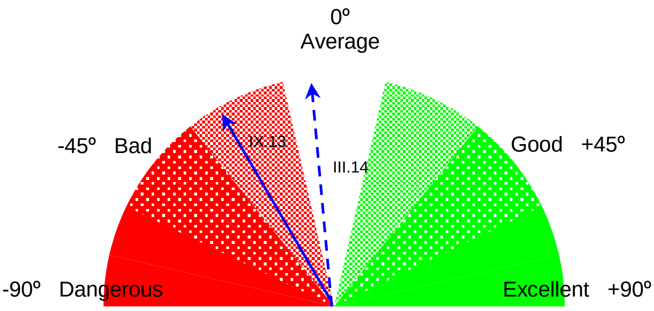
Issue 15 Oct 2014

expat compass

2 October 2014

EXPAT CURRENCY BOARD WATCH



OUTLOOK: UNCERTAIN

We have moved the needle of the Compass to an all-time-low reading. While we see no risks with the forex reserves, we are worried about the budget deficit, new spending, and the energy sector. The elections this week should result in a government whose priorities are still uncertain.

GUEST COMMENTS

EDITORIAL COMMENT

We are living in interesting times, using the Chinese terminology. Since we published our last Expat Compass #14 in March:

- Oresharski's government fell, and a caretaker cabinet led by Georgi Bliznashki was appointed.
- The 4th largest bank, KTB, was shut down, together with its very recently acquired small subsidiary – Victoria Bank (formerly Credit Agricole). Brace up for a large government-sponsored bailout.
- The 2014 budget is now out of control, with a looming deficit of 3-4-5-6% of GDP. The government's debt is rising, too.
- The energy sector is in dire straits. Without a sharp increase of electricity prices of up to 40%, bankruptcies should be expected. Soon.
- The parliamentary elections on 5 October this week might result in a strong reformist government which will have to sort out the big institutional and financial mess in the country. Or rather not.
- Thus, the mood of this issue is not rosy.

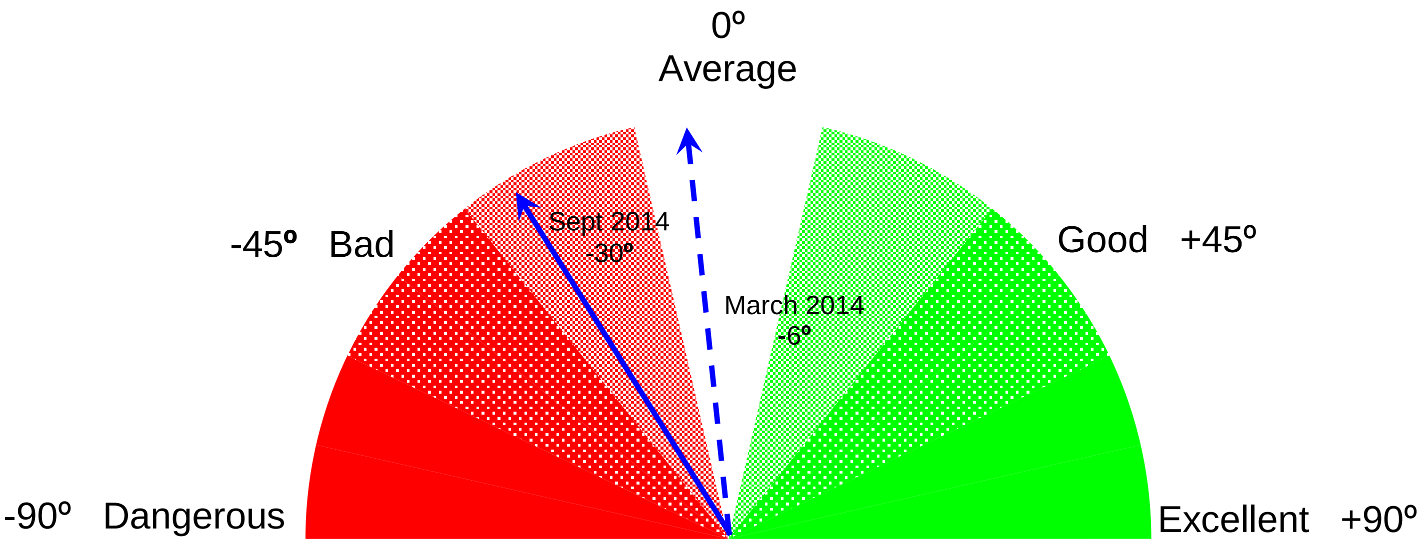
Our expectations for year-end:

- Boyko Borisov will be prime minister in a coalition government, most likely with the Reformist Bloc.
- The budget will be amended, the deficit will be raised by some BGN 3 bn or more – very negative for the macro stability of the country. The credit rating agencies might surprise us some Friday afternoon…
- We fear that the 2 banks might never reopen, while the government might choose to foot the whole bill of several billion levs to pay all the deposits.
- Electricity prices are to rise by up to 10% in October. Will the next cabinet have the courage to continue?
- Will there be a deeper pension reform next year?

The currency board should continue to hold firmly. We do not expect any future government to have alternative ideas about the currency.

EXPAT CURRENCY BOARD WATCH

OUTLOOK: UNCERTAIN



Read 'Uncertain' as a synonym for 'Negative'. We view the main risks for Bulgaria as political, not economic:

- Will there be a stable government?
- How populist or reformist will it be?
- Will it be as committed to the currency board and the macroeconomic stability as all governments and major parties have been since 1997, or will it have 'alternative' ideas?
- What will be the year-end budget deficit and debt/GDP ratio? We will consider any deficit over 3% as dangerous. However, even 4-5-6% is possible, considering the current public discussions.
- How will the KTB crisis unravel? We will not be happy with a full-scale bailout with taxpayer funds.
- What will be the new policies in the energy sector? Will the new government be brave enough to drastically increase the electricity prices? Or will bankpruptcies in the sector be avoided with a massive bailout from the budget?

The currency board by itself is as stable as always. The currency reserves of BNB generously cover all banknotes and coins in circulation. The risks are not in the coffers of the central bank but in the brains of the politicians.

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 (see the next page) 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.

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	Fiscal reserves falling sharply. Intentions to spend the Silver Fund
Nov 2012	+5º	+10º	Successful Eurobond; good budget; Silver Fund forgotten
Jan 2013	+15º	+10º	Almost balanced 2012 budget
Feb 2013	0º	-15º	Government resigns; fiscal reserves depleted; pre-election populism
May 2013	+4º	+4º	Good caretaker government; no street protests; rising fiscal reserves
Jul 2013	NOT PUBLISHED -10º	-14º	Unstable government; increased 2013 budget deficit; populism
Nov 2013	NOT PUBLISHED -8º	+2º	More stable government; better public finances
Mar 2014	-6º	+2º	Stable government; better public finances; watch the energy sector
Sept 2014	-30º	-24º	Risk of a populist government; KTB crisis; budget out of control

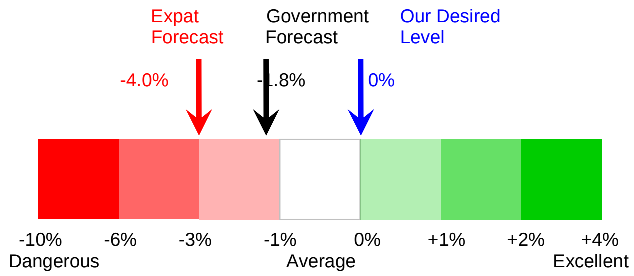
How to assess the stability of the currency board and to predict any danger of devaluation? We suggest the following check-list of 16 questions and provide our answers:

ISSUE	OLD	NEW	COMMENTS
I. Political issues			
1. Does the government support the currency board?	++	+	Expecting a new government
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	-	--	2014 budget out of control
5. Budget spending	-	--	Rising – banks, health, energy
6. Government debt	+	+	Low, rising
7. Foreign liabilities of the private sector	--	--	High, falling
8. Fiscal reserves	-	--	Low
III. Economic cycle related issues			
9. GDP growth	-	-	Just above zero
10. Inflation	+++	++	Deflation (also not good)
11. Unemployment	--	--	Average
12. Strength of the banking system	+	+/-	Uncertain
IV. External balances			
13. Current account deficit, trade deficit	-	-	Stable
14. Foreign direct investment	--	--	Low
15. Revenues from international tourism	++	++	Good
16. Foreign exchange reserves	+++	+++	High

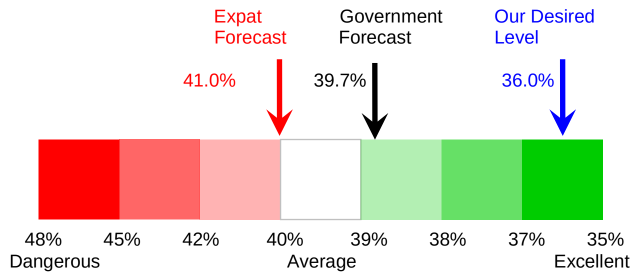
Legend: Good Bad

INDICATORS, 2014

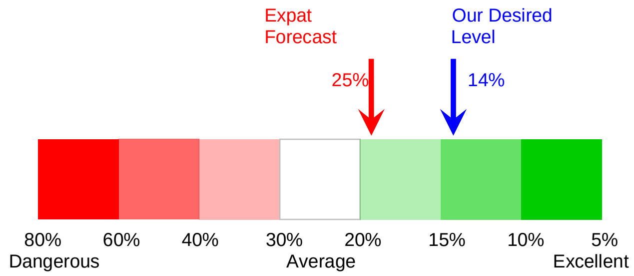
I) Budget Surplus/Deficit, % GDP, 2014



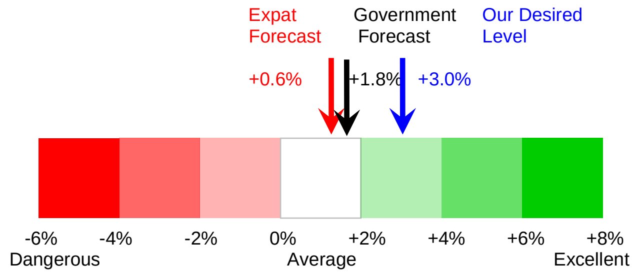
II) Budget Spending, % GDP, 2014



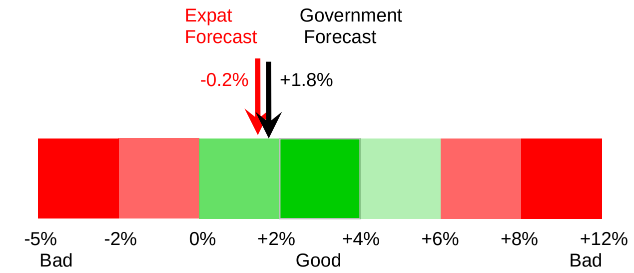
III) Government Debt, % GDP, 2014, Year-End



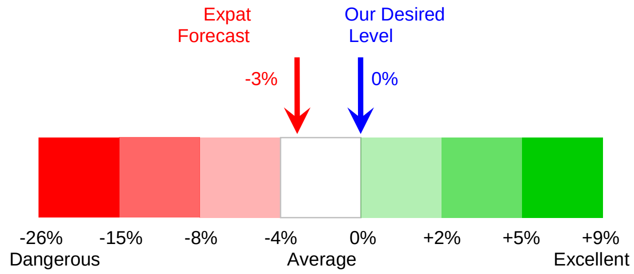
IV) Real GDP Growth, %, 2014



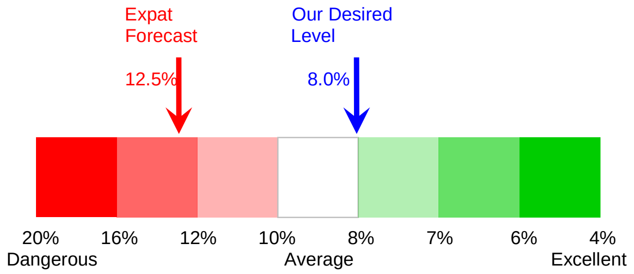
V) Inflation, %, 2014, Year-End



VI) Current Account Deficit, % GDP, 2014



VII) Unemployment, %, 2014, Year-End



'FEED THE ANIMALS AND TOUCH NOTHING' – EPISODE 2

The 2 achievements of the 2013 interim government

In an article in Compass 13, we made some suggestions about what the 2013 caretaker government led by Marin Raykov could possibly achieve within 3 months or so. Then, in Compass 14, we presented our evaluation of the results. The bottom line was:

1. Marin Raykov's government coped with 2 issues very well:
   - It managed to **calm down the protests** and made people leave the streets and go home in expectation of the early parliamentary elections.
   - It improved significantly the country's fiscal position. While it inherited a surprisingly large deficit in Jan-Feb 2013, it left office with a **surplus!** A good example which the new interim cabined should follow.
2. However, on one front it failed, in our view. The **organization of the elections** was one of the worst since 1990:
   - Several hundred thousand ready-to-use ballots were discovered in a printing shop, and they should clearly not have been there.
   - For the first time since 1990, the media did not observe the one-day 'contemplation period'. Although no election propaganda was allowed on the Saturday preceding the Sunday elections, there were significant violations of that rule. Again, no efforts on behalf of the government to prevent this from happening.
   - The parties misbehaved in the usual way, which also included the purchasing of votes. The government did not do anything meaningful in this area, either.
   - Also for the first time since 1990, on the night following the elections, the government was physically absent from the congress centre where the election results were formally announced. The parties were left to organize the press-conferences themselves. A group of minor parties conquered the microphones and spoke on all TV channels for over an hour. The feeling was that the country had no government at all.
   - Also for the first time since 1990, the winning party (GERB) contested the election results in front of the courts. As expected, this appeal had no concrete results, but the bitter taste remained.
3. We do not remember anything that the interim government has achieved in any other area. One potentially useful step was the detailed analysis of the energy sector. As we had feared, however, the following left-wing government threw it in the garbage and followed even more populist policies which have now left the sector in an even greater mess than it was in a year ago.

In the old Soviet-era joke, a dog and a monkey were driving the spaceship, while the cosmonaut was only supposed to 'feed the animals and touch nothing'. Hence, the title of this article.

In our modest opinion, it is not a worthy cause for the members of a government just to go to work, sign a pile of routine papers, attend routine meetings, and then leave office. We did not notice any major achievements in 2013. Similarly, we do not expect any in 2014, either. Of course, we would be happy to be positively surprised.

What can we realistically expect of the 2014 interim government?

The term of Bliznashki's caretaker government will not be over with the 5 October 2014 parliamentary elections. A new regular government will have to be formed before this one ceases to exist. How many weeks the process will take remains to be seen. Our guess is for a short period of 16 days after the election date. The country is in a painful 'vacuum' period, a new budget has to be passed, and a banking mess to be sorted out – to start with.

The interim government can still do a lot. The new ministers are well educated and capable professionals. However, we conservatively insist on just 2 relatively straightforward priorities:

1. Reduce the **budget deficit** and possibly switch to a **surplus** until a new cabinet is formed. The fact that the last parliament did NOT amend the budget to allow the interim government to borrow an additional BGN5bn or so (some 6% of GDP – a very large number) is positive, in our view. It is easy to borrow and spend billions. It is more difficult to achieve results without borrowing and spending billions, but for that one needs to improve tax collection and to prioritize. Will this be achieved? The new finance minister Rumen Porozhanov has a chance of matching Minister Kalin Hristov's achievement of 2013.
2. Organize better **parliamentary elections** than the ones in 2013. We have seen few reasonable initiatives in that direction so far, and time has practically ran out.

Other wishes and hopes

Other than that, we can come up with a very long list of dreams, such as:

1. Fix the problems with Corporative Commercial Bank which was closed a couple of months ago – no progress there whatsoever. No information in the public domain either.
2. Sort out the chaos in the energy sector in not less than a dozen steps:
   - decide what to do with the South Stream gas pipeline
   - decide what to do with the Belene nuclear power plant (Russian)
   - decide what to do with the 7th reactor of the Kozloduy nuclear power plant (Westinghouse, US)
   - decide what to do with the renewable energy producers (whether and how to reduce the purchase price of the electricity they produce)
   - decide what to do with the Maritsa-East coal power plants (whether and how to reduce the purchase price of the electricity they produce)
   - increase the price of electricity for households by 20, 30 or possibly 40%
   - make a few million consumers of electricity happy
   - send a manned mission to Jupiter ☺

   ...Yeah, right.

…..

99. Persuade the European Commission to restart all the European funds that have been temporarily stopped. Possible.
100. The new-old European commissioner, Kristalina Georgieva, should get a high-profile portfolio. Achieved! She has become Vice President of the European Commission and is responsible for the Budget and Human Resources. Impressive. *Although this task was accomplished before we finished writing the Compass, we have left it here to illustrate that other tasks could have been achieved, too. But they haven't…*

The government might overdo things, too

Doing close to nothing is a waste of time, but doing things one should not do might also be controversial. While we prefer an active and ambitious caretaker government, others rightfully point out that such a cabinet does not have the political mandate and the parliamentary backing to make far-fetched moves. Examples:

- The government wants to borrow more. Much more. We think this is both constitutionally impossible and fiscally imprudent.
- The government has made moves to make GMO production easier. Quietly, without public debate and a cost-benefit analysis. We oppose this, while others may not.

At the end of the day, we will mainly judge the work of the interim cabinet based on the budget balance and the organization of the elections. This will be discussed in the next issue of Expat Compass.

THE UNENVIABLE LEGACY OF ORESHARSKI'S GOVERNMENT

As usual, we will try to refrain from expressing political sympathies. We will concentrate on policies.

Plamen Oresharski's government was supported by a thin majority of BSP (socialists), DPS (or MRF – the Turkish ethnic party), as well as on important occasions by Ataka. GERB stayed in opposition. It will remain in history as one of the shortest governments in the last 24 years as it stayed in power for about a year, with the last few months being spent in agony. In our view, it has also been one of the least successful cabinets with almost no positive achievements in any sector, and with a plethora of problems and wrong policies.

I. Several success stories

Every government is likely to have achieved at least something positive. We would like to point out the following success stories:

1. The general feeling of fear from the state and the arbitrary use of the law-enforcement agencies in particular disappeared with the start of Oresharski's mandate. Important.
2. The amount of VAT owed by the state to businesses was reduced significantly. Good.
3. Economic growth started picking up somewhat – from around 0% to 1-2%. Simultaneously, unemployment was marginally reduced. Good.
4. Almost BGN 3 billion (EUR 1.493 bn) of new debt was issued at the best possible moment on 26 June 2014 at a record low yield of 3.056%. On the one hand, a simplified comparison with other yields at different historical moments is unfair. Global interest rates are now at historical lows. On the other hand, the Ministry of Finance used the good moment before the government collapsed and before some banks were shaken up to issue the large portion of debt. A good job.

Well, our memory might be weak, but our list is this short.

II. We do not consider the 'social defreezing' for its own sake a success

As expected, the left-wing government boasted with the so-called 'social defreezing':

- Pensions were increased 2.7% in July 2014 after the previous government kept them 'frozen' from mid-2009 till 2012. We should remind you that we had supported the lack of pension raises during the worst years of the crisis.
- Child subsidies were also increased. However, we support this policy, as it addresses partially the greater demographic problems the nation faces.
- The minimum wage was additionally increased from BGN310 to BGN 340 per month. Thus, the cumulative recent growth has been by 42% for 3 years. In the meantime, inflation has been negligible. During a period of high unemployment (12% or so), excessive increases of the minimum wage and of wages in general do not lead to economic growth and to the creation of jobs.
- The price of electricity was additionally reduced on 2 occasions.

While spending more money on social policies might look positive to the ones who receive the payments, we strongly disapprove of the following vicious circle:

- no growth and no investment
- new budget deficits
- more borrowing
- more spending – 'spend first and ask questions later'
- energy price cuts – 'reduce the electricity prices first and do not ask questions about the bankruptcy of the energy sector; it is the next government's problem'

III. 9 disasters and wrong policies

Here is our assessment of the wrong policies. Let us start in an ascending order from the least serious ones.

9. No [major] cuts in the administration

Although the government repeatedly announced a 10% cut in the size of the administration, we have seen no firm evidence thereof. Very similar to the 2009-2013 period – claims of cuts with no real numbers to support those claims.

8. Small reversals of previous successful reforms

- Before 2004, the maximum age of taxi automobiles had not been limited. As a result, 85% of the cars used for taxi services used to be 10-35 years old and had 1-2 million kilometres of 'mileage'. Did this look more like the EU or like the Philippines and Venezuela? In 2004, the maximum age was limited to 10 years. In 2014, just when some of the brand new cars purchased in 2004 reached the maximum age, the limit was raised to 15 years. We consider this a wrong and unnecessary populist move. It was made to appease the protests of just a few dozen taxi drivers. The millions of Bulgarian consumers and foreign tourists would hardly approve. We can now expect to see cars with over 1.5 million kilometres of mileage again.

- In 2012, the previous government banned smoking in closed areas such as restaurants. In 2013, attempts were made at reversing the rule. This did not happen, but the ban is not strictly enforced. The situation is a source of corruption, too, as restaurant owners often bribe the officials to close their eyes and not inspect the premises. We support the full smoking ban in close public areaas.

7. The pension reform was stopped and reversed

We had repeatedly criticized the 2009-2013 government for its lack of courage to start and finish a deeper pension reform. One step would have been a sharper increase of the retirement age. A one-off move would be preferable to a gradualist approach. As we had feared, a following government might stop the gradual 4-months-every-year process. And it did in 2013. Negative.

The 2009-2013 cabinet also raised the retirement age for the military. Good. Oresharski's cabinet reversed that. Negative.

6. The disastrous status-quo in health care continued

The analysis of the health care sector deserves a whole book. Yet another government did nothing to improve the situation, namely:

- No redundant hospitals have been closed. We do not consider the reopening of the hospital in the mountain town of Devin a success.
- No hospitals have been privatized. The idea of shutting down or privatizing dilapidated and loss-making hospitals is as foreign to the Bulgarian decision-makers as sending a Bulgarian manned mission to Jupiter.
- There has been no intention to introduce co-payments by the patients in order to strengthen the sector financially, limit abuse, and introduce market competition.
- No efforts have been made to improve the collection of social security and health contributions.
- No efforts have been made to reduce the wide-spread corruption in the sector.
- There have been no intentions to de-monopolize the National Health Insurance Fund and introduce competition among many mandatory health insurance providers, thus driving down costs both to the budget and to the households, and increasing quality of service among healthcare providers.
- Although the budget spending on health care is at its all-time-high, a financial 'abyss' of some half a billion levs has opened. Again.

There is a general feeling of chaos, mess, and lack of satisfaction and reforms in the health care sector.

5. Attempts for communistic management of the economy – no privatizations and concessions, talk of nationalizations, talk of state-run 'reindustriali-zation', budget money for companies, price controls, state-owned development bank

To the extent that there was any such thing as economic policy in the last year at all, we disapprove of the direction.

- **Electricity prices** were reduced sharply on several occasions instead of being increased. A gap of some 40% between costs and revenues has appeared.
- Forget **privatizations.** The economic minister repeatedly and proudly said that he would 'save' this or that company from privatization. VMZ Sopot (defence products), coal mines, energy companies…
- What **concessions?** What missions to Jupiter?
- There were plans to **nationalize** a couple of industrial companies. Then possibly privatize them again (we traditionally do not 'buy' such promises). We wonder why, and suspect some conflict of interest. Fortunately, all these remained just plans.
- The new leftist mantra of **reindustrialization** has become wide-spread in Europe. We do not know exactly what this means. Probably, building new industrial factories with budget moneys. While the word *reindustrialization* might sound attractive, we do not support the idea of state involvement, and believe that investment and economic growth should come from the private sector. Fortunately, all these also remained just words.
- The **state budget** gave some BGN 28 million to VMZ Sopot. Has any restructuring or privatization followed? Of course not. Long live the taxpayer!
- A lot of noise was made against the [foreign] **retail chains.** While we have not spent much time trying to understand the plans to curtail the power of the chains, we are skeptical about the state's ability to regulate commerce.
- We have been traditionally skeptical of the role of the state-owned **development bank.** In the book 'Menu for Reformers', the development bank has been described as: a) an additional state budget for spending, b) an additional opportunity for political (and other) parties to siphon off resources. We see no 'development' component there.

To summarize, we view the economic policies of 2013-2014 as chaotic, old-fashioned, and populist. There is no guarantee it will be any different next year, though.

4. The energy sector – populism, chaos, and financial distress

This title coincides with an article in our previous Expat Compass. We consider the whole sector to be in a distress situation. A multi-billion mess. Please read the related articles in issues 12 and 14.

A) Populist electricity price cuts. Wrong. The result is deep financial distress for the whole sector – state-owned and private.

B) A crusade against renewable energy. 'Cut the purchase prices or switch them off the grid first and think about the consequences later.' The consequences will be bankruptcies, court and arbitrage cases against the state, bad loans in the banking sector, destroyed investor confidence.

C) A smaller crusade against the investors in the Maritsa-East power plants. 'Cut the purchase prices first and think about the consequences later.'

D) What privatizations?

E) Statements by the energy minister: 'Miners are dearer to me that the renewable energy sector.' Back to the 19th century.

3. The banking crisis of 2014 – a political, not an economic problem

For over a decade, the Bulgarian banking system had been in a very good shape – no bankruptcies, the highest capital adequacy in the EU, a very low level of NPLs (non-performing loans) till 2008 and a high level afterwards. Fortunately, the majority of the banks were owned by large European banks from Italy, Hungary, Greece, France, Austria, etc.

In the late spring of 2014, the situation changed. After a bank run on KTB (Corporate Commercial Bank) lasting several days, it was closed down by BNB (the Bulgarian National Bank) together with its newly acquired subsidiary, Victoria Bank (until recently a subsidiary of Credit Agricole).

The whole story is quite long and quite a mess without a clear end on the horizon. In this issue, we will just offer several conclusions:

- The bank was not a typical commercial entity but rather a hedge fund run by the owners with the co-operation and protection of the political establishment and the regulators. Financed by the gullible depositors and public funds, of course.
- Whatever happened on the balance sheet of the bank, its failure has more to do with the politicians and institutions than with real business reasons.
- The institutions have demonstrated a surprising lack of coordination and decisiveness, to say it mildly.
- In short, we have no trust that the institutions will do their job properly and will find a solution which would protect the depositors and – equally importantly – the taxpayer.

What is the best-case scenario?

The best option would be recapitalize the bank with private money – by the old or by new shareholders, possibly with some limited state financial aid. Not likely and too good to be true. The liquidity necessary to restart operations might reach a few billion levs.

The middle scenario

- The Deposit Guarantee Fund (DGF) and the state budget will cover the deposits up to the guaranteed maximum of EUR100,000 per insured depositor.
- The administrators of the bank (to be appointed) will do their best to recover or sell most of the loans and other assets of the bank and return the proceeds to the DGF, the state budget, uninsured depositors, and other creditors.
- Thus, the depositors may be paid back additional amounts.
- There should be more transparency about what had actually happened and who is responsible. Legal consequences in case of criminal improprieties as well.

At this moment, this scenario also sounds too optimistic for us. There is total lack of information about the actual situation of the bank – a veil of secrecy enforced by the current interim government and all the other institutions. We believe this way of tackling the situation will continue until a stable government is formed after the elections on 5 October 2014. Disappointing.

The worst-case scenario

What *should* be done is one thing, but what *will actually* happen is another. Here is what we fear:

- The bank will not reopen [soon]. Nor will it be formally bankrupted.
- Compensating the depositors (at least up to the guaranteed maximum) will be belated. This has already lead to a punitive procedure by the European Commission and might also lead to numerous lawsuits against the state.
- There will be cries for the state budget to cover all obligations of the bank. The number could reach BGN 5 billion. Those calls will be 'heeded' in the name of 'economic growth' and 'social justice'.
- If the bank is ultimately shut down, it will be up to the anonymous bank administrators and liquidators to chase after the companies (many of them close to the controlling shareholders and stakeholders of the bank) which took out loans with little intention to repay them. The politically-appointed administrators might cover up the traces, and the public might never learn the whole truth, let alone see meaningful proceeds go back to the state budget.

- The whole story might be the biggest Bulgarian robbery of the 21st (or of any other) century, pulled off by a small politically-connected business circle under the long-lasting protection of the political establishment at large.

2. The dangerous addiction to budget deficits

On the surface, Oresharski's government can claim that its budget policy was conservative:

- 2013 finished with a moderate deficit of -1.8% of GDP
- a moderate deficit of -1.8% was planned for 2014
- After the May 2014 elections for European Parliament, the government's days were counted. The cabinet refused to amend the budget before the parliament was dissolved, claiming that everything was normal on the budget front. In this particular case, we would not have supported a budget amendment. We prefer the caretaker government to feel pressure on the saving side, rather than have the luxury to spend a few more billion.

However, on the other hand, the real situation with the budget is not rosy.

- First of all, we did not approve of the **budget amendment** to increase the 2013 deficit from 1.3% to 2.0%. The actual year-end deficit was a bit lower at 1.8%. Let us remind you that Oresharski inherited a budget surplus (!) from Marin Raykov's caretaker government in mid-2013.
- We did not approve of the 2014 budget which envisioned a **deficit.** Again, for a 6th year in a row.
- The 1.8% planned deficit would now sound a positive mirage. Bulgaria might end the year with a deficit of 3-4-5-6%. Make your wild guess. It depends on the way the **KTB crisis** is resolved and whether the budget will have to spend billions on that. A budget amendment plus a drastic change in the current banking legislation is required to spend billions on a bank bailout, however. It will depend mostly on the will of GERB and its leader Mr. Borisov, who is widely expected to be the winner in the coming elections.
- The situation in the **energy sector** is also critical. The financial gap in the sector is widening by BGN 1 billion per year, and most companies are on the verge of bankruptcy. Subsidizing the population from the balance sheets of the state-owned energy companies is possible for a couple of years, but the show is about to end. Very soon.

Summary: measuring the level of the 'mud'* in the budget (BGN billions) during the Oresharski era

Item	Approximate amount
Achieved budget deficit in H2 2013	-1.4
Planned budget deficit in 2014	-1.4
Additional gap in the budget apart from the problems of the energy sector, health care, and banks	-0.5
Financial losses in the energy sector for 18 months	-1.5
Additional deficit in the health sector	-0.5
Likely budget expense for sorting out KTB	-3.0
TOTAL financial mismanagement by Oresharski's cabinet	**BGN -8.3 bn**

* *"Measurement of the level of mud in cantimetre" is a witty phrase which we liked and borrowed from the Mediapool internet forum.*

The table above is a back-of-the-envelope calculation. One might argue about each number. The numbers, however, reflect our evaluation of the dire straits of public finances in 2013-2014. This is the aftermath of the short 18 months. There has been no war, no recession or a new global crisis. Just bad governance. What a shame!

1. Who is running the country? Apparently, the oligarchy behind the scenes [Явно, олигархията в задкулисието]

People vote for parties and leaders, but they do not seem to be the people making the real decisions. Institutions have failed en masse. The situation looks quite desperate. A new government might change the landscape. Or not.

NICOLA YANKOV, Managing Partner at Expat Capital

We hoped to see a new wind of change in the policies of the current interim government regarding transparency and public scrutiny over the affairs of the administration. We expected most (or why not all) documents related to the big investment projects of the past few years to be published online – Belene, Kozloduy, South Stream, the other bigger energy sector deals, information about the use of public funds to prop up locally-owned banks. We expected the minister of finance to disclose publicly detailed information about the actual state and past dealing at KTB – he is entitled to receive such information and to make an independent assessment of the balance sheet of the bank, since the state budget and the Deposit Guarantee Fund might soon become the senior and largest creditors of the institution. Moreover, such information is absolutely indispensable for any political or executive decision regarding the future of the bank and the use of public money for its winding down or revival. Regretfully, we have seen none of that. If this cabinet is an indication of things to come, then we do not expect drastic changes in the style of governance in Bulgaria.

WHAT CAN WE EXPECT FROM THE 5 OCTOBER ELECTIONS?

In the 13th issue of Expat Compass, we were not very successful in predicting the outcome of the 2013 elections. Our scenario 1 envisioned a GERB-led coalition government. That option was short by 1 parliamentary seat. Our scenario 2 for a BSP-DPS coalition materialized instead.

Our prediction for the 5 Oct 2014 election results

We see 5 parties in the parliament with the following results:

Party	% of the votes	Number of seats
GERB	38%	104
BSP (socialists)	23%	63
DPS (Turkish ethnic)	14%	38
Reformist Bloc (right-wing)	7%	19
Bulgaria Without Censorship	6%	16
Other parties	12%	-
TOTAL	**100%**	**240**

Scenario 1. Almost certain: GERB + whoever else

Today, a few things seem certain:

- GERB will win, again. It is interesting to point out that GERB has never lost any elections for the national parliament, the European Parliament, or local elections (aggregated at the national level) since the party was created some 8 years ago.
- BSP will be second, DPS will be third.
- Boyko Borisov will be the new prime minister. He held that position for a close-to-full term in 2009-2013.
- GERB will probably need 1-2 coalition partners to form a stable government.

The key questions are how many parties will pass the 4% threshold, and who will be likely to join the coalition.

Party	Likelihood of being in parliament	Likelihood of forming a coalition with GERB	Degree of populism
GERB	100%	**************	Low
BSP (socialists)	100%	Very low, but not zero	High
DPS (Turkish ethnic)	100%	High (hidden agreement)	Not populist
Reformist Bloc (right-wing)	80%	Logical but uncertain	Not populist
Bulgaria Without Censorship	60%	High	High
Patriotic Front	30%	High	Probably average
ABV (former President Parvanov)	30%	High	High

For the first time, the winner might be able to form a coalition with practically any other parliamentary party:

- The most logical coalition partner would be the **Reformist Bloc.** The RB is made of 5 parties, mostly right-wing and reformist, as the name suggests. Such a government would be the most likely to implement unpopular but necessary reforms. There is a danger, however, that the contradictions within the RB and the personal animosities between the leaders of GERB and the RB might make a coalition difficult.
- The most interesting question is whether there will be a formal or informal agreement between GERB and **DPS.** While such a combination might be unpopular with GERB's electorate in the long run, it might produce a stable and somewhat reformist government. It will hardly produce the much-needed shock to the current political establishment, however.
- The other **small parties** are populist but without a clear ideology or programme. Any of them might provide the necessary parliamentary votes to support a GERB government, with or without a formal coalition agreement.
- The last important question is whether a GERB-**BSP** German-style grand coalition is possible. We think not. It would be possible only if all other options are unavailable, and a strange government is formed to avoid early elections and a bigger mess in the country.

Base-case scenario

Our expectation is of a GERB-RB coalition government led by Boyko Borisov. Any of the other parties except BSP might support it, too, with or without a formal coalition.

Scenario 2. Very improbable: the others without GERB

Again, this is very improbable, but Bulgarian politics has sometimes produced unexpected results, such as in 2013.

The main reason for the fall of Oresharski's cabinet was the rift between BSP and DPS after the May 2014 elections for the European Parliament. After a decade of alliance with the Turkish ethnic party, BSP now says it will not make the same mistake again and will not form a coalition with DPS. Until this changes again. In Germany, the last several decades produced several coalitions between SPD and FDP, CDU and FDP, as well as CDU and SPD.

Imagine a parliament with 4 parties or so: GERB, BSP, DPS, and Bulgaria without Censorship. Such a result cannot be excluded. No party has an absolute majority. What government can be formed?

- GERB + DPS. This still falls under Scenario 1.
- GERB + BSP. This also falls under Scenario 1.
- GERB + Bulgaria without Censorship. This also falls under Scenario 1.

Each of the above is an unstable outcome with many problems. If none of those work and if Boyko Borisov cannot or refuses to form such a government, then is the combination:

- BSP + DPS+ Bulgaria without Censorship

Possible? We think it is. This is our Scenario 2 with a probability of below 10%.

THE WESTINGHOUSE PROJECT – THE 7TH NUCLEAR REACTOR AT KOZLODUY

We support the idea, but are not happy with how it is being implemented

In principle, nuclear energy and the construction of new reactors can be a good solution to diversifying the energy mix of the country and lowering supply risks. Bringing onboard reputable US partners and investors is also a positive development. However, we would prefer much more transparency around all aspects of the deal.

How to buy a house?

What would happen if you asked a family whether they would like to buy a large house on the sea coast in Varna? Yes, the wife would say – she would go shopping in Varna with her girlfriends more often. Yes, the children would scream – they would play at the beach.

However, the father is more likely to ask questions first, such as:

- How much does the house cost, and how does this compare with similar houses elsewhere?
- Can the family afford the mortgage?
- What is the technical condition of the house, and how does this compare with other houses? What would be the annual maintenance expenses?
- Has the family looked around Varna to check whether there are any better houses for sale?

Certainly, buying a house is a major investment and lifestyle decision of any family, and one should pay slightly more attention to the process than when buying a book. If the father just says: 'I have found us a wonderful house. Trust me, it is a good choice, although we now have to take a large mortgage and also spend the college funds of the kids.' Then, the family is expected to protest: 'Can we discuss that first? May we at least see it?'

A nuclear reactor is equal to 30,000 houses, give or take

The public often extensively discusses scandals and problems around public procurement procedures with the size of above or below 1 million levs. And it should – spending the money of Bulgarian or European taxpayers should be transparent and responsible. In contrast, the process of building a 7th nuclear reactor at Kozloduy has not been transparent enough:

- There have been no public discussions about whether Bulgaria needs more nuclear reactors, and how many.
- Will Bulgaria build Kozloduy-7 *together with* or *instead of* Belene 1 and 2?
- What will be the effect of building Kozloduy-7 on the ongoing international arbitrage on Belene?
- Why should we do it with Westinghouse and not with someone else – Britain, Canada, France? There is nothing wrong with Westinghouse itself, we are just asking a principle question.
- How much will the reactor cost? We have heard of some 5 billion (in what currency?), but what does it include? The devil is always in the details – are we not buying a house without a garden and a roof?
- How much will the electricity cost per kWh? 5 cents? 15? 50? We have no idea. Do you?
- Is the foreign partner actually an investor? Or rather just a supplier of equipment. It seems that the state budget will have to finance the project. We would have preferred a privately financed project.
- What about the fuel supply agreements?
- What about the spent nuclear fuel depo costs?
- What about the market projections – both the supply and demand of electricity?
- Would it not be cheaper, more reasonable, environmentally sound, quicker, and easier to invest the same amount in government-sponsored energy efficiency projects, reducing household and industrial energy consumption instead?

Problem 1: There should always be a competitive procedure

In a democratic society (and even in many autocratic ones), it is not acceptable for a government to just appoint a buyer of a company under privatization, a supplier of goods and services, a builder of a project, a large investor.

IF PUBLIC MONEYS AND PUBLIC INTERESTS ARE INVOLVED, THERE SHOULD ALWAYS BE A COMPETITIVE PROCEDURE. FULLSTOP.

Here, a handful of people in the government have decided to choose one particular partner, Westinghouse, to build what would by far be the largest project in the country in the last 25 years. The idea may be good, but this is not the best way to implement it.

The failed Trakia Highway concession in 2005

A decade ago, the Bulgarian government tried to appoint a Portuguese consortium to build the Trakia Highway under a BOT arrangement (concession). The project definitely had many positives:

- in our view, it is better to build infrastructure projects with private funding under concession agreements than with public money
- the construction price was low, around EUR2m per km

- the contract was professionally prepared
- the Portuguese partner chosen was experienced
- the project was politically advantageous – the former Portuguese prime minister Baroso became President of the European Commission for the following 10 years
- a few years later, the courts decided that the deal was concluded legitimately

However, the project had two big flaws:

- There was no competitive procedure.
- The PR was obviously unsuccessful, especially in view of the parliamentary elections approaching in 2005. The opposition named the project 'The robbery of the century'. It was hardly the robbery of the century, but the incumbent government suffered badly in the elections.

The conclusion: the deal may have been good, but there should have been a very open and public competitive procedure. Kozloduy-7 is a similar story, just 7 times larger.

Problem 2: Why is it becoming the Bulgarian governments' habit to negotiate all large deals secretly?

Examples:

- all deals with Gazprom
- the South Stream gas pipeline
- the Belene nuclear power plant
- the above-mentioned Trakia highway concession
- the 7th reactor at Kozloduy…

Most of these projects have been negotiated by the energy ministry. The usual algorithm is the following:

- Several high-ranking politicians decide to build a project or sign a large contract. Secretly.
- Often even the other members of the government are not informed about it.
- Someone negotiates with the foreign partners, usually from the north-east. Secretly. This someone may not necessarily be a public servant.
- A several-billion-euro contract is signed. Secretly. The time, place and signing parties become known only weeks or months after the fact.
- The public has no idea about the terms of the deal. The explanation is 'commercial secret'. We disagree.
- The projects usually involve financing from the state budget or the state-owned energy companies. We disapprove.
- Hundreds of millions are borrowed and invested by the state-owned energy companies to start the project. Secretly. We disapprove.
- The partners and contractors are selected without a real competitive tender. The prices of construction usually seem very high. It is not difficult to guess why.
- The political opposition usually names the deal scandalous. After the fact.
- The following government usually puts a break on the project. Publicly. Then often restarts it after a while. Secretly. We can wonder why. *As an example, more money was spent on Belene during 2009-2013 – when the project was 'stopped' – than before that.*
- Many of the deals end up in international arbitrage. Bulgaria tends to lose most of these. With the absence of responsible and reliable institutions, this is hardly a surprise…

MERGING THE BANKING AND THE FINANCIAL SUPERVISION IS NOT A GOOD IDEA

NIKOLAY VASSILEV, MANAGING PARTNER AT EXPAT CAPITAL

The article was published in Pressa Daily on 2 Oct 2014

I am writing this article as one of the people involved in the creation of the Financial Supervision Commission (FSC) as Minister of Economy, and as a person who has been working in the field of financial markets for a number of years. It is true that there are counties in the world where there is a single supervisor of the banks and the financial institutions, but there are also many others where there are two separate regulators. I believe that considering a merger of the Bulgarian National Bank and the FSC is unwise. The same discussion took place a little over 10 years ago and it resulted in the creation of a separate supervisor. What has changed so much to warrant making the opposite decision? Here are several more reasons.

1. Each organizational change means a blockage of the system for at least a year

Everyone who has experienced this would know what I mean. New laws (who is going to write and pass them and when?), new leaders of both institutions (which parliament is going to appoint them and when?), new employees, buildings, budgets, software, and many more details. Meanwhile, during the transition period, most of the employees, expecting to be affected by the changes, will spend their time following the political processes instead of completing their daily duties. And there is no lack of important current tasks in either of the supervisors. A large portion of the administrative capacity, which cost a lot of efforts to develop, will evaporate.

2. Such steps are usually made for personnel reasons

Most new governments come to power wondering how to get rid of the members of the regulatory bodies appointed by other governments. What better way to do it than some kind of organizational restructuring? This practice is vicious and only leads to negative results. A quick reference – the energy regulator. The frequent appointment of party loyalists so that they can execute politically motivated orders has led to nothing good, just to chaos and financial distress in the sector.

3. When big structures merge, one 'half' is left neglected

When the Ministry is of economy, energy and tourism, 90% of the attention of the leadership is focused on energy. Tourism is left with 'whole' 2%. When information technology shares the same portfolio with transport, it may be left with under 1%.

4. The problems of Corporate Commercial Bank are not related to the FSC

The idea about the merger of the two supervisors arose during the banking situation this summer. The FSC does not deal with deposits, credits, and capital adequacy. It deals with banks in relation to listing their shares on the stock exchange, issuing bonds, prospectuses. You might agree that the fact that the bank was listed was not among the reasons for its shutdown.

5. Instead of merging with another institution, it is better for the FSC to focus on its own tasks

Over the past years, the commission played well in a few situations. It opposed the idea that the Silver Fund should invest [mostly] in Bulgarian government bonds. It is a pity that most of us did not think to raise the issue why half of the Bulgarian Deposit Insurance Fund's money is invested in Bulgarian government bonds as well. The FSC did not make a mistake in the complicated gambit with the unrealized sale of a large pension fund. The Commission also opposed the partial nationalization of the private pension funds – the nationalization was a very wrong move. The years after 2008 have been difficult, but both the insurance and the investment sectors are still looking into the future, although sometimes the relations with the regulator are slower and more formal than desired.

Still, let us not be fooled that everything in the system is okay. On FSC's turf, a huge potential problem with investments in related parties, as well as with non-arms-length relations is taking shape. The regulator, with the support of the future government, should analyze more thoroughly in what some pension funds, mutual funds, and insurance companies invest mostly, so that it does not turn out in a few years that there are surprises there as well. The FSC's priority should be capital markets which currently are not developing well enough to provide alternative access to financing for Bulgarian businesses. Moreover, the level of corporate governance of the public companies is not at the required level, and some majority owners act as sole owners.

6 Financing the FSC is a complex issue

In the context of the adoption of a new Law on the FSC, the issue about the adequate remuneration of its employees was raised. The BNB with its operational independence resolved this and managed to attract highly qualified professionals and provide them salaries consistent with the highest positions at private banks. And so it should be. The Commission is dependent on the state budget and is experiencing the traditional problems of ministries and agencies, so the FSC wages are not adequate. One of the proposed options is the FSC to be funded by fees and fines from the regulated sectors – which are currently not low anyway. The critics properly see a conflict of interest – the commission would be in collecting high fees and fines for what it should and should not because this would be the only way to increase revenues and hence wages. Another option is that the FSC should lobby with the Ministry of Finance for higher budgets in coming years. The financial industry should support the Commission in this, because we are all interested in having a professional regulator where better educated and better paid experts work – with previous experience in the private sector.

BONDS INVESTMENT STRATEGY 2015

MARIA BOYCHINOVA, HEAD OF RESEARCH AT EXPAT CAPITAL

Maria Boychinova is Head of Research at Expat Capital.

Her professional career in finance started at Merrill Lynch Wealth Management in New York where she was an academic intern (2007). At JP Morgan in New York she was a summer analyst in Equity Research and in Fixed Income Strategy (2007-2008). Prior to joining Expat, Maria worked as a Research Analyst at the Norwegian financial services company Edge Capital (2009-2012).

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The article was published in Investor.bg on 29 Sept 2014

Bonds performed very well for the last couple of years, driven by the policies implemented by central banks to support the markets, the historically low interest rate levels, and the recovery from the 2008 crisis. Risk appetite grew amongst investors, which drove credit spreads to historically low levels.

At the same time, interest rates on US and European riskless and low-risk instruments fell substantially. In the medium and long term, we expect market interest rates in Europe and the US, as well as credit spreads to rise. This will have a negative impact on fixed income markets. In such a scenario, investors must consider a strategy to restructure their bond portfolios.

What determines bond prices?

1. Risk from rising interest rate levels

Interest rates and bond prices are negatively correlated – when interest rates rise, bond prices fall. An increase in interest rates affects foremost instruments with a fixed coupon and many years to maturity. Let us say that bond X trades at par value, has a fixed annual coupon of 5%, and matures in 30 years. The interest rate in the economy for a risk level lower than that of bond X is 2%. Investors agree to an annual yield of 5% on bond X for its level of risk, resulting in a price equal to the face value of the bond. The central bank however decides to raise interest rates from 2 to 4% by financing central banks at lower interest rates and/or by selling government bonds (aiming to reduce the supply of money, thereby increasing interest rates). Investors could receive an interest of 4% if they deposited their money in a bank or bought government bonds on the market and they are no longer willing to pay the par value for a bond with a higher risk and a coupon of just 5%. Hence, they start selling the bond until its price falls to a level that makes the bond's yield attractive again (for example, a yield of 7 or 8%).

2. Credit risk or a risk of default

Corporate bonds are debt issued by a company. Whether this debt will be repaid depends on the financial condition and development of the respective company. The yield of corporate bonds has to be high enough to compensate investors for the credit risk they take. To a large extent, a bond's credit rating reflects its credit risk. Bonds with a rating of BBB- (by S&P and Fitch) or Baa3 (by Moody's) or higher are considered investment-grade, while bonds with a rating of BB+/Ba1 or lower have a speculative profile (also called "junk").

3. Systematic risk

Also known as 'volatility' or 'market risk'. This type of risk cannot be completely avoided but its impact can be minimized by hedging or by a well-developed allocation strategy among different asset classes, in different geographical zones, currencies, and economic sectors.

These three main types or risks associated with bond investments are now close to their lowest historical levels, and it seems that the potential for further decreases has been exhausted. On the contrary – concerns are that in the next years these risks will rise, which would lead to a decline in bond prices.

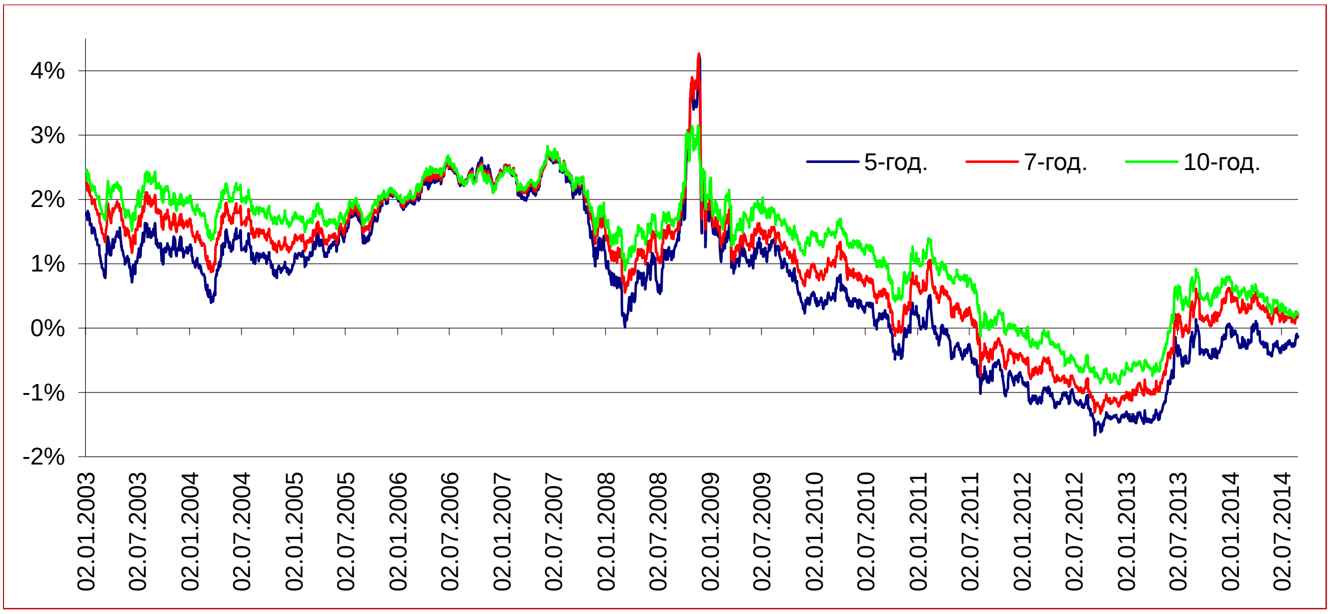
When will central banks increase interest rates?

One of the most discussed economic topics in 2014 is the future interest rate policy of central banks. It is expected that interest rates will be raised first in the U.S., where economic fundamentals have greatly improved, and the Federal Reserve has not increased rates since May 2006.

Every quarter, the Federal Reserve publishes its expectations for the benchmark interest rates. The June 2014 report showed that most members of the Federal Open Market Committee expect the benchmark federal funds rate to reach 1.00-1.25% by the end of 2015. At the moment, the target level is between 0.0% and 0.25%. Increasing the interest rate level in the U.S. will most likely have a negative impact on fixed income instruments because of the reasons described in the example above. For some time, the real rate of return (the nominal rate adjusted for inflation) of the 5-year U.S. treasuries has been negative – another indication that nominal interest rates will be raised until real interest rates become positive again.

A change in interest rates affects long-term bonds the most. Every bond has a characteristic called duration which measures its sensitivity towards changes in interest rates. The longer a bond's time to maturity is, the higher its duration is. The higher the duration, the larger the change in the bond's price is for a given change in interest rates. For example, consider a bond with a modified duration of 5 (maturity in approximately 6 years). All else equal, if the interest rate level rises by 1%, its price will fall by 5%.

Graph 1. Real yields of 5yr, 7yr, and 10yr U.S. treasuries



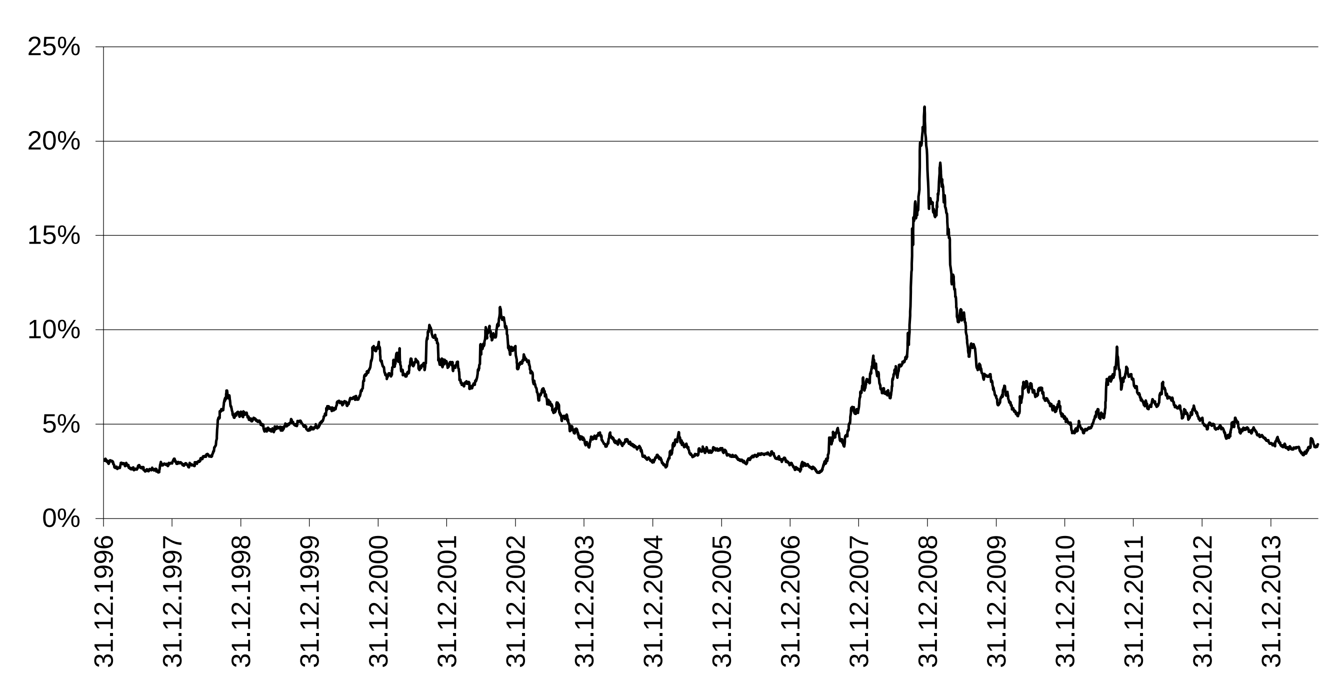
Source: U.S. Department of the Treasury

Is there a bubble in the speculative bond market?

Over the past few years we notice a stronger investors' interest towards riskier assets, including speculative bonds. There are many reasons for that, among which are: a search for higher yields in a period of extremely low interest rates in the economy; a global recovery from the financial crisis; improvement of the economic indicators; improvement of the companies' financial performance. This investors' interest resulted in credit spreads reaching historically low levels.

The credit spread represents the difference between the yield of two bonds with different levels of credit risk but identical other characteristics (maturity, currency, etc.) At present, the credit spread of the high-risk bonds in the U.S. is close to its historic low for the last 18 years. This can be interpreted as an indication for a speculative bubble in the high-risk bond market. If the credit spread rises to its average historical levels, this would result in a substantial and most likely sharp fall in the prices of bonds with ratings below investment grade.

Graph 2. Credit spread of high-yield bonds in the U.S. according to data from the Merrill Lynch US High Yield Master II Index (BofA Merrill Lynch US High Yield Master II Option-Adjusted Spread)



Source: Federal Reserve Economic Data

How can investors protect themselves from changes in the bond market?

History shows that after certain periods of time market crashes happen. The economic and financial problems in Europe have not been resolved yet with Portugal's banking failure being the most recent example. Tensions in Ukraine and the Middle East are mounting. Volatility and uncertainty will increase in the next 12 months, but we do not expect a new financial or economic crisis in the United States or in Europe. Nevertheless, we think that we will gradually start to observe a rise in interest rate levels and an increase in credit spread towards their levels from the beginning of 2012. In periods of market uncertainty, we usually notice a 'flight to quality'.

In such a scenario of market development, we recommend that bond investors follow some main principles:

1. Lower portfolio duration

Bonds with a shorter maturity are usually better protected from rising interest rates because even if they experience a temporary fall in price, they can still be held to maturity. Meanwhile, investors get their coupon payments, while the bond's price gradually moves towards par value on the maturity date.

2. Investments in bonds with floating coupon rates

These are bonds whose coupons are not fixed but depend on the market's interest rate. For bonds issued in U.S. dollars, coupons of such bonds are usually formed on the basis of the yield of U.S. treasuries with an identical maturity; the interest rate at which a depository institution lends funds to another depository institution overnight (federal funds rate); or the U.S. Dollar Libor plus a fixed margin.

3. Investments in money market funds

These are mutual funds investing in short-term debt securities (for example U.S. treasuries). These instruments reduce investors' exposure to credit and market risks. According to Vanguard, the average annual return of such funds in the United States for the last 10 years has been 1.35%.

4. Switch towards issuers with a high credit rating

The yields of non-investment grade bonds at the moment do not offer investors a premium high enough to compensate them for the credit risk taken. Credit spreads have reached historically low levels in a period of political and economic uncertainty in many regions of the world. In such an environment, it is better to look for investments in issuers with a high credit rating and an improving financial performance.

5. Portfolio diversification

The good diversification improves the overall performance of a portfolio. This means a balanced exposure towards different instruments, industries, and currencies.

When expecting a rise in interest rate levels, a moderate exposure towards the stock market can be a good strategy. Historical performance of the S&P 500 index shows that the stock market performs well after an interest rate increase – on average, the index has returned 31% for the three-year period after the beginning of an interest rate increase.

Table 1. S&P 500 performance after an interest rate increase in the U.S.

Beginning of the interest rate increase	Yields from the moment of the increase		
	until 12m. after that	until 24 m. after that	until 12m. after that
16.07.1971	8.4%	6.6%	-18.8%
16.08.1977	5.7%	10.6%	25.2%
21.10.1980	-8.9%	5.5%	25.9%
22.03.1984	-14.3%	48.9%	90.3%
04.12.1986	-11.5%	7.4%	38.9%
30.03.1988	13.3%	31.7%	45.4%
04.02.1994	1.9%	35.3%	68.0%
30.06.1999	-6.0%	-10.8%	*-27.9%
30.06.2004	-4.4%	11.3%	31.8%
Average yield	**3.7%**	**16.3%**	**31.0%**

Source: Fisher, Ken. Debunkery.
** The period after 30.06.1999 includes the U.S. market crash due to the dot-com bubble which burst in early 2000, while prices continued to fall during 2001*

A rise in interest rates in an economy usually comes with strengthening of the domestic currency. Thus, during a possible increase of interest rates in the U.S. in 2015, investors who have previously turned Euro-denominated investments into U.S. dollar-denominated will probably realize foreign exchange gains.

For additional portfolio diversification, investors can add to their portfolios an exposure towards gold and oil – two sectors which in the past have had a good performance in times of market uncertainty.

6. Hedging

There are financial instruments which are negatively correlated with the bond market – when bond prices fall, these instruments rise. An example of such an instrument is ProShares Short High Yield ETF, which takes short positions against the U.S. speculative bond market. The performance of this fund is inversely related to the performance of the Markit iBoxx $ Liquid High Yield Index – an index of liquid bonds with a non-investment grade credit rating, denominated in U.S. dollars. Currently, the price of ProShares Short High Yield ETF is at its lowest since the inception of the fund in 2011 because of the strong performance of the high-risk dollar-denominated corporate bonds sector.

7. A selection of undervalued bonds

There are bonds on the fixed income market that offer a higher credit risk premium than the average premium for similar instruments. The attractive yield is normally linked to worsened performance and an expected downgrade of the company's credit rating. For some bonds, however, there is no objective reason for the more attractive credit spread. We believe that these bonds are undervalued and we expect a rise in their price.

** The article has analytical nature and is not a recommendation for purchase or sale of securities.*

GUEST COMMENT

BULGARIA STUCK IN LOW GEAR ON EUROPE'S ECONOMIC TRACK

GEORGI ANGELOV

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He has published numerous analyses and articles about tax and fiscal policy and the budget, economic reforms and development, etc. He is a co-author of the books "Bulgaria in International Rankings", "Anatomy of Transitions", "The State against the Reforms". Mr. Angelov has a Bachelor's degree in Finance from the University of National and World Economy (Sofia).

The article was published in the Open Society Institute's edition Politiki.bg

The European convergence motor has not stopped working even in these bad times for the European economy. The poor new member states of Eastern Europe are managing to make progress even in the most difficult times for the Eurozone. This proves that convergence is not simply a temporary result, but a real structural achievement working even in troubled times.

One may ask: *Why does the economy matter?* Why bother with it, why are we not interested only in the quality of life in a given country? And this is right, to a certain degree. Achieving a good standard of living and high quality of life is the most important thing indeed. However, history teaches us that the good standard of living requires a good economy. Without a stable, prospering and growing economy the unemployment rate is high, poverty and inequality increase, consumption is limited, budgets have fewer possibilities to fund public services, thus the health and educational achievements deteriorate. In short – there is no quality life without the economy. Greece is a typical example – in spite of the severe economic crisis several years ago it seemed the country could maintain a good standard of living. A bad economy, but a good standard of living. Greece was even given as an example that the economy does not matter, what is important is how you live. Yes, but this is not sustainable. A sinking economy, a sharp increase of the unemployment rates, bankruptcy of the state and the social systems – it all gradually starts to influence the quality of life indicators. In the last year alone, Greece lost 5 percent points of its quality of life evaluation. In other words, the drop in the economy is gradually getting to the standard of living, though 1-2 years later.

This is why the economy should be carefully observed. This allows us to see the changes in the foundation on which the living conditions of a country are built. This applies not only to a deterioration, but to an improvement, too. When the economy improves sustainably, then the quality of life will ultimately follow the trend, though with a certain delay. The economy is also a measure of the degree to which the reforms related to the quality of governance and the institutions in a given country are working. If the institutions improve, this will result in better economic indicators.

The 2012-2013 Eurocrisis

After in 2008 the Eurozone economy marked a considerable delay and in 2009 – a deep recession, in 2010 and 2011 the situation started improving with economic growth of 2% and 1.6% respectively. However, at the end of 2011, as well as during most of 2012 and 2013, the Eurozone was faced with a huge challenge – the doubt that the single European currency may collapse. This doubt over the ability of Europe to counteract the crisis (together with the political indecisiveness, contested elections in key countries, changes of governments and leaders) led not only to capital outflows and a drop of the euro, but also to a continuous recession which hit a number of countries of the Eurozone. In this way, after the global financial crisis Europe was affected by an internal financial crisis. This is clearly evident in the new edition of the Catch Up Index and most of all – in the economy trends. Most countries of the Eurozone mark a drop in terms of their indicators (only Germany and Estonia rank higher in the last year). It is no surprise that Greece lost 7 positions in the economy ranking in two years (from 2011 to 2013), Portugal is in the same situation, whereas Cyprus is at their heels with a drop of 6 positions in the ranking for this year only. Then Malta comes – deterioration of 4 positions for two years, and Ireland – of 3.

In the last year, however, Ireland has managed to stop the sinking since the decisive reforming measures of their government succeeded in bringing back the economic growth, stabilizing the financial system, and placing the state deficit and debt under control. Ireland became the first country of the Eurozone that went out of the bailout programme of the EU and the IMF and is now coping on its own, without relying on permanent loans. In this sense, the stable evaluation of Ireland for 2013 compared with 2012 is an important indication that the country is no more in a regime of global fall, and the Catch Up Index reflects accurately the development.

Cyprus is in exactly the opposite position because the country was hit by a severe financial and economic crisis in 2013, and the deterioration in the ranking of this country happened in the past year indeed. Remember that it was in 2013 that the biggest banks in Cyprus went bankrupt and since the country was heavily indebted anyway, it could not afford to save them (and the banks themselves were so large for the capacity of the Cypriot economy that it was impossible to save them). Thus, only the small depositors were protected, and the rest suffered massive losses.

In addition, in order to prevent panic and the mass capital outflows, the country introduced capital controls and restrictions on payments and drawings, which had a negative effect on the economy, as well as on the image of Cyprus as an offshore center.

The Catching-up

Despite all difficulties in the Eurozone, which spread to our region too, we must note the fact that the new member states are coping relatively better in these hard times. Only one new member state has gone down the ranking in the last year, and this is Slovenia. In other words, while the old members – especially those of the Eurozone – have worse economic indicators, the new members reverse this trend. The Baltic countries – Lithuania, Latvia and Estonia – are the leaders, but the Visegrad Four also make progress in general (Poland, the Czech Republic and Hungary advance, whereas Slovakia remains in the same position). Even the new member states with the worst results show no deterioration, but keep their positions in the ranking - Bulgaria, Romania, Croatia, Slovakia. As we have already mentioned, Slovenia is the only exception in the group of the new member states, but it only makes the achievement of the region stand out.

In any case, the European convergence motor has not stopped working even in these bad times for the European economy. The poor new member states of Eastern Europe manage to make a progress even in the most difficult times for the Eurozone. They prove that convergence is not simply a temporary result from the easy money and the pre-crisis artificial prosperity bubble, but a real structural achievement working even in troubled times. Some new member states are already overtaking old member states in terms of economic indicators – for instance, the Czech Republic is already richer than Portugal, and Slovakia – than Greece. Very soon, when we have the new data of Eurostat for 2013, at least 1-2 new member states will probably find themselves ahead of Greece and/or Portugal, and the Czech Republic is soon likely to overtake Cyprus in terms of income.

Of course, the good news has a negative shade too, because it is the countries lagging most badly behind by the economy indicators (Bulgaria, Romania and Croatia) that have failed to mark progress during the past year.

However, they have not completely stopped their development – the evaluation of these countries in comparison with 2011 improves too, by 1 to 2 percentage points. In practice, the whole of new Europe gives the green light for the improvement in the economy evaluation in comparison with 2011, once again with the exception of small Slovenia, which suffers the pressure of a problematic banking system, losing public enterprises and ineffective budget spending.

The poor new member states of Eastern Europe manage to make a progress even in the most difficult times for the Eurozone.

The worse results of Bulgaria, Romania and Croatia are not really surprising – especially when we have in mind that these countries are also at the bottom in term of the institutional indicators (governance and democracy). It stands to reason that we are catching up when the respective internal conditions are available, i.e. reforms ensuring a good environment for economic development.

Energy Focus

If we take the topical subject of energy and energy dependence, we can clearly show what distinguishes the reforming countries, which improve their institutions, from the passive ones – like Bulgaria, for example. The Baltic countries, Bulgaria and other EU countries are dependent upon the import of natural gas. Actually, most EU countries are completely or partially dependent upon the import of natural gas, including Spain, Portugal, Austria, Germany, France, Belgium, etc. In other words, most countries have one and the same problem. This is the similarity. The difference lies in the way they handle this problem. The data show that Bulgaria has one of the highest delivery prices of natural gas in the EU, whereas other countries – although also dependent on import – have far lower price levels. We may say the price of natural gas in Bulgaria is with 20-25% higher than the one in Austria, Belgium, Spain and Portugal according to the latest data of the European Commission. Where does this difference come from?

In fact the answer is relatively simple. Many EU countries depend on imports, but not from one supplier. To put it another way, Bulgaria is not just dependent on imports, it is dependent on the imports from a monopoly supplier (Gazprom) and cannot import from another supplier due to the lack of infrastructure and gas pipelines providing an alternative. In most EU countries the dependency on imports is restricted since many gas suppliers compete to offer gas – and this clash of competitors leads to lower price levels.

Europe imports gas not only from Russia, but from Norway and Algeria, too, there is also own production (Holland, Denmark and England), as well as imports from other exporters by sea through liquefied gas terminals. Apparently, if there had been the will in the last decades (even in the last years), Bulgaria could have also developed the necessary infrastructure allowing access to alternative sullies. Here this did not happen, although it happened in most of the other countries.

The EU invests heavily in liquefied gas terminals, which allow even countries completely dependent on Russia (such as the Baltic ones) to start receiving alternative supplies (the first terminal is almost ready). Bulgaria has neither taken part in such a project, nor has a pipeline for this type of gas. Even projects with secured funding of 5 years ago – such as the connection with Greece or Romania – are extremely delayed, and others are still in the negotiation phase.

Ultimately, after another crisis between Ukraine and Russia, the EU will most probably make Bulgaria accelerate the respective infrastructural projects, too, and as a result the differences in the prices in the different EU countries will gradually decrease, and our country will have a real alternative. However, where is the difference? Some countries have already solved this problem and enjoy the benefits; others – like Bulgaria – will resolve it with an enormous delay and only under external pressure. This is so for many other reforms as well. Then it is no surprise that some countries go ahead with the reforms and get quickly rich, while Bulgaria is bringing up the rear.

More information on 'The Catch Up Index' study may be found on http://thecatchupindex.eu/TheCatchUpIndex/

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