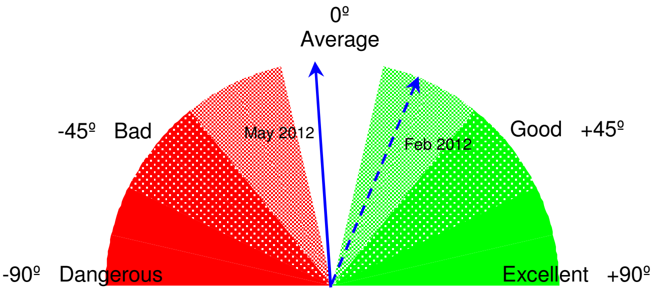
Issue 10 May 2012

expat compass

18 May 2012

EXPAT CURRENCY BOARD WATCH



OUTLOOK: STABLE

We are not worried about the currency board and see no immediate danger of devaluation. However, new risks are emerging which are not being addressed properly by the government (Page 2).

GUEST COMMENTS

ARTICLES

EDITORIAL COMMENT

We are surprisingly downgrading our rating due to new developments we had not foreseen before 8 February 2012 (when the 9th issue was published).

After 18 months of positive assessments in 6 consecutive issues of Expat Compass, we are now shifting the arrow of the Compass to the left (i.e. in a negative direction) to wipe out all the improvements from the past. The reasons are:

1. Bulgaria's fiscal reserves have fallen sharply below the reasonable level – WRONG POLICY
2. The government is planning to spend some of the Silver Fund on financing the deficit – WRONG POLICY
3. The country will have to borrow from the [international] markets to meet its eurobond payments in early 2013
4. A belated decision on the Belene nuclear power plant has been made (see p. 20)
5. Exports have slowed down. The trade deficit is growing
6. As many countries in Europe are falling into recession, Bulgaria might follow as well
7. Continuing lack of reforms – no surprise here
8. With the 2013 elections approaching, more populistic spending is likely – also not surprising

Could we not have foreseen all this in February?

While the lack of reforms is no news, and we made comments on the potential lack of growth, we had no reasons to suspect that the Ministry of Finance would set out on a self-destructing trajectory:

1. Lately, the problem with the falling fiscal reserves has been neglected and played down
2. Instead of *investing* the Silver Fund more successfully (GOOD POLICY), we will now be *spending* some of it (WRONG POLICY)
3. As incredible as it sounds, it might not be a piece of cake to repay the eurobond next year. The timing of a new eurobond issue might prove difficult

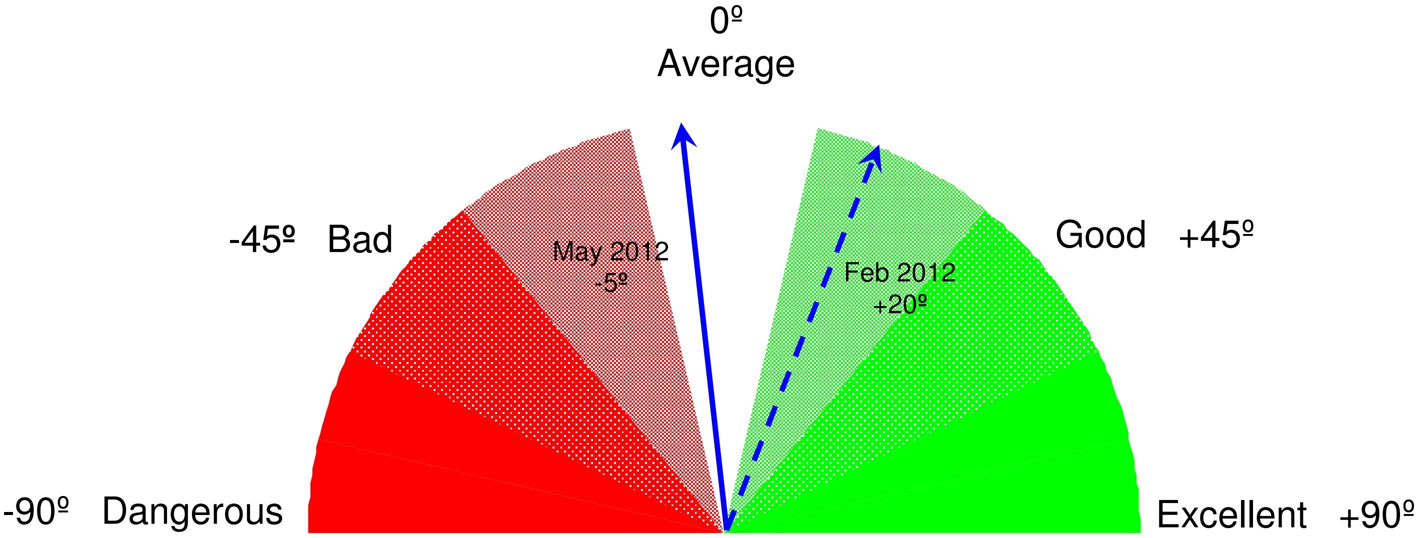
Are we worried about the exchange rate?

No, we are not. Most countries in the Eurozone are in a worse shape than Bulgaria.

However, we will watch very closely the 2012 budget and the level of fiscal reserves. It is never too late for the government to make more mistakes.

EXPAT CURRENCY BOARD WATCH

OUTLOOK: STABLE



In the last year, the main issue of concern for the business community in Bulgaria and globally has been the debt crisis, including in Greece and in Western Europe. Bulgaria has not been directly hit by these tremors. While high economic growth cannot be expected in Bulgaria soon, here is our conclusion – less positive than before:

We are not worried about the currency board and see no immediate danger of devaluation. However, new risks are emerging which are not being addressed properly by the government.

In the future months and years, we will continue constantly monitoring the development of relevant economic indicators in order to assess the health of the currency board and to potentially predict any negative events, should they ever occur.

Date	Reading of the Compass (Angular Degrees)	Change	Comment
2005	+64º		Currency board very stable
2008	+44º	-20º	Deterioration due to current account concerns
Jan 2010	+20º	-24º	Deterioration due to budget and recession concerns
Mar 2010	+9º	-11º	Deterioration due to budget and reforms concerns
Jun 2010	0º	-9º	Deterioration due to budget and reforms concerns
Oct 2010	+4º	+4º	Improvement due to exports growth
Feb 2011	+8º	+4º	Improvement in many economic indicators
May 2011	+10º	+2º	Smaller concerns about the budget
Aug 2011	+12º	+2º	Small budget and trade deficits
Dec 2011	+14º	+2º	Conservative 2012 budget, some pension measures
Feb 2012	+20º	+6º	Troubles in the Eurozone; good 2012 budget
May 2012	-5º	-25º	Sharply falling fiscal reserves. Intentions to spend the Silver Fund

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

How to assess the stability of the currency board and to predict any danger of devaluation? We suggest the following check-list of 16 questions and provide our answers:

ISSUE	OLD	NEW	COMMENTS
I. Political issues			
1. Does the government support the currency board?	+++	+++	Yes
2. Does the Central Bank support the currency board?	+++	+++	Yes, absolutely
3. Do the European institutions (EC, ECB) support Bulgaria in joining the ERM II and the Eurozone?	--	--	Not much
II. Budget and debt			
4. Budget balance	-/+	-/+	Deficit, low
5. Budget spending	+++	+++	One the lowest in the EU
6. Government debt	+++	++	Very low, rising
7. Foreign liabilities of the private sector	--	--	High, falling
8. Fiscal reserves	-	--	Falling below critical levels
III. Economic cycle related issues			
9. GDP growth	-	-	Close to zero
10. Inflation	++	++	Moderate
11. Unemployment	--	--	Average, rising
12. Strength of the banking system	+	+	Average
IV. External balances			
13. Current account deficit, trade deficit	+	-	Back to negative
14. Foreign direct investment	--	--	Above zero
15. Revenues from international tourism	++	++	Moderate, rising
16. Foreign exchange reserves	++	++	High

Legend: Good Bad

What has deteriorated in the economic situation in Bulgaria since February 2012?

This time, mainly bad news

1. Although the **fiscal reserves** have been falling steadily since mid-2009 (see the analysis on p. 5), their amount was still high. What makes things worse is that the government does not seem to acknowledge the problem and thus it is not looking for appropriate solutions. In the 9th issue, our comment was 'Must not go lower'. Now, it is 'Falling below critical levels'. We will watch the numbers very carefully.
2. The **Silver Fund** had been intact since 2008. However, facing budget deficits and forthcoming eurobond payments, the government is changing the law so that it can *'invest'* a part of the Silver Fund in Bulgarian government bonds. The word *'spend'* would be more appropriate (see the articles on p. 6 and 16).
3. Until recently, no plans were made for a new **eurobond** issue to refinance the old one. Now the new borrowing seems inevitable. Not a problem, but the whole messing around has raised the perception of uncertainty.
4. The government has decided not to continue building the **Belene** nuclear power plant. While this decision might be reasonable and even positive for the budget in the long run, it was made too late and after significant new expenses (see the analysis on p. 20).
5. After a couple of years of better-than-expected improvements in the **trade balance,** the trend is now reversing.
6. We are downgrading our 2012 **GDP growth forecast** again: from +1% to +0.3%. The EC's forecast has also been lowered to +0.5%. With a new recession likely in much of the EU, Bulgaria would be lucky to report growth at all.
7. The last chances for implementing any **reforms** during this government's term are likely to be missed. We would not call the new ideas for moving the administration around the country a 'reform', but a waste of time.
8. On the positive side, the **budget has only a small deficit** of BGN 217 mln year-to-date. However, we see certain new risks for the budget. On the one hand, lower growth should lead to smaller revenues. On the other hand, some pre-election spending on salaries and pensions is likely.

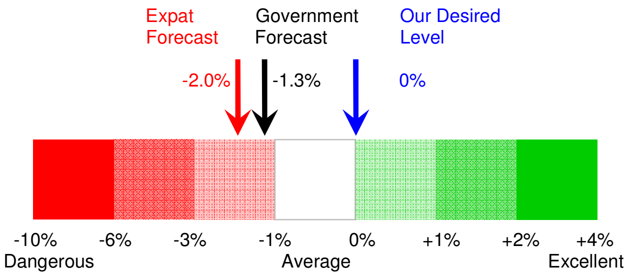
We are lowering our Expat Currency Board Watch reading to an all-time low of -5º

Is the situation worse than in mid-2010 when the reading was **0º?**

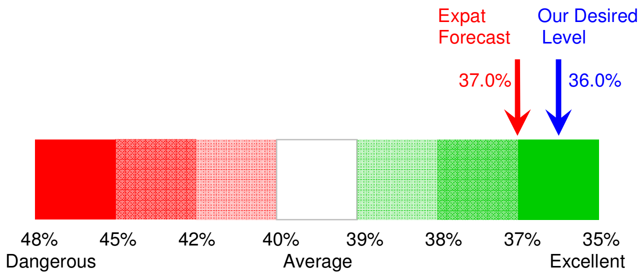
- The budget and the current account are in a better shape.
- However, the lack of reforms, the fiscal reserves, the plans about the Silver Fund, and the banking system are worse. Hence, the negative reading.

INDICATORS, 2012

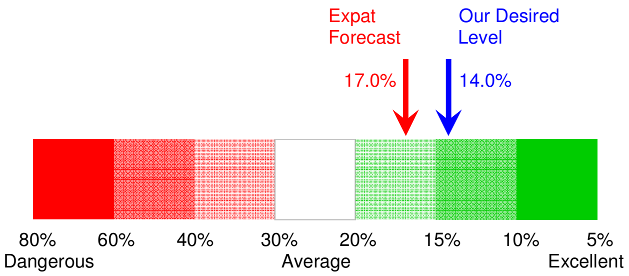
I) Budget Surplus/Deficit, % GDP, 2012



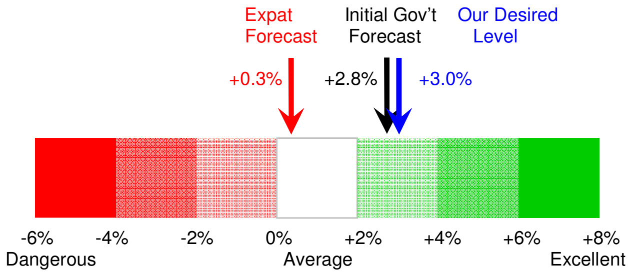
II) Budget Spending, % GDP, 2012



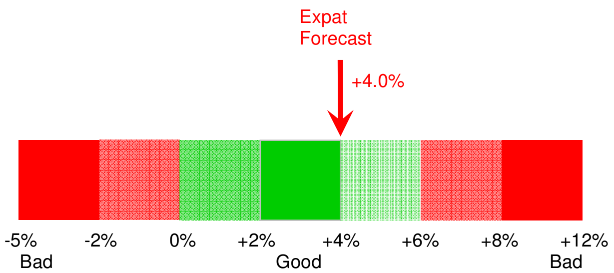
III) Government Debt, % GDP, 2012, Year-End



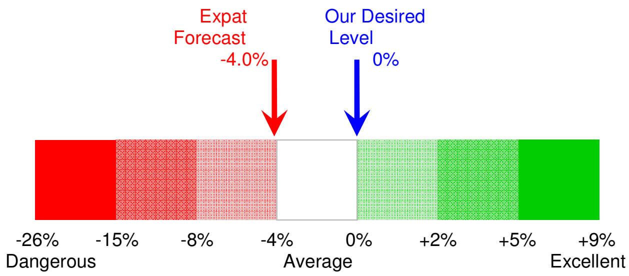
IV) Real GDP Growth, %, 2012



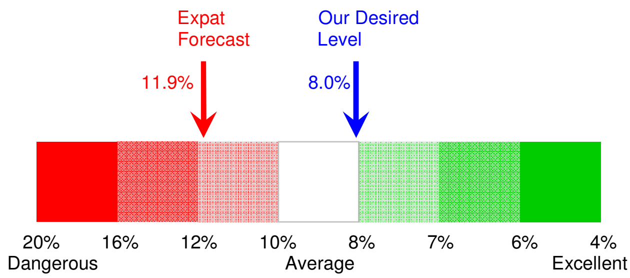
V) Inflation, %, 2012, Year-End



VI) Current Account Deficit, % GDP, 2012



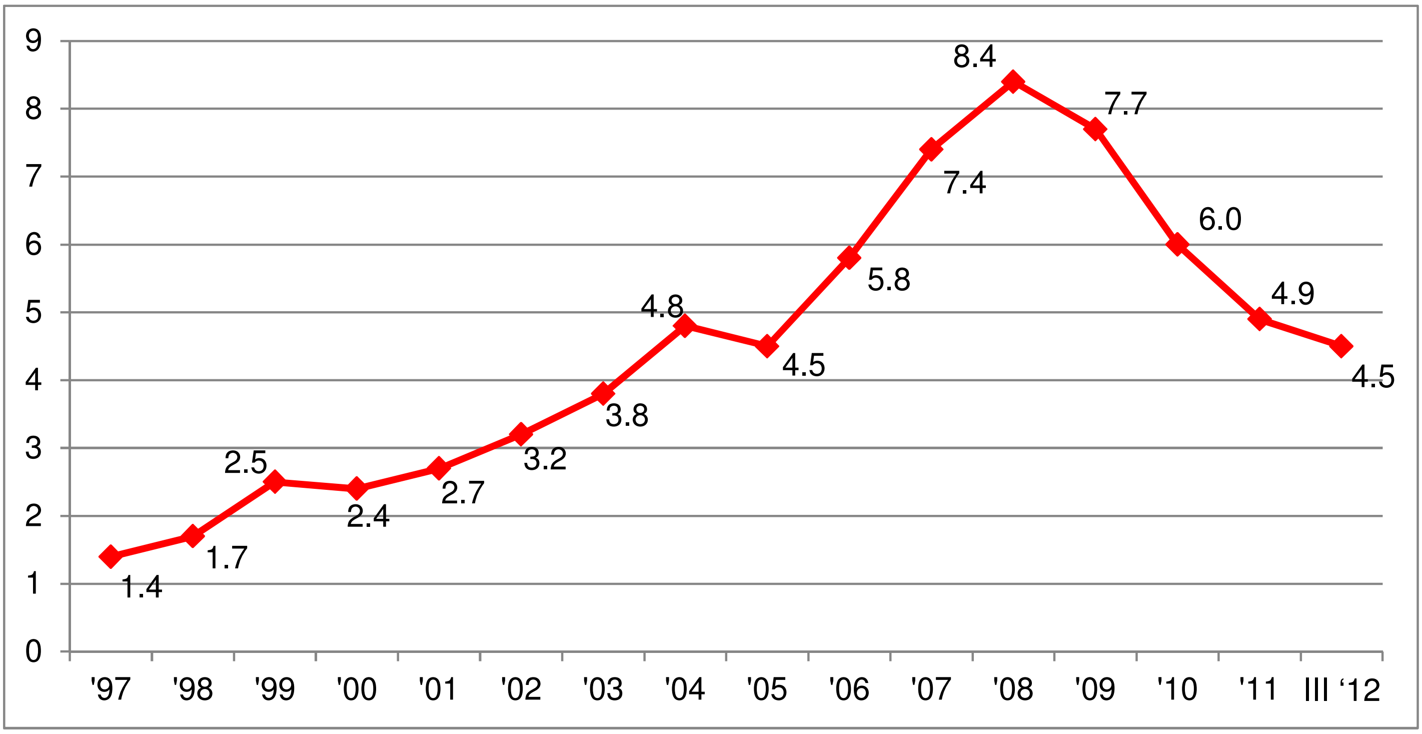
VII) Unemployment, %, 2012, Year-End



ANALYSIS

FISCAL RESERVES

Chart 1. Fiscal Reserves, 1997-2012, BGN bn



Source: Ministry of Finance

As it can be seen on the chart above, the history of fiscal reserves during the last 15 years can be divided into two distinctive periods. After the major crisis in 1996-97, Bulgaria almost went bankrupt. With the help of the IMF, through numerous privatization deals, three consecutive governments kept on accumulating large reserves, million by million. The process accelerated after 2003 when the country enjoyed about 6 years of large fiscal surpluses – cumulative over 15% of GDP.

The trend has reversed as the current government is likely to finish all the years of its term with budget deficits. As the 2012 nominal GDP is much larger than that of 1997, the BGN 1.7 bn of reserves in 1997 was much larger as % of GDP than today's reserves. Today, the number is between BGN 4 and 5 bn, with no prospects of rising to more moderate levels.

The reasons are:

- Budget surpluses are not likely any time soon. On the contrary, deficits have become the norm
- We do not expect any major privatization or concession deals till the end of the government's term
- The government is planning to deplete a part of the Silver Fund by 'investing' it in government bonds – i.e. by spending it to finance the budget deficits

In our view, all these are wrong policies.

BOUT THE SILVER FUND

DESSISLAVA NIKOLOVA

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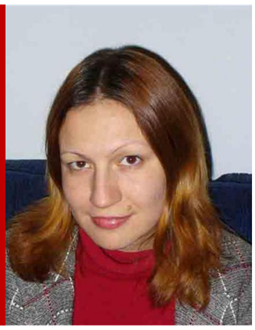
She is a Ph.D. in Economics from the University of National and World Economy (Sofia), and holds Master's degrees in Economics from the Central European University in Budapest and in International Economic Relations from the UNWE. Dessislava passed postgraduate studies in the field of monetary policy, exchange rate regimes and currency crises at Oxford University. She has extensive experience as a macroeconomic and economic adviser.



QUO VADIS, MR. DIANKOV?

This article was published in the 567th issue (March 2012) of the newsletter of the Institute for Market Economics

In the last months, the fiscal reserve happens to be in the limelight more often because of its persisting fast meltdown. What do the data show? Compared with the BGN 12.1 bn peak at the end of October 2008, we have a little less than 1/3 (or BGN 4 bn) of that level at the end of January 2012. The data about the deposit of the government and the budget organizations in the Issue Department of the Bulgarian National Bank, which represents the major part of the fiscal reserve, show that **even in February, the reserves continued to melt.** While by the end of January this deposit was BGN 3.4 bn (the remaining BGN 622 mln from the fiscal reserves is deposited with commercial banks), as of the end of February we have a new decline by nearly BGN 300 mln to BGN 3.1 bn. If we assume that the part of the fiscal reserves deposited with banks has remained unchanged in February, then **all of the fiscal reserves were about BGN 3.7 bn at the end of February.**

The main reason for the decline of the reserves since the autumn of 2008 is the covering of budget deficits. In other words, although there are various options for financing the deficits – issuance of domestic debt, issuance of external debt, privatization and concession revenues – in the last three years and several months the Ministry of Finance has been using mainly two ways of financing its deficits: domestic-market government securities and fiscal reserves.

Things are a bit different when it comes to privatization. According to the Silver Fund law prescriptions, the privatization revenues should be directed precisely to this fund. In 2010, the government came up with a way to circumvent this regulation with the creation of the so-called State Consolidation Company (SCC). Shares and entire companies (which have to be privatized) are put into this company as a contribution-in-kind. After the end of their sale, the privatization proceeds go directly into the budget via SCC's dividend to the government. However, this method has no formal relation to the financing of the deficit below the line, as SCC's dividend is recorded above the line as non-tax revenue. Ultimately, **in the last 3 years, the fiscal reserves have borne the main load of the deficit financing:** the cumulative deficits of the consolidated budget for 2009-2011 were about BGN 5 bn, while BGN 3.4 bn of it was financed from the fiscal reserves.

At the beginning of 2012, the melting of the reserves continued, and in January not only the consolidated budget deficit (about BGN 300 mln), but also the subsidies to farmers under the Common Agricultural Policy (BGN 743 mln, BGN 645.5 mln of which came from the EU and the rest – from national co-payments) played their part. As the Ministry of Finance explained, the part of these subsidies which are direct payments under the CAP (BGN 645.5 mln) will be reimbursed by the EU within 3 months. Viewed from this side, the reduction of the fiscal reserves by this BGN 645 mln is only temporary. If not counting this payment, the fiscal reserves should be around BGN 4.2 bn.

This is probably the right moment to explain **what the fiscal reserves serve for.** Their original idea was to guarantee the government's debt payments in the following 12 months. Even if this amount changes constantly and is not public, and even if we take into consideration the large debt payments in the middle of January 2013 (about BGN 1.9 bn counting the interest on the two Eurobonds as well), the fiscal reserves are obviously sufficient to meet our debt payments in a 12-month horizon. However, the big question is **whether all of the fiscal reserves are at the disposal of the Ministry of Finance.**

The fiscal reserves consist of several different funds and budgets, and, **de jure, the Ministry of Finance should have at its disposal only the state budget fund** (excl. the Silver Fund which is part of it) and the so-called central extrabudgetary funds. The main components of these extrabudgetary funds are the National Fund managed by the Ministry of Finance which should provide the national co-financing and the advanced payments for the European programmes, as well as the reserves of the State Fund 'Agriculture' whose functions are not clearly defined.

It is a fact that in January over BGN 700 mln was paid to the farmers, provided that there was only BGN 193 mln in the reserves of the State Fund ‘Agriculture’ at the end of December 2011. I.e., these payments were covered by other funds in the fiscal reserves – the republican budget fund and/or the National Fund of the Ministry of Finance. The last year’s data show that the reserves of the State Fund ‘Agriculture’ remain unchanged at BGN 301 mln in the first 10 months, while the farmers’ subsidies were paid in the spring, i.e. obviously this fund does not have any relation to the payment of the subsidies.

The other funds that are part of the fiscal reserves are the reserves of the NSSI (social security – BGN 96 mln in December), the NHIF fund (health – BGN 28 mln in December) and the so-called other budgets (BGN 294 mln) within which the two funds for NPP Kozloduy should be located: the ‘Decommissioning of nuclear facilities’ fund and the ‘Radioactive waste’ fund. The Ministry of Finance is not supposed to have them at its disposal for financing the budget deficits, but who knows. As a rule, the Ministry should not use the Silver Fund for such purposes either, but a way of using these resources via changes in the law has been found.

Now let us return to the question what amount of money the Ministry of Finance officially has at its disposal. According to the latest available data (from the end of December 2011), the sum of the republican budget reserves (without the Silver Fund) and the central extrabudgetary funds is BGN 2.8 bn. However, the extrabudgetary funds are targeted – as mentioned above, the National Fund (which had about BGN 1.4 bn in December) is supposed to provide the (smooth) financing of the European programmes by Bulgaria, while the State Fund ‘Agriculture’ should have some relation to agriculture (though it is not entirely clear in what way).

In other words, if these are excluded, **the disposable reserves for the Ministry of Finance, i.e. the republican budget reserves without the Silver Fund, will remain with the modest amount of BGN 1.2 bn in December.** It is interesting what happened to this fund in January. Given the shrinking of the total fiscal reserves by about BGN 1 bn in March, the largest part of the reduction should have come exactly from the republican budget fund.

We can only guess about the structure of the fiscal reserves in January and February, but the swift changes in the Silver Fund law made by the Ministry of Finance suggest that the Ministry is currently seeking ways to increase the proportion of the fiscal reserves available for spending. At the end of January, the balance of the Silver Fund was BGN 1.8 bn. With the draft amendments to the Silver Fund law, 70% of this amount will be available for investments in Bulgarian government securities, i.e., approximately BGN 1.2 bn. Even if the Ministry of Finance continues its reserve-reducing policy, the question is what we are supposed to do in 1 or 2 years when the reserves will be reduced to the minimum.

Then, debt in larger amounts should be issued. Having in mind the objective limits on debt-taking in the country, it is very likely that we will resort to external debt as well. The question here is whether, **if we reach the minimum levels of the fiscal reserves, this would make the conditions under which we can get external borrowing worse** in a period when we will have no other opportunities for financing? It is a fact that rating agencies, in their comments on our stable financial situation, quote several strong points, the fiscal reserves traditionally being among them. If they reach a minimum size, would this not increase the probability of a negative action against our sovereign credit rating (or its outlook)? Also, would this not reflect on the price at which we can get external borrowing? It would be nice for the Ministry of Finance to try to give answers to these questions.

** Quo vadis is a Latin phrase that literally means ‘Where are you going?’*

CASHING THE SILVER FUND IS THE EASIEST THING TO DO, BUT IT IS EXTREMELY UNWISE

Published in the 24 Chasa Daily Newspaper, March 2012

At the beginning of 2013, Bulgaria will have to meet its foreign debt payments amounting to EUR 818.5 mln, or BGN 1.6 bn. If we add to these the last coupon payment of EUR 61.4 mln due on these bonds, and another USD 44.8 mln of interest on another bond, then the payment will swell to about BGN 1.8 bn.

The date on which the treasury should part with this large amount is set to be 15 January 2013. Having in mind the few working days in the new year before the payment day, the Ministry of Finance will have to get prepared for it within this year. I.e., apart from the expected 2012 budget deficit of BGN 1.1 bn, this year the government will have to find financing even for the debt payments at the beginning of 2013. The total amount of the required resources which have to be raised somehow in the next 8-9 months is almost BGN 3 bn.

In the recent weeks, there has been a lot of talk on how these payments will be financed. It seems that one of the sources for the debt payments will be *the so-called Silver Fund*. By the end of February, the assets of the fund were BGN 1.8 bn. This significant amount has obviously stimulated the appetite of the Ministry of Finance, if changes in the Silver Fund law were swiftly prepared to allow some of its money to be used for this purpose.

The ‘cashing’ of the Silver Fund will be elegant and legally precise by allowing the fund managers to invest up to 70% (or about BGN 1.2 bn) of its assets in Bulgarian government bonds. The excuse of the Ministry of Finance is that this will allow better management and a higher return for the fund.

According to the data qouted, the fund currently has a negative real return and, de facto, is losing money because of inflation, as its assets are held in a low-interest deposit with the Bulgarian National Bank.

However, what the Ministry of Finance is not telling us is that even now the Silver Fund law allows the fund’s assets to be invested in a number of instruments. If the fund managers wanted, they could run it more actively even now – investing in bank deposits, shares of companies from the EU or third countries with an investment grade, debt securities with an investment grade, money market vehicles, and other securities. I.e., the argument which the Ministry of Finance is using to justify the changes in the law is frankly deceitful.

What puts the Ministry of Finance at unease is actually another text in the law which explicitly bans the investment of the fund's assets in Bulgarian government securities. This ban ties the hands of the Minister to take the fund’s money against a government securities issue. What the Minister is also not telling us is why there is such a ban in the law. One can easily be left with the impression that it is some kind of a mistake of his predecessors who had created these regulations.

Yes, but no. There is nothing accidental in this decree which explicitly bans several types of investments, especially Bulgarian government securities. On the contrary – the logic behind such a restriction is simple and it is linked to the initial idea about the existence of the Silver Fund. The idea of its founders was that the fund should serve as a counter-cyclical instrument and a source of income for the pension system, even when there is low or negative growth. Simply put, if the Bulgarian economy shrinks, there is a great chance for the Silver Fund’s return to suffer less, if its assets have been invested abroad.

The other serious problem is hidden in the obvious conflict of interest that arises with such an operation. On the one hand, the Ministry of Finance will be selling the securities. On the other hand, as Fund Manager, it will be buying them. The question is whose interests will the Ministry defend – those of the Fund (to buy higher-yield securities) or those of the government (to sell bonds at a minimum yield)?

In the last few days, both the Minister of Finance and the Prime Minister calmed us that only a part of the Silver Fund’s money will be invested in government securities.The Prime Minister mentioned a 20% roof, and Minister Diankov tossed the idea of buying securities by the fund ‘step-by-step’ – initially 35%, next year – 45%, etc. However, the exact percentage of the Silver Fund’s assets which will be exchanged for securities is of no importance and does not change the fact that the fund’s reserves will not be used for their intended purpose.

As the minister himself admits, treating these reserves as ‘money for rainy days’, is too far away from the purpose of its creation – namely, to support the state pension system. Yes, currently, the money in this fund is not much, compared to the needs of the pension system. But this is no reason for us to spend it lightly. On the contrary, we should try to raise its assets and at the same time manage them more actively, so that they bring higher returns.

But let us return to the upcoming debt payments and the possible sources of their financing. Recently, there are talks about the so-called ‘Holy Trinity’ consisting of domestic financing, issuing external debt, and privatization. The minister's plan is that the domestic government securities (incl. the ones which will be sold to the Silver Fund) and the privatization get the leading role, and the external debt – a secondary one.

Undoubtedly, the best option to finance the debt payments is privatization since it does not increase the debt burden. From an economic point of view, privatization should be leading, as the more resources are gathered this way, the better. The idea of the Ministry of Finance is that a minority stake of the Bulgarian Energy Holding and several smaller companies should be sold this year. The problem is that we have not seen much progress on any of the planned deals so far. If we want something to happen in this area before the end of the year, we must act more decisively.

The issuing of government securities in the domestic market is also a traditional option for refinancing. The question is what number of government securities could be taken by local players (banks, pension funds, investment funds, etc.) this year. Last year, around BGN 1.1 bn of government securities have been sold in the domestic market. Even if we assume that this year a little more of them will be sold because of the decreased lending and of the huge liquidity injection to European banks by the European Central Bank, it is unlikely that the domestic market will be able to provide all the necessary resources.

The external debt option has been on the table for several years, but up to now, the government has not resorted to it. Given the relatively small financial needs of our country (compared to the ones of Italy or Spain, for example) and our stable public finances, such an issue will be sold easily and at an affordable price.

However, under all circumstances, no matter what the ratio among privatization, external debt, and domestic government securities will be, the Silver Fund should remain untouched. If the Ministry of Finance cannot manage it effectively within the current law, then let it select professional managers to do that. Just like the Bulgarian National Bank does successfully with a part of its foreign exchange reserves, by the way. There are plently of opportunities for meeting the government’s financial needs via privatization and new debt. The question is to plan from afar and to act reasonably and not to seek the easiest way with the spending of the Silver Fund.

GUEST COMMENT

WHERE ARE YOU GOING, EUROPE?
BISSER MANOLOV

Bisser Manolov is a financial consultant. He was Chairman of the Management Board of the Bulgarian Deposit Insurance Fund for two mandates and now is Board Member. He has been working in the banking sector since 1990. Mr. Manolov was one of the founders of the Bulgarian Dealers' Association and its President in 1998-2002. He is Member of the Executive Council of the International Association of Deposit Insurers. Bisser Manolov holds a Master's degree in Economics from the University of National and World Economy, Sofia.

The article was published in the author's blog – www.bissermanolov.com

I do not know why, after this question, I remembered those winged Bulgarian words 'Do not give me any wisdom, give me money'. I have always known that this formula does not work but I was not expecting to get such confirmation of my belief. The proof are the recent events in Europe – there is a lot of money but so what – when there is not enough wisdom. Here are the facts. In the last few months, the European Central Bank has poured liquidity of more than EUR 1 trillion into the financial system. Obviously, the Eurozone economy was not affected by this. You are wondering what happened with the money? The European banks are buying German government bonds. A total paradox. The more liquidity is being poured into the system, the more it becomes obvious that the system is not working. The macroeconomists, recently best known for their erroneous predictions, accumulated so much material on what should not be done in times of crisis that the role of chroniclers suits them better than that of experts. The repeating of the refrain 'The worst of the crisis is behind us' does not automatically make it a fact. And who can tell us if it is so?

The presidential elections in France will determine the direction of the economic development in one of the pillars of the EU for the next five years. Therefore, I will introduce my interpretation about whether the worst is behind us, Europeans, through the prism of the preelection political speaking and economic statistics. At a multi-thousand preelection meeting held in support of his stated ambitions for a new mandate, the [former] French President Sarkozy said that in order to support economic growth in Europe, he would raise the question about the powers of the European Central Bank. Otherwise, Europe will lose ground under its feet. I admit that I remained dumbfounded by these wise words. With what more than low interest rates and infinite liquidity could the ECB support growth? Perhaps, Mr. Sarkozy means that the Central Bank should start directly giving corporate credits as well? Should he be reminded that in November 2011, during a meeting between him, Mrs. Merkel and Mr. Mario Monti, he vowed not to make any further comments on the actions of the central bankers? There is nothing more dangerous for Europe than a politician shaping his own conceptual despair in hollow phrases. The ECB should take care of growth. But how?

In 2011, the policies of the current French government resulted in:

- public debt amounting to 85% of the French GDP, EUR 1.69 trillion at nominal value
- government budget deficit of 5.8% of GDP
- unemployment – over 10%
- GDP growth – about zero

Whenever we are talking about France, it is absolutely logical to make a parallel with what is happening in Germany. In Europe's largest economy things seem diametrically opposite. Unemployment is at its lowest level in the last 20 years. In 2011, the prices of real estate recorded a 5% growth due to the Germans' concern about the future of the common currency. The 2011 budget deficit is slightly over EUR 34 bn (in comparison, in France it is EUR 116 bn – the largest nominal budget deficit of all the European countries).

Against these figures, I wonder what exactly Mr. Sarkozy has in mind when he refers to the ECB as a participant in the measures for stimulating economic growth. We all know about the extremely generous social system in France. It is obvious that under the conditions of a financial and economic crisis, it cannot withstand, and the question 'Which way now?' arises reasonably. For all Europeans it is now clear that whatever a politician speaks about, it is all about money in the end.

The Maastricht Treaty is fundamentally outdated. Its fiscal criteria still remain a good intention far from the actual behavior of member states. Can you imagine what would happen if the deficit and national debt criteria are applied directly to France? One of the EU pillar countries is violating the basic fiscal principles with impunity. Exactly this double standard shook the foundations of the entire system. The fundamental question is should the system's operating principles be changed or the system itself? Do not get me wrong, I am an outspoken supporter of the market principles in the economy. But now there is a huge amount of accumulated errors, and the question is what kind of quantitative changes they will transform into. If a conclusion about the situation could be made today, it would be not that 'the worst of the crisis is already behind us' but that 'social Europe in its old form is already behind us'.

Social policy is a function of the real economy, the state only redistributes (if there is, of course, something to be redistributed). If there is no ‘money under the mattress’, and the state continues to behave ‘socially’, the budget deficits are piling up and sooner or later will explode in a devastating way and ‘take’ all the social benefits in the manner in which they have been distributed.

My main point is that Europe is currently suffering from a symptomatic lack of ideas how to deal with the present situation. I gave Mr. Sarkozy as an example on purpose. His behavior is a classic example of how an unreformed social system destroys societal wealth instead of creating it. However, something else is of greater importance: To what extent does society itself want the painful reforms? In France, ‘leftist policies’ are rapidly gaining popularity. Let me just remind that the main populist ideas thanks to which the so-called ‘left front’ is gaining such popularity among voters are the increase of the minimum wage from EUR 1,400 to 1,700, a state confiscation of the entire annual income over EUR 360,000, as well as the introduction of a ban for the profitable companies to dismiss their employees. What would you say about it? What kind of financial stability pact, what kind of budget constraints are we talking about?

The truth is that Europe, unlike America, has failed to take full advantage of the financial and economic crisis in order to implement real reforms. Everything was based only on pouring money into the banking system and tightening bank regulations. The bill was paid by corporate Europe again. The inability of the European leaders, excluding Germany, to draw the contours of economic growth brought the ‘populist’ ideas to the stage again. William Boetcker’s words from 1916 sound rather up-to-date in this case: ‘You cannot lift the wage earner by pulling down the wage payer’.

Europe has failed to take full advantage of the financial and economic crisis in order to implement real reforms.

The size of the various funds for financial stability no longer shocks the financial markets. Today, even kids at school know how many zeros there are in a trillion. There are no real reforms. Decisions are spontaneous and only aim at postponing the problems. Economic growth is a function of the free entrepreneurial spirit, not of the froth at economic and political conferences. All the money spent by the governments so far has not reached real business. Its purpose is to ‘stabilize’ the financial system, but without economic growth this seems like trying to fill a pool with a sandy bottom. We need fresh, really fresh ideas. Or better may the Chinese come!

MANAGING THE SOFT LANDING OF THE TURKISH ECONOMY – BETTER LATE THAN NEVER

MEHMET GERZ, ATA ASSET MANAGEMENT

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Previously, Mr. Gerz was Regional Director, responsible for investments in Turkey, MENA and EuroAsia regions, at the New York-based hedge fund Drake Capital. His professional experience also includes serving as Head of Equity Research, Strategist and Research Analyst at a number of Turkish brokerage companies, incl. Yapi Kredi and Bayindir, and as Buy-side Analyst at Sparx Asset Management.

Turkey's GDP growth will slow down to a more sustainable 4% in 2012, down from 8.5% in 2011 and 9.0% in 2010. Driven by strong domestic consumption and private investments, Turkey seems to have no problems growing. The problem is the large current account deficit (10% of GDP) that is the result of the domestic savings rate (13% of GDP) falling short of investments (23% of GDP). The second highest external deficit in the world makes Turkey's decade-old economic success story susceptible to a potential deepening of the European economic crisis. This was the case during the global financial crisis four years ago when Turkey's growth rate slumped to -4.8% despite its healthy domestic growth dynamics. Nonetheless, Turkey's annual GDP growth rate between 2002 and 2011 recorded a healthy average of 5.4%.

Armed with strong domestic and international credibility, the Turkish government became somewhat over-confident as it left the solution of the large current account deficit problem to the Central Bank (CBRT). The government-friendly CBRT management tried its best as it managed an orderly, yet sizeable devaluation of the Turkish Lira in 2011. In an effort to help tame domestic consumption, it imposed a 25% limit to bank credit growth, down from as high as 40% in 2010.

However, all these measures proved insufficient as the oil prices continued to rise into 2012, despite a soft-patch in the global economic recovery. Turkey's energy import bill exceeded USD 50 bn in 2011, accounting for 2/3 of its record-high current account deficit of USD 77 bn.

Finally, the usually growth-oriented and self-confident PM Erdogan was convinced by the more prudent economy minister Ali Babacan that something more fundamental needed to be done to reduce import dependency and to increase domestic savings. The first policy response was to unveil wide-ranging investment incentives aimed at import substitution in areas such as mining, chemicals and defense electronics that caused the trade deficit.

State Contribution to Private Pension System to Help Boost Domestic Savings

Second and more recently, the government announced measures to help improve Turkey's notoriously low savings rate. The specific measures include a lower withholding tax rate for longer-term bank deposits as opposed to the current practice of a 15% flat tax across all maturities, a zero withholding tax rate for equity mutual funds (defined as those having at least 75% invested in listed Turkish stocks) versus a 10% tax for all other mutual funds, and, finally, the all-important government contribution to Turkey's relatively young but strongly growing private pension system.

In essence, the government will start matching 25% of all participants' contributions, up to a limit of 25% of the minimum wage that currently stands around USD 500 per month (after-tax: USD 400). This means the government will contribute at most USD 125 per month to an individual's private pension account. With 2.8 million members and TL 16 bn (USD 9 bn) in assets under management (1.2% of Turkey's USD 772 bn GDP), the 10-year-old private pension sector welcomed this change with the hope that growth in assets under management (AUM) will accelerate. There are widely varying estimates for the pension fund size to reach TL 50-90 bn (USD 30-50 bn) in five years' time.

We find these forecasts conservative in light of comparisons with other emerging economies such as Chile and Poland. An important difference in the comparison is that Turkey's private pension system is a voluntary, defined-contribution pension plan (the so-called 3rd pillar in the World Bank model) whereas most Latin American and CEE countries adopted World Bank's model with a mandatory second pillar. Thus, most Turks still rely on the government-funded social security system which is a typical PAYGO, defined benefit retirement plan. However, as Turkey's GDP per capita now exceeds the USD 10,000 mark, the growing middle class will find the social security retirement salary insufficient to maintain post-retirement life standards, and hence, increasingly participate in the voluntary private pension plans.

Spill-over Effects of Pension Funds Growth to Turkish Capital Markets

One industry expert claimed the big jump in the private pension system will be achieved when GDP per capita exceeds USD 15,000, probably sometime between 2018 and 2020. We think Turkey's pension funds by then will have reached the point where Poland is today. With 15% of GDP, the Turkish pension funds have the potential to reach USD 180 bn by 2020, with the following potential spill-over effects on the development of Turkish capital markets:

- Local equities accounted for only 15% of the Turkish private pension funds – in comparison to 30% in Poland. Keeping the 15% equity allocation constant, a Merrill Lynch study estimates annual inflows of some USD 750 mn from Turkish private pension funds into local equities. Taking the Polish case as a reasonable guide, we think such inflows may soon reach USD 1.5 bn per year, more than the average USD 850 mln annually invested by foreign investors into Turkish equities.
- Notwithstanding its reduced borrowing needs, the Turkish Treasury is offering longer term local bonds such as 10-year to help form the Turkish yield curve, helping investors and corporates better utilize debt markets. As Turkey's EU-defined government debt-to-GDP ratio fell to 39% last year, way below the EU's Maastricht criterion of 60%, the government no longer crowds out the debt markets, thus allowing the corporate bond market to start growing. Bonds issued by major banks offer an additional yield of around 1.0% on top of the government bond yield, currently at 9.3%, while non-bank corporate bonds offer spreads ranging from 1.5% to 4.0%.
- The Treasury is also offering floating rate notes and inflation-linked bonds (the so-called CPI-indexed government bonds) which are essential for pension funds whose primary objective is to maintain the purchasing power of the participants against inflation. The last 10-year CPI-indexed bonds yielded 3.5% per annum above the CPI.
- The Government plans to allow pension funds to invest into gold, real estate and SUKUK (Islamic bonds) instruments, helping broaden the pension fund investor base to more conservative sections of the society.

Asset Management Needs Further Reforms to Complement the Progress in Pensions

The new incentives for the private pensions are in line with the Turkish government's determination to help develop the local capital markets and make Istanbul a regional financial center. To this end, the tax laws are being revised to make it as easy as it is in Luxembourg to conduct asset management business in Turkey. However, the reform package did not propose any measures towards making asset management more competitive. Presently, large banks dominate the business by restricting the distribution of mutual funds to themselves. In a similar vein, the pension companies, most of which are owned by large banks, grant the management of their pension funds to sister asset management companies. Due partially to the lack of competition, the pension funds paid asset management and distribution fees as high as 3.7% of AUM in 2011.

The incentives for the private pension system are in line with the support for development of the local capital markets.

One criticism the pension reform faces is the fact that Turkey's private pension system is an optional system, as opposed to the mandatory pension systems in the CEE and LatAm countries, and hence, it may not have the desired impact on the development of the local equity and corporate debt markets. While academically true, the sharp reversals in the private pension reform of the CEE countries in the aftermath of the global crisis lend support to a gradualist approach.

For example, Poland reduced pension contributions from 7.3% of the gross salary to 2.3%, diverting 5% towards social security, while Hungary nationalized its private pension system altogether. These reversals may shake the trust in the private pension system and potentially disrupt the growth of local markets. By contrast, Turkey has chosen to keep its private pension system optional, but encourage participation through a meaningful state contribution.

GUEST COMMENT

CORPORATE SOCIAL RESPONSIBILITY AS AN INVESTMENT

DESSISLAVA TODOROVA, CSR BULGARIA

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Dessislava has a degree in International Economic Relations from the University of National and World Economy. Currently, she teaches 'CSR Business Practices' which is part of the first-of-its-kind master's degree programme in Bulgaria 'Corporate Social Responsibility' (Financial Management) at VUZF University, Bulgaria.

Corporate Social Responsibility is a relatively new phenomenon in Bulgaria, but it has a basis to lean on and to develop here. In fact, it is already doing it with success.

For those of you to whom this phrase sounds implausible and even less would consider it an investment, in the next lines I will start from afar in order to explain the contents of it and the synergetic effect that lies behind these words.

Corporate Social Responsibility (CSR) is part of business. It is even the way in which we do business – with responsibility for all the parties involved – our shareholders, employees, suppliers, customers, residents of the communities in which we do our business, etc. CSR is a concept which the companies voluntarily implement in their business strategies in order to show their long-term commitment to the sustainable development of their business, the society, and the environment. They accept engagements that go beyond the legal requirements, striving to improve the standards for quality, social development, environmental protection, and, of course, their employees' standard of living.

However, what would motivate a company to focus on the 'social', on the 'responsibility', what would get it to increase its engagements, and, as it seems at a first glance, its expenses? Is not the focus of a company just and only on profits and cost reduction?

On the one hand, the motivation for this is the emerging new competitive environment – the customers' requirements, the pressure from non-governmental organizations and competitors who have already begun to implement CSR activities. However, this is the external, the 'negative' motivation. On the other hand, there is an inner motivation for sustainable growth and good public image, and of course – the marketing aspect of CSR implementation in the strategy of the company. This plan exactly shows the perception of CSR as a sustainable and long-term investment.

Today, it is extremely important to be competitive and make the right investments. What exactly does it mean to invest through CSR and what exactly do we invest in – in society, in our employees or in the development of our company? And who benefit from this?

If we want our CSR activities to have an economic sense and to realize their maximum synergetic effect, they should come from the 'heart' of the business – to be inwrought into the corporate mission, the culture and the climate of the organization. The trends are: having started from fragmented activities that cannot be identified with the company at all and have an almost zero marketing effect except making noise about a concrete event, companies increasingly move towards a strategic approach in deciding on CSR activities. This means that the activities should be aligned with the business objectives and recognized as useful by the employees, and should have a connection with the products and/or the services offered by the company.

Following these basic requirements, the benefits come logically – for the society, the employees and other involved parties, for the company and its development, for its public image and among shareholders, investors, and competitors.

Concrete benefits:

- More responsible and motivated employees who identify themselves with the company and the good deeds it does for the society, and are proud of it
- More loyal customers who buy products made more ecologically or support a cause they feel engaged with
- Suppliers and partners with long-term win-win contracts meeting the quality and environmental requirements
- Greater presence in the positive news, not in the black chronicle
- More competitive products/services, meeting the higher requirements of the consumers today
- Cost reduction due to optimization and 'greening' of the production processes, employees' motivation and efficiency, the stronger commitment to the company and its culture and less absence from the work process
- Social trust in the company because it has proven that it thinks about its customers and offers them quality at competitive prices
- Stronger brand positioning in the consumers' minds
- Better corporate image and influence
- Easier access to capital because the value of the company is increasing

The coin, of course, has another side. The CSR benefits are not directly measurable, companies still do not report their costs for this activity, and it is difficult to trace and evaluate the returns. These benefits come after more efforts, strategically focused actions and pursuit of goals.

However, the effect of this process compensates the efforts. After all, the companies always take more than they have given. But if you want to take something, you have to give first.

CSR BULGARIA

CSR Bulgaria is the first Bulgarian professional network for corporate social responsibility (CSR) that builds a stable relationship between needs and resources of the society and business. The first specialized media for CSR News is a part of this network – CSR Media which promotes CSR's concept and informs about projects, events, and practices in this area.

THOUGHTS ABOUT THE 1995'S BEST EMERGING MARKET FUND

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

The article about Steve Hanke's Toronto Trust Mutual Fund Argentina was published in Micropal

The long, dark shadow of the Mexican Peso crisis cast itself over the emerging market universe in 1995 like some sinister ghoul, frightening away investors and sending many of the dedicated managers scurrying into the distant, unfamiliar corners of the investment world: Africa, the Middle East and Russia.

For some, however, the crisis in Mexico was an unexpected boost. Just ask Steve Hanke, Professor of Applied Economics at Johns Hopkins University, Forbes columnist, advisor to Argentina's Minister of Economy, President of the best performing Emerging Market fund for 1995 (Toronto Trust Mutual Fund Argentina), which was up at a stunning 79.25%.

The investment policy for Toronto Trust Argentina was laid out in Hanke's Forbes column in December 1994, just prior to the Mexico crisis. Hanke identified that understanding a country's monetary policies is crucial to getting right timing in emerging Markets investing. Key to this is understanding a country's exchange rate system.

There are three types of exchange rates – floating, fixed and pegged. The floating exchange rate, which is used by the US and by most major currencies, is not used in Emerging Markets, but both the fixed and the pegged are, with the latter being prevalent. Fixed and floating systems are free-market mechanisms, limiting a governments' control over the currency, whilst a pegged rate is an interventionist tool, decreeing that the central bank must manage the exchange rate, liquidity and the capital account. Hanke cites this as a near impossible task, and warns investors to pay the most careful and anxious attention to pegged exchange rate systems.

The fixed exchange rate is used only in a small minority of countries: Argentina, Lithuania, Estonia and Hong Kong. Prof. Hanke was involved in the creation of the currency-board systems in Lithuania (April 1994), Estonia (June 1992), and most notably in Argentina (April 1991). As a result, the Argentinean peso, fully backed by USD denominated assets, is freely convertible into US Dollars at the fixed rate of one peso to one dollar, and Argentina is now part of the unified US Dollar area.

The markets considered Argentina's currency-board as high risk, even before the crisis in Mexico. For the Toronto-based Friedberg Mercantile Group, which manages Toronto Trust Argentina and where Hanke was Vice-President, the picture was somewhat different. Hanke's thorough understanding of the system, gained from within, suggested a different scenario. Whilst the rest of the market thought Hanke and Friedberg to be not entirely serious and ultra-optimistic, the company started to make its investments.

Friedberg's basic premise is this – once the exchange rate is absolutely fixed, interest and inflation rates in a currency board country will start to converge towards those in the anchor country currency. Inflation in Argentina was indeed falling, ending in 1994 only just above the US rates. Interest rates, however, were well above those in the US. Peso-denominated T-bills were yielding around 10% and 7-year paper yielded 16.75%. Comparable rates in the US at the same time were just over 5 and 8% respectively. The differences can occur for a number of reasons – for international investors, the total cost of investing in Argentinean paper was higher than for US bonds, and perhaps more importantly, Argentina's credibility as a debtor was somewhat below that of the US. However, Hanke and Friedberg considered that the differences in yields between the US and Argentina were unjustified and, that Argentinean debt securities were, hence, a very interesting prospect.

> *'Mexico was the best thing that happened', asserts Prof. Hanke.*

Then the Mexican Peso was devalued, and most of the rest of the world sought to liquidate Argentinean peso holdings. By March 1995, panic selling was nearing a peak and yields were as high as 46% on some paper. The world, and its dog it seemed, was selling while Friedberg was buying. Whilst the world saw collapse and disaster, Hanke saw greater opportunity – 'the rest of the market got it wrong'.

So why was there almost unanimous misconception? How could experienced traders and managers from the rest of the world miss such an opportunity?

Hanke cites his and Friedberg's experience as currency traders as a core reason. 'This gives us a better understanding of the market than many other players. Half way through 1995, nobody foresaw that an Argentinean fund would be top of the pile at the year end, but this 'anomaly' was predictable. It just requires knowledge of the system', argues Hanke.

Indeed, on 17 January 1995, Argentinean Finance Minister Cavallo recruited Hanke as an official advisor, to explain to the world how the currency-board worked. 'But was anybody really listening?', asks Professor. It seemed to Hanke, that the international players took his optimism with a large grain of salt. 'People who I spoke with, and who obviously thought I was a bit off-the-wall, would later ring me back and say 'you were right all along', but they still would do nothing about it.'

Emerging Markets, more than developed ones, are rife with rumors and hearsay. 'I have known Menem [Argentinean President] since 1989, and I knew that the rumors that Cavallo was going to be sacked, or resign, were nonsense', comments the Professor. To reinforce this, Hanke and his wife Liliane interviewed Menem for Forbes magazine in September 1995. It ended with Menem's assertion that Cavallo would stay with the government 'until 1999'. Obviously, fund managers do not believe everything they read in the press.

'People do not always seem to pay attention. The market's perception was completely out of line with reality. A fantasy land', Hanke continues. He is also a little critical of some of the less experienced players, predominantly from London and New York. 'They are too much influenced by the Argentines, who, given Argentina's propensity to shoot itself in the foot, have become rather pessimistic.'

Friedberg, because of their own knowledge of the market, did not succumb to this negative local bias. Coupled with a rather superficial understanding of currency markets, especially the fixed-rate currency board system, it was the influence if this local pessimism that kept most of the big foreign players out of the Argentinean debt market.

Hanke notes that 'more people are realizing the strengths of Argentina now'. This does, to some extent, reinforce Hanke's view that the competition in 1995 was 'too hesitant, too slow and too reactive. Our knowledge of the system helped us to anticipate developments, and get our timing right.'

With interest rates in Argentina falling in 1996, liquidity rapidly increasing, and the economy likely to grow by 5% in real terms (Hanke considered it may do even better) and profits returning, Friedberg was now looking seriously at equity investment. Already, they hold 10% of the fund's portfolio in convertible debentures, and the first straight equity investments will probably follow shortly.

Prof. Hanke re-iterates the advantages of knowing the currency markets. 'If you do not understand the currency situation, you can get clobbered. You will therefore get your buy-sell timing wrong, and you will only react, not anticipate. We succeeded in 1995 because we anticipated the situation. Mexico just made things better.'

At Friedberg people are, according to the Professor, currency specialists first, country pickers and portfolio allocators second. 'If you get the country right, and you know now much to allocate to bonds and equities, individual stock selections are not always vital. Obviously, if you just pick the dogs, you will not get anywhere. But, if you get the currency right, then the stock selection will be less important.'

'Ultimately, victory is often not being overwhelmed by the opposition', Prof. Hanke muses, quoting the Duke of Wellington.

AN EXPERIMENT WITH 2 BILLION PIECES OF SILVER

NIKOLAY VASSILEV, CFA

The ideas for more creative activities with the Silver Fund have kept on appearing since the beginning of the government's term – allegedly for two noble causes:

- To achieve a higher return on this rather large amount – accumulated mostly by the previous governments
- To use the resources to stimulate the Bulgarian economy, instead of 'working for foreign countries'

For the non-professionals, these arguments sound nice and generate support for the recently proposed changes – to invest a large part of the Silver Fund in Bulgarian government securities, stocks and bonds.

In my opinion, however, the reason for the proposals is different and not so noble: seeking for easier ways to finance the budget deficits which accumulate every year. This will be the first government since Videnov which will end all the years of its term with a deficit, albeit smaller than the deficits of dozens of others more reckless and unreformed countries.

Is it easy to achieve a higher yield? How about the risk?

The general public can easily be convinced of the following:

- Bulgarian banks pay 6% interest on deposits, while Swiss or German banks – a little above zero.
- Why finance France via French government securities if we could invest in Bulgarian ones?

Not surprisingly, however, there is a strong connection between return and risk. The interest rates in Romania are naturally higher than those in Austria because the risk of losing everything is also bigger.

The savings of a family for 'rainy days'

The nation is like a big family – the children study, the parents work, the elderly receive pensions. Regardless of the amount of its income, every reasonable family strives to store at least some reserve – in the form of a deposit, a 'money jar', or gold and family jewels. It is used only in extreme situations: a disaster, an illness, an income crash, the children's education. If, instead of being kept for 'rainy days', the savings are frivolously wasted on a newer TV, a more modern phone and expensive vacations, this would call into question the ability of the family to come out of a potential crisis unscathed.

All the eggs into one basket?

Let us suppose that you work for Kodak (which went bankrupt in 2012). Is it reasonable to put all your savings into your employer's shares? If the company goes bust, you will lose both your job and your savings. Such examples, described in the finance textbooks, sounded rather abstract to me so far. Until I learned that two of my fellow students from the U.S., who built a whole career at Lehman Brothers, were left unemployed after its unexpected bankruptcy in 2008, and they also had the imprudence of investing hundreds of thousands of dollars in shares of the same bank.

No matter how much they believed in the success of the company, they should have saved their money elsewhere. If the bank is successful, their career will reward them sufficiently. Because if the bank fails, they will get the bitter lesson about the advantages of the diversification and the risk of putting all the eggs into one basket.

The same applies to the Silver Fund

The future of the Bulgarian pensioners greatly depends on the success of the Bulgarian economy. When there are investments, growth, jobs – more taxes and social insurance contributions would be collected, and there will be higher pensions. And what if crises and recessions follow?

If the Silver Fund also invests mainly in Bulgarian government securities, we put the eggs again into a single basket. If another crisis overtakes us, we will have neither enough budget revenues (as it is now), nor profitable securities (the Bulgarian Stock Exchange is down by 84%, and many corporate bonds have imploded).

Look at Greece. If both public and private pension funds, and also the personal savings of the people there were mostly in Greek securities (government bonds and shares), what would happen to the pensioners? Both their state pensions would be reduced, and their savings would evaporate. And if a currency crisis hits them with the return of the drachma – congratulations!

Global portfolio management and local markets knowledge

Should the savings of the Swedish and the Danish pensioners be invested in the same way or differently?

Today, the financial markets are global, and it is easy to invest from Tokyo to Toronto. The contemporary financial theories would recommend that Swedish, and Danish, and Brazilian pension funds should have approximately the same diversified portfolios. Apart from short-term tactical forecasts for the market movements, there should be a variety of vehicles in the portfolio. The U.S. and the European securities would be much more than the Indonesian ones because the sizes of these financial markets are different.

In this sense, it should not matter whether the fund is Swedish or Danish. Within this allocation, the securities from Sweden and Denmark would be below 1%. The same goes for the Bulgarian funds – the theoretically correct distribution in Bulgarian assets should be minimal.

What happens in practice?

Actually, things do not happen this way. When I worked in the UK, the private pension fund in which I was saving was some 40% invested in British securities – and it was managed by one of the largest banks in the world. As I expected, the lack of diversification played a bad joke. The depreciation of the British currency in the recent years has led to negative returns in euro for my retirement accounts.

There exists the so called 'home bias', or the propensity of portfolio managers to invest at home more than it is logical. There are several explanations – some of them are reasonable, others are not:

- Lower transaction costs – it is easier and cheaper to trade on our exchange, rather than on the Australian one.
- Better awareness of local companies. The Bulgarian portfolio managers know better the success stories of Albena, Sopharma or FIB, while they might learn about Kodak's bankruptcy from the world media when it is too late.
- It is expensive and impossible for small funds to maintain hundreds of competent analysts, speaking many languages and tracking thousands of companies and vehicles worldwide, 24/7.
- There are also corporate affiliations – 'Our fund will invest in our affiliated companies'.

The risks for the politicians

Life is often unfair to the good intentions of the politicians. If they are lucky with the market movements, invest the Silver Fund in Bulgarian securities, and get a return of +20%, it is unlikely they will receive special thanks. If, however, they are not so lucky, and the fund loses -20%, the size of the scandal would wipe out ministers, even governments. No expert analyses that investment decisions had seemed logical would help. This happened in Greece with the Karamanlis government several years ago.

Here, 5 years ago, there were suggestions that the Silver Fund should be invested in Bulgaria. Had these whims not been stopped, we could have lost even one billion, having in mind what happened after 2008.

For the politicians, there are also other risks:

- Who will decide who will manage the Silver Fund?
- Who will select the securities?
- Who will decide in which bank to put deposits?

The Silver Fund (i.e. the fiscal reserves) in government securities?

It is interesting how an operation in which the money of the government (the Silver Fund is part of the fiscal reserve) is invested in government securities will be booked for accounting purposes. It is like giving a loan to yourself. If you give all your savings to yourself in order to spend them, you will actually have no savings. The idea that you 'have invested' in a financial vehicle issued by yourself, would not help you when you have to pay your bills. What does Eurostat think about this?

The idea that the hard-accumulated money in the Silver Fund may be used to finance the budget deficit is at least as harmful as the nationalization of the private pension funds. In Hungary they nationalized some 10 billion euro, they 'ate it up' in one year and they almost went bankrupt recently, again.

Conclusions and recommendations

1. No experiments with the Silver Fund.
2. The problem is why there are budget deficits in the first place. If we had a surplus, such a discussion would not exist.
3. It is unacceptable for the fiscal reserve to fall to critical levels. It urgently needs to be topped up through higher budget revenues and lower expenses, by revenues from privatizations and concessions, and, if needed – by new external loans.

THE POINTLESS MIGRATION OF THE ADMINISTRATION

NIKOLAY VASSILEV, CFA

The article was published in the Presa Daily Newspaper in May 2012

The idea of relocating some agencies and ministries from the capital to other cities, although not entirely new, is a unconventional and bold one. We must admit the government's sense of PR. The message that some of the important administrative headquarters will move to a few selected cities will be very positively accepted by the local communities. The places are appropriately chosen. Of course, if all this is implemented at all, which I doubt.

There are many questions and risks

1. When will the relocation happen?

If the intentions are serious, the changes should be made immediately, not after 1-4-5 years. Otherwise, the administration will organize lines of resistance and will sabotage the process. In bureaucratic language, the term a 'functional analysis is needed' means that we do not want changes and will protract them as long as possible. Elections will come close, and the topic will be postponed and forgotten.

2. Relocation is neither free, nor easy

In 2005, two new ministries were created. It took a lot of months and resources for the buildings to be found, the teams to be recruited, and for their activity to start. Even if there is a building in Veliko Tarnovo suitable for the National Revenue Agency, millions will be spent on transportation, renovation, etc. Is this expenditure a top national priority? Has someone thought about how many months and years will the preparation and implementation last for? When you move to a new home, you need weeks to sort the luggage. What about the whole building of the NRA? Who will collect the taxes in this period of transition? The mess and work delays are guaranteed.

3. What about the employees?

On the one hand, if the current experienced employees of the agencies move with their families to another city (very unlikely), the argument about new workplaces there does not exist. If they do not move, will they be dismissed and on what grounds? Or will they be moved to other administrations in Sofia, which will just inflate the number of civil servants instead of optimizing it? There are employees who have worked for many years at ministries and agencies in Sofia. What will happen with their experience, institutional memory, with the investments in their professional training? I am sure that there are many qualified university graduates in Ruse who will cope well with the job at the Customs Office. But how much time and money will be needed for the new ones to 'switch on'? People are not robots. Do not think that we can just snap our fingers and a new super-efficient Ministry of Agriculture will open in Plovdiv.

4. Is this the most important for the other cities?

The message 'tourism is managed from Plovdiv' will probably be very popular in that city. But they hardly depend on these 40 jobs in this department, at least some part of which will be for the current employees coming from Sofia. For the intellectual development and the pride of Ruse and Plovdiv, perhaps it would have been better not to plan the closure of their philharmonics and operas. Is it not more appropriate to implement policies stimulating production, exports, tourism that would create not 40 but 4,000 or 40,000 new jobs? The Hungarian town of Kecskemét has not received a ministry but a new Mercedes plant worth EUR 800 mln. You decide which one is more important.

5. Is the fragmentation of departments practical?

All the three ministries I managed were located in two buildings. Although just a few minutes of walking distance from each other, this fragmentation hampers communication and work efficiency. The control also suffers. Now, some parts of ministries will be in another city – they will be disconnected from the epicenter of the events, and life there will run more slowly. The number of business trips between the two parts of one institution will increase.

6. What is appropriate for the business community?

I doubt a lot that tourism companies from Varna to Sandanski or agricultural producers from Vidin to Silistra will have any benefit going to the relevant ministries not in Sofia but in Plovdiv. If they have work to do at two administrations, they will have to drive to two cities, and instead of reducing traffic they will clog the Trakia highway and the Tsarigradsko Shose roads – both in Sofia and Plovdiv. For better or worse, a significant part of businesses, and especially the headquarters of the big companies, are located in the capital. These are actually some of the biggest employers and taxpayers in the country. So far, their ministries and agencies were at hand for them, now what?

My prediction

As it has happened with many other proposals in recent years, we will play another 'tango' – two steps forward and many steps backwards. We will discuss, analyze, and plan. In the end, the government's term will finish without a single memorable reform – in the field of the pension system, health, education. Ministries will move away from downtown Sofia [the so-called 'yellow paves' area] as much as Sofia Municipality and the Ministry of Agriculture have been exchanging their buildings for several years now. The next cabinet will leniently forget the intentions for relocation.

What else is not happening in the administration?

- We do not know how many jobs have been cut, but the numbers are insufficient
- Will trainings of civil servants come close to the 225,000 from the previous term?
- Nobody enforces the transliteration law
- Nobody follows the legal requirement to employ disabled people
- Where is the inspectorate for the public administration?

My recommendation is to focus on other priorities

Once the PR effect is consumed in the selected cities, the sobering will come. It will become clear that nobody in the administration is charmed with the new proposals. Certainly, the Minister of Agriculture would not want to be alone in another city either – in how many countries in the world is this the case? It will be calculated that the benefits from the change are very few, while the damages are much more. Would it not be much better if efforts and resources are focused on developing e-services for citizens and business? Then, it would really not matter whether the other side of the Internet connection is in Sofia, Varna or Plovdiv. Reforming the public sector, as well as economic growth, would be much more important for the country. Then, the private sector will create a larger number and more attractive jobs both in Burgas and in Veliko Tarnovo.

THE SHAMEFUL TANGO WITH THE BELENE NUCLEAR POWER PLANT: 1981-2012-20XX

NIKOLAY VASSILEV, CFA

The word tango describes appropriately the (in)actions in the last few years – the government is making some steps forward and many steps backwards. On the topic of Belene, in particular, the tango has continued for 31 years now and may still not be over. I believe that, disregarding whether it is advantageous to build this power plant or not, Bulgaria has performed the worst possible dance:

- the decision to start the construction was made and cancelled twice
- billions were invested in it before 1989 and also in the last 10 years, as well as at the present moment...
- ...but in the end there is no NPP (nuclear power plant) at all!
- the state has demonstrated a chronic inability to make correct and timely management decisions and to manage large projects

I was too young in 1981 to remember whether the decision for a second NPP had something to do with the 1300th anniversary of Bulgaria. I think, however, that if Khan Asparuh [the founder of the country] had fooled around on the banks of the Danube River just as we have with the Vidin – Calafat bridge, the hydro-electric PP Nikopol – Turnu Magurele and NPP Belene, a state that has survived until today would have not been created. The Chinese had obviously not fooled around too much either with the construction of the Great Wall, or now with the construction of many new power plants every year.

The public opinion rather supports nuclear energy

Here, I will not make any comments on the pros and cons of nuclear energy in general. It is clear that after Fukushima, Japan and Germany have changed course. In Bulgaria, the protests led to the suspension of the second NPP after 1990 (in Belene people believe that the jealousy of the Svishtov neighbours was a part of the reasons), but no one is against NPP Kozloduy.

What had we not clarified by the beginning of 2009?

The present government is right that for nearly two government terms, their predecessors did not cope with the basic parameters of the project:

- Who will be the shareholders? RWE was attracted before 2009.
- How much will Belene cost in the end? The figures are somewhere between zero and infinity.
- How much will the produced electricity cost, and is this advantageous?

But we have not done it after 2009 neither

The last 3 years did not improve the picture in any way. We do not have any new answers to these crucial questions.

Why did we kick out RWE?

The unbalanced messages to foreign investors – especially in the energy sector – led to the outflow of half of the foreign companies in the sector, including the German RWE. It is one thing if this large European company participates in NPP Belene with its capital, experience, and lobby, and another thing if the project is entirely Russian – 'the Trojan horse in Europe' style. Even the German E.ON left the regional electricity distribution company in Northeastern Bulgaria.

How did we treat Russia?

It is clear that Russia is not our partner in NATO or in the EU. However, this does not mean that the irregular tango is an appropriate dance to play with this important supplier for our energy sector. Does anyone remember how many times the deadline for making the decision has been postponed for 'three months later'? Have we not been derided in the international press because we do not know what we want and we have neither the competence nor the courage to make a decision? And who will be responsible for the additional hundreds of millions spent in this government's term? And why did we spend them?

How long did we wait for the HSBC report?

Nobody is questioning the professionalism of this leading global bank. However, two things are remarkable. First, it was constantly repeated that the report would be ready 'after three months', while its preparation took years. Second, a political decision to stop the project was made in the end without the final report being ready. Let us hope that at least the drafts have been read. Although the several million paid for this analysis is nothing compared to the total number of billions wasted, it is also a part of the expenses without an accomplished project in the end.

Belene can become even a site for space shuttles

After the decision to stop the NPP Belene project, the authorities made the typical for the recent years media moves to mislead the public:

- I believe the idea of moving the reactor to a new 7th block of NPP Kozloduy is rather a PR-exercise than a reasoned technical and economic solution. After how many government terms will we have a working 7th block with this reactor?
- This relates even more to the idea of a gas power plant at the Belene site. There is no gas pipeline or other infrastructure leading to it – was this not one of the reasons for the cancellation of the second NPP? I do not feel that anybody intends to build a gas power plant there.
- With the same success I will not be surprised if someone proposes a site for launching space shuttles to be built in Belene. It will sound good in the news tonight...

Is this the end of the Belene nuclear power plant?

I am not sure. It seems the decision is final, as it was 20 years ago. But it is absolutely possible for a new government to try to restart the project. If it is exclusively with private funding – then the appropriateness will depend on the concrete mathematics. If it is with state funding, it could destroy the finances of the country.

Still, how should have we proceeded with NPP Belene?

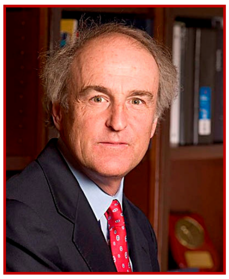
With the clarification that as a member of the two previous cabinets I was not responsible for the energy sector, my opinion about the project has not changed:

1. The state should not have spent money from the state budget or from state-owned companies for NPP Belene.
2. An international tender for the construction of the project should have been launched targeting leading global (not only Russian) companies. Not the state but the foreign company should be the majority owner and investor. I see no reason for the project to be public.
3. The state should not have made a commitment to purchase the electricity. Let this be a part of the risk for the new investor. If he/she wants to invest, let him/her invest. If not – let him/her not appear in the contest at all.

So, if there were participants, Bulgaria would get many benefits with no new risks. If there were no investors – there would be no Belene. Apart from that, all the Fukushima-style safety considerations are obvious.

EXPAT NEWS

MR. PAUL KIMBALL IS A NEW PARTNER AT EXPAT CAPITAL



Mr. Paul Kimball has joined Expat Capital as Partner and Board Member. The change of the management team is due to his acquisition of 14.94% of the company.

Paul Kimball is an American citizen and has had a long and successful career in investment banking. He spent 23 years at Morgan Stanley, rising to management positions among the top 10 in the bank, such as Global Head of Client Relationship Management, Head of Global Foreign Exchange, and Member of the Firm-wide Risk Committee. Mr. Kimball has been a member and chairman of the New York Foreign Exchange Committee – the industry oversight group that advises the Federal Reserve Bank of New York on important issues related to the FX markets. He has sat on the boards of various institutions of systemic importance, such as the Chicago Mercantile Exchange. Mr. Kimball was also the first Chairman of FXall – the world's largest platform for client foreign exchange trading. In 2006, he founded Sagebrush Capital – an investment company focused on venture capital and portfolio management services. Currently, he resides in Jackson, Wyoming. Mr. Kimball has an MBA from the University of Chicago, a BA from the University of Notre Dame, and a License en Sciences Économiques from the Université Catholique de Louvain in Belgium.

EXPAT BETA REIT HAS BEEN INCLUDED INTO THE BGREIT INDEX

In March 2012, Expat Beta REIT has been included into the BGREIT index being the sixth biggest fund among the actively traded ones on the stock exchange. Expat Beta has 100% free float. The fund is fully invested in various real estate projects, and the potential market value of its portfolio is over EUR 7 mln.

In addition, as of March, because of the large trade volumes and market turnover of the shares, the issue is placed in the main segment of the Bulgarian Stock Exchange – Sofia.

Sixth deal for Expat Beta REIT

On 28 March 2012, Expat Beta REIT concluded a sixth deal – the REIT purchased 16 plots zoned for development and construction in the residential complex ‘St. Stefan’ in the city of Bankya, near Sofia, with a total size of 21,814 m^2, and a permission to build on another plot of 97 m^2 in the same complex.

The purchase price of the plots was EUR 3.25 per m^2 (totalling EUR 71,121 / BGN 139,100), which is considered attractive for the REIT and in line with the policy of buying high-quality undervalued assets. In this deal, the previous owner has a buy-back option within 2 years with a fixed yield for the REIT.

Investment projects of Expat Beta REIT by now

	1. KAMCHIA	2. TSAREVO	3. VARNA	4. BANKYA	5. SOFIA	6. BANKYA
Investment status	Purchased 2009	Concluded the deal in Oct 2010	Concluded the deal in Feb 2011	Concluded the deal in June 2011	Concluded the deal in July 2011	Concluded the deal in March 2012
Location	Kamchia Resort, Varna Region	Tsarevo, Burgas Region – waterview property overlooking the marina	Vinitsa district, City of Varna	City of Bankya, St. Stefan Residential Complex	Lagera District, Sofia	City of Bankya, St. Stefan Residential Complex
Description	Plots, zoned for development and construction	4-storey building with 9 apartments	A yard with a 3-storey residential building	5 plots zoned for development and construction	3-room apartment	16 plots zoned for development and construction and a permission to build on another plot
Property size	3 plots, totalling 140,099 m^2	Plot – 284 m^2 Built-up area – 826 m^2	Plot – 390 m^2 Built-up area – 640 m^2	5079 m^2	123 m^2, plus 16.5 m^2 basement	21,814 m^2 plots and a permission to build on another plot of 97 m^2
Price	BGN 4,711,913 (EUR 17 per m^2)	BGN 300,000 (EUR 186 per m^2; land – for free)	BGN 300,000 (EUR 240 per m^2; land – for free)	BGN 298,010/ EUR 152,370 (EUR 30 per m^2)	BGN 50,852/ EUR 26,000 (EUR 211 per m^2)	BGN 139,100/ EUR 71,121 (EUR 3.25 per m^2)
Current status	Land plots	Holiday apartments	Finished residential building	Plots zoned for development & construction	Finished apartment	Plots zoned for development & construction
Approximate valuation	Over EUR 5,000,000	EUR 550,000	EUR 500,000	EUR 300,000	EUR 80,000	Over EUR 95,000

THE TEAM

THE EXPAT COMPASS TEAM

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