion of Bulgarian stock market, due to country's accession to the EU, positive data from the real sector and the trust in the newly listed companies and issues of the BSE, was followed by pertinent corrections, which could not be determined as disastrous, dramatic or else.
- Moreover, after those corrections Bulgarian market kept for a while the accumulated positive energy and trust, which within encouraging signs from the external economic environment, could easily turn back on the positive side of successive development.
- Yet the recent ubiquitous panic of the late months of 2008 with a mass withdrawal of investors, an outflow of foreign direct investments, and the tightening of credit conditions in the country, combined with the overall bad expectations from the financial sector eventually caused a distinct negative situation.
- The indices reflecting the movement of prices of the Bulgarian securities are going down, not because of worsened results of the companies, but rather because of presence of more sellers than buyers, i.e. because of the changed perspective for trade.
- Just the opposite the results of the public real sector companies remain positive after the third quarter of 2008; as it is shown in the published positive balances and reports. Nevertheless, the value of the companies continues to shrink due to massive sell-offs based on the panic which swept through world markets.
- After October 2008, one has a good reason to conclude, that a process was developed on the Bulgarian capital market, which do not just reflect, but also amplify and multiply the negative external influence of GFC. This process emphasizes, the specifics of the national economy inducing in some investors fears about uncertainty and unpredictability about the economic performance of some real sector companies.

The more the negative events unfold in the developed market economies, the more certain this situation is going to worsen and deepen. Apparently, the lack of positive reaction of the American markets after the announcement of the new survival plan of the government administration and the failure of the EU to adopt such a plan for the most badly hit countries of the Eastern Europe is driving away the hopes for short and not too severe recession of Bulgarian economy.

The more apparent becomes that the world recession is going to last more than a year, the more cloudy becomes the perspectives for Bulgarian survival and the hopes that this economy has a substantial positive potential, gradually but steadily turn into fears that such a vast outflow of investments will erode the very basis for development of the capital market. Even more, the concerns now start to include

even the stability of the Currency board, which definitely will be challenged under the condition of negative balance of payments, which is quite possible to develop in the early months of the 2009.

Some suggestions

The suggestions, for alleviation of the sharp negative impact of the global financial crisis, which are offered here, find its ground in the presumption that the current problems of Bulgarian financial markets are rather due to a problem of trust, of confidence in the near future, than to a lack of available resource. Hence, the main suggestion addresses the efforts for maintaining and enlarging the confidence in the Bulgarian Stock Exchange, emphasizing the stable fundamental development of the successful real sector businesses. All in the same direction are the enlightening activities of the capital market institutions, targeted on the small investors, in order to focus the attention of the latter on the individual performance of the companies, making them less penetrable to the bad market news and more immune of the chaotic and panic responses.

An emphasis needs to be done on the advantages brought by the good corporate governance and the associated high status of the public companies, thus encouraging those businesses which decide to obtain such a status. A short-term measure might be also, creation of clearing house and the so called “double-listing” of some securities, where a company goes simultaneously at two markets – on BSE and somewhere else on bigger world bourses.

Within the context of the good corporate governance, it is quite possible to consider the abandonment of the withhold dividend tax as a measure stimulating the trade in securities. Currently, this tax is not an important source of revenues for the Bulgarian government and its dismissal will create another motive for investors to obtain and hold securities for longer period. Actually, this is also seen, as a measure to encourage the companies to distribute less reluctantly their profits through the dividend policy, under the condition where the market refuses to appreciate their performance adequately.

Later, provided the extremely fast development of the world financial processes, and the huge capital transfers occur within days and hours on a global scale, it is necessary to elaborate the system for monitoring of those processes. That means more precise and detailed measuring of the portfolio investments, separation of the data for the public and private companies, publishing of the data for the share capital as individual items etc. The objective is to make clear and available in any moment, all the information about the size of foreign investments in order to allow more precise forecasts of the policy makers about the effects in case of rapid outflow within abrupt movements of the world market.

Apparently, the serious worsening of the indices for trade in securities from the last months requires even more radical measures for supporting the Stock exchange. Those may include preferable participation in the auctions for EU funding, or

introducing new trade instruments on the market floor as raising capital for large infrastructure projects.

Not least, the policy makers need to contemplate again the opportunity for privatization of the remaining shares from the still government owned companies, including the use of different voucher instruments, which are also accepted as means of payment.

Finally, it seems quite necessary originate a debate about the future development of the BSE- Sofia; to attempt to answer truthfully of the question – what are the possibilities for quick recovering of the world and so Bulgarian economy? What are the chances to guarantee a minimum but sustainable level of trading volume of the market, needed not just for the functioning of financial institutions, but also for attaining good corporate governance in near future? And if more of those answers are negative, it seemed quite necessary to discuss the forms for making the Bulgarian stock market a division, a branch or part form a bigger and more developed stock market, most probably a European one. This hard decision could be realized in many different ways through merger, selling or other transformation, keeping more or less independence of its future existence according to the understanding and wishes of Bulgarian economic establishment.

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