Issue 6 May 2011

expat compass

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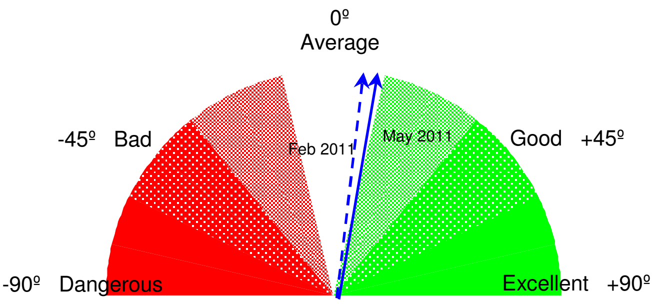
EXPAT CURRENCY BOARD WATCH



OUTLOOK: POSITIVE

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

GUEST COMMENTS:

WE ARE NOT CHANGING MOST OF OUR 2011 FORECASTS FOR THE MOMENT

We are now publishing the sixth issue of Expat Compass, #2 for 2011. No surprising economic news has come out since February. Thus, we are sticking to our forecasts from February, with two exceptions:

- We are raising our 2011 year-end inflation forecast from 4 to 5%. For the first time since 2008, we now think that inflation is a problem.
- We expect revenues from international tourism to rise by up to 10% year-on-year. This would be good news for the current account, for employment and growth, as well as for the real estate and banking sectors.
- We have not modified our +3% GDP growth number for 2011, but see some risks on the downside.

NEGATIVE DEVELOPMENTS

We have been disappointed by 4 events in the spring, from the point of view of the business community:

1. No decision has been made yet whether the Belene nuclear power plant will be built or not
2. The Renewable Energy Law is expected to hamper investments into wind and solar power plants, as well into the production of biofuels
3. The stock exchange is still state-owned
4. The Commercial Register will become less transparent

POSITIVE DEVELOPMENTS

Nevertheless, we have moved the hand of the compass rightwards by +2º, i.e. in a positive direction, for the following reasons:

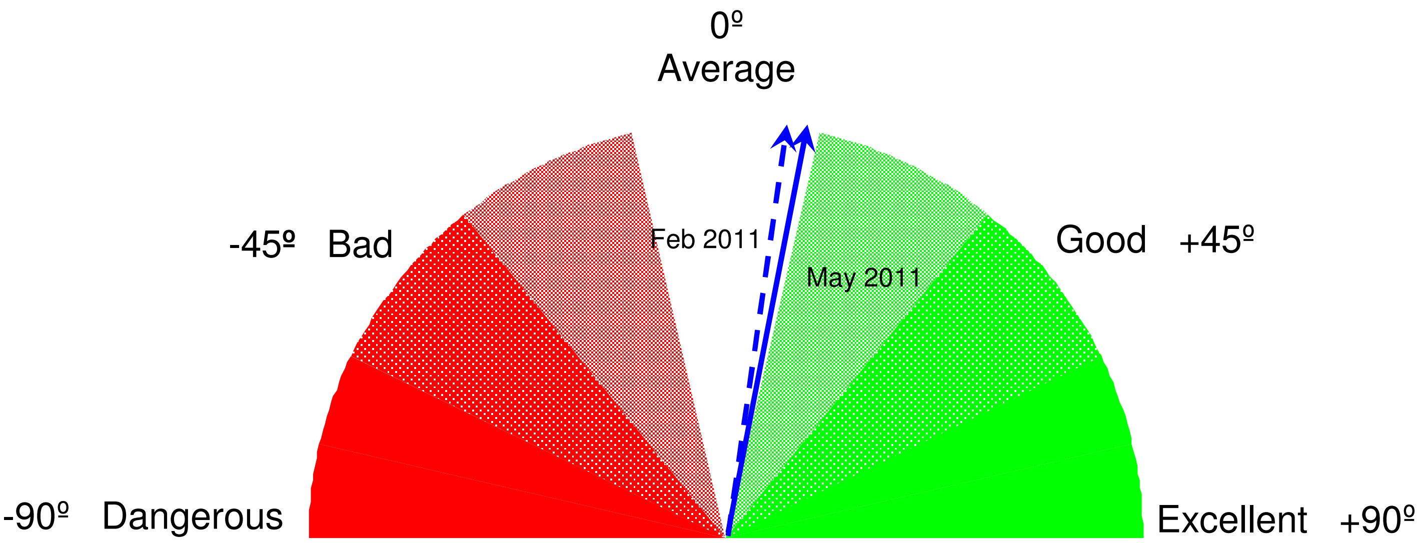
1. The privatization procedure for Bulgartabac Holding, as well as several concession procedures for airports and ports, have finally been opened
2. The budget deficit for Jan-Feb has fallen by half year-on-year
3. The government has been brave to keep on resisting pressures to raise wages and pensions

NO INDICATOR ANALYSES THIS TIME

For the first time, we have decided not to include analyses of individual economic indicators such as the budget balance or the current account deficit. The reason is that we see no reasons to change our forecasts or comments from the February issue.

EXPAT CURRENCY BOARD WATCH

OUTLOOK: POSITIVE



A year ago, the exchange rate was frequently discussed at economic discussions and business meetings. More recently, concerns have faded away as most economic indicators have started improving since the middle of 2010. Here is our positive conclusion:

We are optimistic about the currency board and see no immediate danger of devaluation.

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

Date	Reading of the Compass (Angular Degrees)	Change	Comment
2005	+64º		Currency board very stable
2008	+44º	-20º	Deterioration due to current account concerns
Jan 2010	+20º	-24º	Deterioration due to budget and recession concerns
Mar 2010	+9º	-11º	Deterioration due to budget and reforms concerns
Jun 2010	0º	-9º	Deterioration due to budget and reforms concerns
Oct 2010	+4º	+4º	Improvement due to exports growth
Feb 2011	+8º	+4º	Improvement in many economic indicators
May 2011	+10º	+2º	Smaller concerns about the budget

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, moderate
5. Budget spending	++	++	Not excessive anymore
6. Government debt	+++	+++	Very low
7. Foreign liabilities of the private sector	--	--	High, falling
8. Fiscal reserves	+	+	Average
III. Economic cycle related issues			
9. GDP growth	-	-	Close to zero
10. Inflation	++	+	Moderate, rising
11. Unemployment	-	-	Stable
12. Strength of the banking system	+	+	Average
IV. External balances			
13. Current account deficit, trade deficit	+	+	Improving fast
14. Foreign direct investment	-	-	Low
15. Revenues from international tourism	+	++	Moderate, rising in 2011
16. Foreign exchange reserves	++	++	High

Legend: Good Bad

This table looks better than in 2010. While sentiment in the economy remains weak, some economic indicators have numerically improved. The current account deficit has improved very fast, the recession seems to have ended. The budget picture is mixed.

In this issue of *Expat Compass,* we have improved our qualitative assessment for the tourism revenues in 2011, but are now more worried about higher inflation and lower growth.

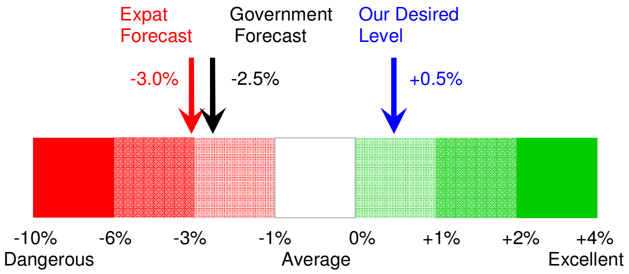
1) **The budget deficit** for Jan-Feb 2011 has been much lower than in 2010. We see no major concerns for the full year, and project a deficit of -3.0% for 2011. Situation – unchanged.

2) **GDP growth.** The start of the year has not been impressive, and we are likely to downgrade our 2011 GDP forecast in the next issue from our previous +3.0%. The government's plan is +3.6%.

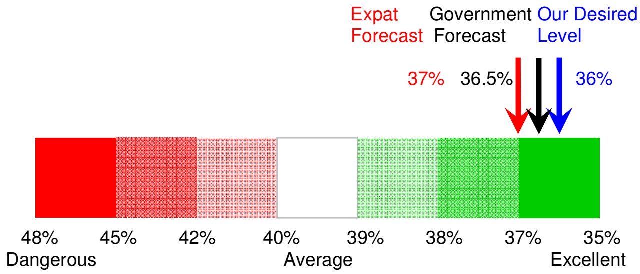
3) **Inflation** is continuing to rise due to the increasing oil and food prices. For the first time since 2008, we now consider this a problem – because it is hampering consumption and causing public protests. We are changing our 2011 year-end forecast from 4 to 5%. Not positive.

INDICATORS, 2011

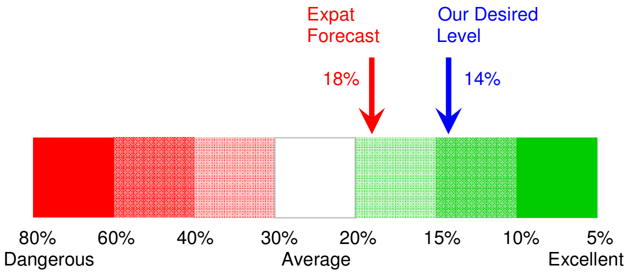
I) Budget Surplus/Deficit, % GDP, 2011



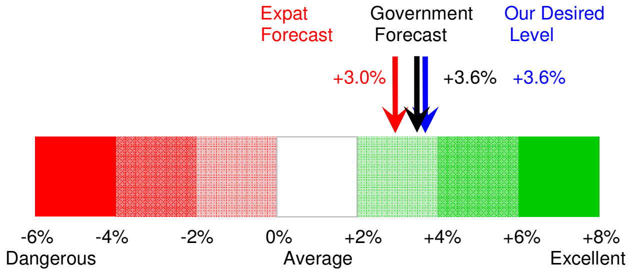
II) Budget Spending, % GDP, 2011



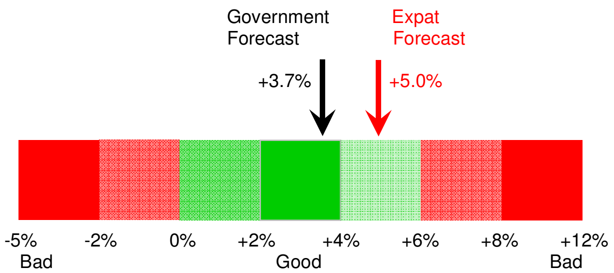
III) Government Debt, % GDP, 2011, Year-End



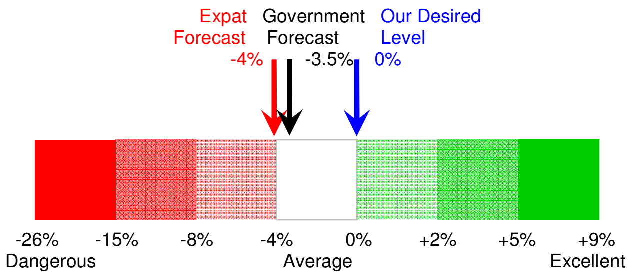
IV) Real GDP Growth, %, 2011



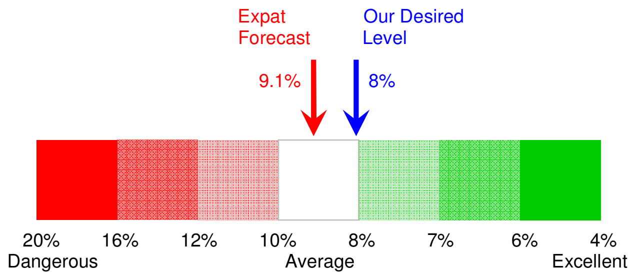
V) Inflation, %, 2011, Year-End



VI) Current Account Deficit, % GDP, 2011



VII) Unemployment, %, 2011, Year-End



EXPAT COMPASS SURVEY COMMENTS

With the last issue of *Expat Compass,* we sent a survey in order to measure our readers' feedback, as well as ask for recommendations. We are very grateful for all the comments. 46 people filled in the survey, which enables us to draw conclusions.

What we can do

Most of the respondents find our publications and articles useful. Almost everyone suggested that a wider variety of external analysts and professionals contribute comments and write articles. These should include experts in financial markets, bankers, industrialists. Concretely, comments about the banking system were requested. We accept this recommendation, and as a result, in this sixth issue of *Expat Compass,* we have invited four professionals with different background to write articles on three different topics: the banking system (2), the European Union's Euro-Plus Pact, and the new legislation on renewable energy.

What we cannot do

One of the suggestions made by several respondents is more difficult for us. They recommend that we invite people with different and even opposite views in order to organize a discussion on the pages of our bulletin. Other people suggested that we strongly broaden the scope of issues discussed in our publications – legal issues, ISO certification, the grey economy, international events, the situation in Greece, company and industry analysis, FX and commodities markets, regional policy, EU funds…

While we deeply respect the wishes of our readers, our feeling is the following:

On the one hand, we try to keep our bulletin independent and objective. We comment issues and make policy recommendations – without lobbying for concrete political or business interests. However, we do not pretend to be in the media sector, having the moral obligation to present all possible points of view.

We belong to a certain school of thought, so it is natural that we prefer to invite authors who broadly share our views. We support:

- the strong currency and the currency board, as well as joining the Eurozone
- prudent macroeconomic policies, including a balanced budget and low budget spending
- low direct taxes
- economic freedom, pro-business and pro-investment policies
- the development of financial markets
- privatization, concessions, and public-private partnerships (PPP)

As for the thematic scope of the bulletin, we would prefer to stick to the area where we feel we are most competent and can contribute the most: **economic policy.** In the first issue of *Expat Compass,* we outlined the main topic – the health of the Bulgarian economy with special attention to the stability of the currency board.

THE RED-GREEN SCALE

Some of our respondents said that it was not clear how our scales worked. Others questioned why we ascribed certain numerical values to the green and red areas. Yet others asked why the colours were green and red.

We did not look for political symbols. If we had, we would have probably chosen colours such as blue, red, yellow. Rather, we used the traffic light symbols – red is negative, green is positive.

expatcapital

REFORM WATCH: MARCH – APRIL 2011

POSITIVE DEVELOPMENTS

1) Bulgartabac Holding's privatization is now possible

We have continuously criticized the lack of privatization deals concluded by the current government. Finally, a privatization procedure for Bulgartabac Holding has been opened – this is probably the fifth attempt since 1997. All the previous ones have failed. Considering the bitter history of this process in the past, we would consider any deal with any buyer big political success. While the sale price and the quality of the investor are always very important, here the most important news is whether there will be a deal at all.

We reserve the right to make a special comment at the end of this transaction.

2) Concessions of ports and airports

Similarly, we have repeatedly been dissatisfied with the lack of any concession deals related to infrastructure. Recently, the *Ministry of Transport, IT and Communications* has opened (or is about to open) procedures for several airports (Ruse, Gorna Oryahovitsa, Plovdiv – cargo, Sofia) and ports (Burgas, Lom, Nesebar, Tutrakan, Ruse – Centre).

Critics say that the deadlines are short and the conditions might be imperfect. However, we would prefer any deal to no deal. We will watch the process with interest.

NEGATIVE DEVELOPMENTS

1) The 'Bolshoy Theatre' in Belene

Bulgaria decided to build a second nuclear power plant in Belene over 3 decades ago. The construction was stopped after 1990. A decision was made to renew the project in 2002. The current government seems to change course every other month. While significant amounts are still being invested in the site, no one knows whether there will be a project or not.

We would not like to go into much detail at this moment, but consider the lack of political will and expert capacity to make a final decision unacceptable.

2) The Renewable Energy Law was changed for the worse

Renewable energy is one of the few areas in which Bulgaria has comparative advantages, and in which we expected billions of euro of FDI in the next several years. However, the law was unexpectedly modified during the second reading in parliament.

Please see the special article on page 13.

3) The stock exchange is still state-owned

When the *Ministry of Finance* effectively nationalized the stock exchange last year through a capital increase, we expressed our worries that they might 'forget to privatize' it afterwards. So far, life has not proved us wrong, although we would prefer the opposite.

4) The Commercial Register will not be so public

Also unexpectedly, the parliament changed the relevant law and made the Commercial Register less open to the public. First of all, not all the information about companies will be accessible. Secondly, only registered users will be able to access any information, and they will have to pay for it. We consider both changes wrong and harmful. In this area, the country will go back to where it was five years ago.

FINANCIAL STATE OF THE BANKS IN BULGARIA IN 2010

GALINA LOKMADJIEVA, KPMG

Galina Lokmadjieva has been working at KPMG Bulgaria since 1994. Currently, she is Senior Manager at the Financial Services Audit Unit. She has considerable experience in auditing both domestic and international banks and insurance companies. Mrs. Lokmadjieva also took part in due diligence projects for financial institutions such as EIBank, DZI Bank, BACB, MKB Unionbank, etc.

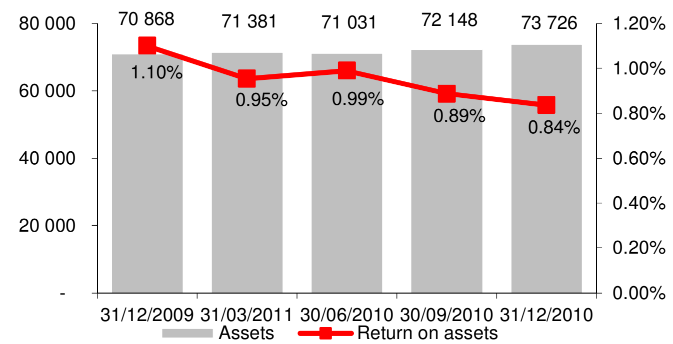
She graduated from the Economic University in Varna and spent time at KPMG London and at the New Zealand Audit Office.

The banking system in Bulgaria preserved its financial stability in 2010. This confidence contributes for lowering the risks in the economy and overcoming some of the negative consequences of the recession. BNB's consistent policy through the years leads to a significant accrual of capital buffers by the banks, which they can use to take higher levels of credit and market risk, so that all economy sectors are supported.

As of the end of 2010, the capital adequacy of the banking system in Bulgaria is 17.5% (being 17.0% in 2009), which exceeds the regulatory requirement of 12% and ensures good coverage of the financial risks, especially of the credit risk, which has the most negative influence on this activity.

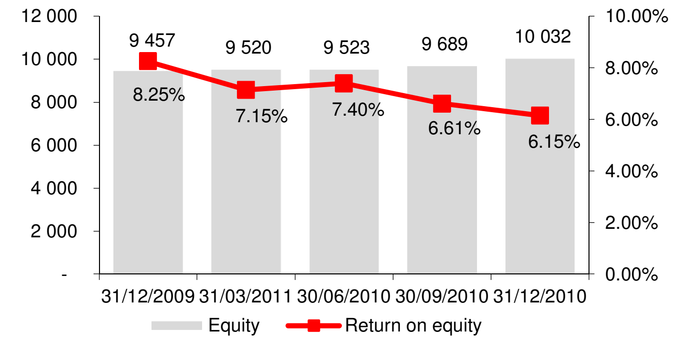
The assets of the banking system increased during the last year by BGN 2,858 mln and at the end of the year were BGN 73,726 mln. The return on assets decreased from 1.1% for 2009 to 0.85% for 2010. The main reason for this is the worse quality of the banks' credit portfolios and the increase of the impairment losses related to that.

Chart 1. Total assets and return on assets (BGN mln)



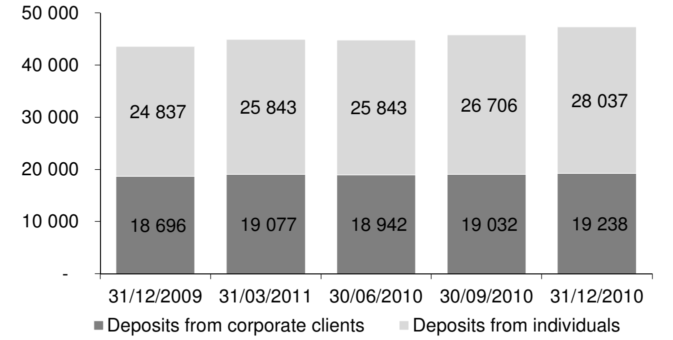
The shareholders' equity of the banking system at the end of 2010 amounted to BGN 10,032 mln and grew by 6.1% from the beginning of the year. Due to the decreased financial results, the return on equity in the banking system decreased from 8.25% at the end of 2009 to 6.15% at the end of 2010. The net profit of the banking sector at the end of 2010 decreased by 21% on an annual basis and amounted to BGN 617 mln for 2010. However, it should be mentioned that in 2010 the banks continued with their measures for optimizing operational expenses and restructuring the credit portfolios. Thanks to these efforts, a large part of them achieve positive financial results.

Chart 2. Equity and return on equity (BGN mln)



At the end of 2010, the borrowed funds reached BGN 63,011 mln – 3.6% higher than the previous year. Personal and household deposits continue to be the main source of financing, recording 13% growth year-on-year. There is a drop in the interest levels of personal and company deposits, although the limited access to foreign investments and the lower activity in the inter-banking market continue to put pressure on the bank policies for attracting investments.

Chart 3. Deposit base (BGN mln)



Loans

The tendency for a more conservative policy on granting loans to huge corporative clients continues. This is determined by the projects which are less economically sound. Individuals and households are not willing to use higher-interest loans for current consumption, as they experience difficulties in paying off old debts and do not have enough income to take short-term credits. The significant increase in the credit risk and the level of impairment allowances of credits is another reason for the fairly low percentage of the credit increase. Depreciations have increased significantly by 49% – from BGN 2,074 mln at the end of 2009 to BGN 3,091 mln at the end of 2010.

In 2010, in comparison with 2009, the corporate clients' credits increased by BGN 1,282 mln (4%), while retail exposure decreased by BGN 85 mln, reflecting the effect of more housing mortgage credits and less consumer credits.

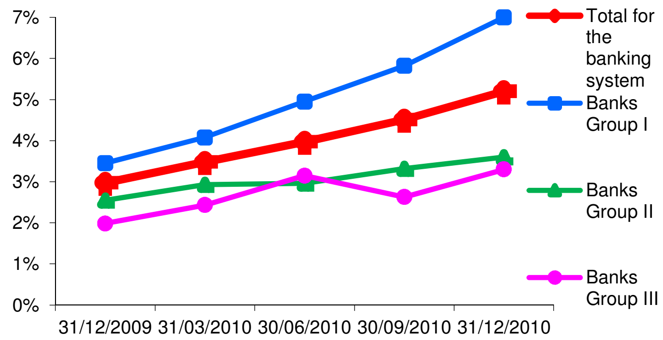
Granted loans	Total value		Change	
BGN 000	31.12.2010	31.12.2009	BGN 000	In %
Corporate clients loans and advance payments	33,993,371	32,711,566	1,281,805	4%
Retail exposure	18,578,695	18,664,149	-85,454	0%
Individual housing mortgage loans	9,268,826	8,953,588	315,238	4%
Consumer loans	9,309,869	9,710,561	-400,692	-4%

Loan depreciations increased significantly during the last years as a result of financial and economic instability in the country.

Granted loans	Impairment Allowances		Change	
BGN 000	31.12.2010	31.12.2009	BGN 000	In %
Corporate clients	1,768,799	972,616	+796,183	+82%
Retail exposure	1,307,878	1,092,092	+215,786	+20%
Individual housing mortgage loans	370,591	269,129	+101,462	+38%
Consumer loans	937,287	822,963	+114,324	+14%

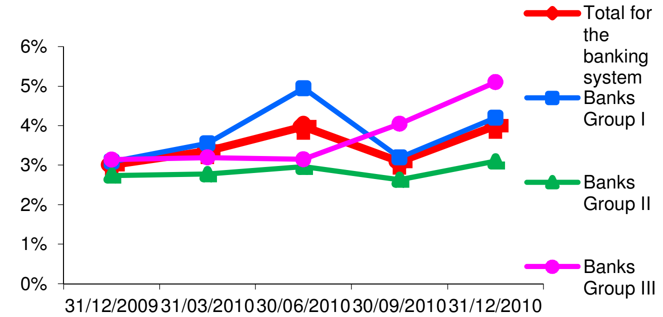
The analysis of the portfolio depreciation for groups of banks best presents the development of the credit risk. In the chart, the banks are grouped according to the methodology of the "Bank Control" Department of BNB, in the following way: Group I – the five biggest banks on the basis of their total assets for the period under consideration; Group II – the other banks in the country; Group III – branches of foreign banks in the country.

Chart 4. Impairment covers – loans to corporate clients



It can be seen from the chart that the depreciations of corporate loans in 2010 increased from 3 to 4%. This is due mostly to the development of the credit risk in the corporate loan accounts of the banks in Group I. However, the level of provisioning of these banks increased almost twice from 3.5% at the end of 2009 to 7% at the end of 2010. This is due to different factors such as the inability of some corporate clients to service their debts – typical as a whole for the banks in this period. It is important to also analyze the policy of depreciation in terms of acknowledgement of the depreciation and the influence of the market value of different depreciations on the final value of the depreciations. When calculating the depreciation expenses, the banks use different collateral, which they discount by a certain percentage, in accordance with their policy.

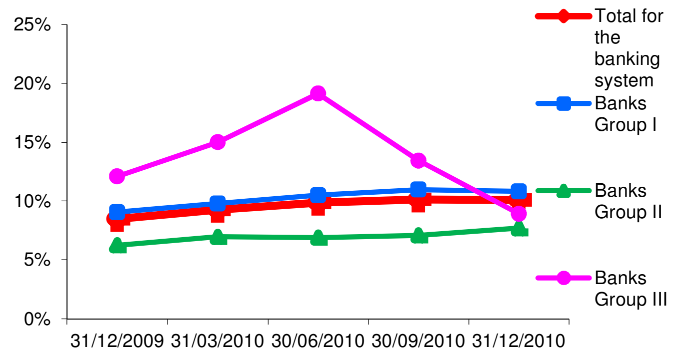
Chart 5. Impairment coverage – mortgage loans



The depreciations of individual mortgage loans increased from 3 to 4%. The trend is explained by the changes of impairment allowances of loans in Group I, which increased from 3% at the end of 2009 to 5% at the middle and 4% at the end of 2010. In the analysis, one should take under consideration the collateral – real estate mortgages whose value decreased in comparison with previous periods.

The level of provisioning of the banks in Group II is lower – around 3%, because their mortgage portfolios are comparatively newer than the ones in Group I, and the credit risk has not crystalised yet. The sharp increase in the level of provisioning of the individual mortgage loans in H2 2010 is impressive – from 3 to 5%. This is a result of the worsening of the credit quality of the loans granted by branches of foreign banks in the last 3 years, including the period of credit boom.

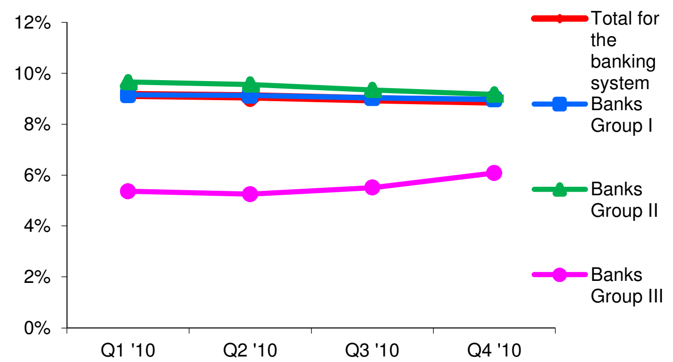
Chart 6. Impairment coverage – loans to individuals



The riskiest loans are the individual consumer ones. Their level of provisioning is a total of c. 10% for the banking system, which is the level of the banks in Group I as well. With the individual consumer loans, the credit risk is the highest, because the ability for paying off the short-term debts is strongly influenced by the financial crisis, and there is usually no additional protection for the banks in the form of collateral. A huge part of the individuals have difficulties in paying off their loans, due to lower incomes, the increased level of unemployment, irregular salary payments. With the banks in Group III, there was a sharp increase in the level of provisioning in H1 2010 – from 12 to 18%. This shows serious worsening in the individual consumer loans and is mainly connected with the branches of Greek banks. At the end of the year, the percentage of depreciation coverage compared to the total amount of consumer loans in Group III decreased to 8%, due to the improvement of the collection measures of loans, and partly because of writing off the bad loans from bank accounts.

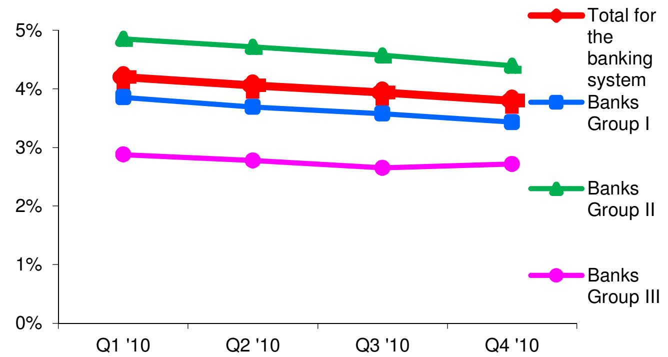
Price of debt and equity

Chart 7 Average interest income



The average interest revenue in 2010 earned by the banks in the country was around 10% and marked a slight drop. It is almost similar in the different groups, i.e. they apply similar percentages in the pricing formation of their credit products. The average interest revenue for the banks in Group III is lower in the 5-6% range and shows the efforts of foreign bank branches to increase the market share in granting loans.

Chart 8. Average cost of borrowings from customers



The average price of attracted clients' funds decreased from 4.5 to 4% in 2010. The banks in Group I traditionally give loans at a lower price, because they can attract from other financial institutions, incl. from their parent companies abroad, cheaper funds compared to the banks from Group II. The attracted clients' funds at the banks in Group III are at the lowest price, because they rely on funds given by the parent companies at a low price.

Forecast

In 2011, the challenges to the banks in the country are connected to the unstable economic situation and the decreased opportunities for generating profits and accumulating capital buffers for meeting financial risks. The application of conservative and reasonable policies of managing all financial risks – market, credit and liquidity, and of operating risks, as well as the conservative supervision policy of BNB will continue to play a key role for the successful recovery of the Bulgarian economy.

BULGARIA – BANKING SYSTEM OVERVIEW, Q4 2010

TEREZA TRIFONOVA, FFBH

Tereza Trifonova is Investment Analyst at First Financial Brokerage House. Before that she was part of the Expat Capital Team working as Financial Analyst and Investment Consultant. She also gained experience as Consultant and Financial analyst at Karoll.

Tereza Trifonova holds a Master's degree in Financial Management from the Academy of Economics 'D. Tsenov' in Svishtov, and a Bachelor's degree in International Relations from the University of National and World Economy. Mrs Trifonova has been a certified investment consultant since March 2007.

The increase in provision costs had negative effects on the financial results in the system. However, we believe the past year has been by far the worst for Bulgarian banks since the crisis onset and expect positive news for the sector throughout the current year with the expected peaking in NPLs and trending down of impairments. Bad loans (*loans that are overdue by more than 90 days*) reached 11.9% of the loan book in Q4'10, a two-fold increase in a year. Our expectations are that NPLs will peak at 15-16%, most probably in the second half of the current year. Domestic demand remained subdued, while the relatively high rates on deposits (still 1-1.5 pp above the pre-crisis levels) supported the propensity of the population to save. On a quarterly basis, the loan book expanded by a mere 0.3%, driven by some revival in mortgage lending and a minor increase in the corporate segment. Consumer loans continued to shrink.

2010 should have seen off the worst for banks' results since the crisis onset

The net income of the banking system shrank by 21% YoY to reach BGN 617 mln in 2010. High risk costs continued to exert pressure on the bottom line results of banks, as provision charges totaled BGN 370 mln in Q4'10, down by 3% QoQ but up by 23% on an annual basis. The cost of risk *(provision costs divided by average gross loans)* rose to 217 bps at the end of 2010 versus 173 bps a year ago, and compared to the end of September the cost of risk moved up by 10 bps. Core banking revenues including net interest income and F&C income managed to compensate partially the surge in provision costs in 2010 and advanced respectively by 2 and 3% on the year.

Six of the banks operating in the country ended the year with a loss, including Latvian Regional Investment Bank, Bulgarian-American Credit Bank (BACB), Slovenian NLB, Turkish T.C. Ziraat Bankasi, and the Greek Alpha Bank and Emporiki Bank. The last two banks have been reporting negative financial results in the past years on the back of the aggressive expansion policy aimed at increasing their presence throughout the country. Currently, interested parties are performing due diligence on BACB, and Kardan N.V. announced just several days ago that it had signed an agreement to acquire NLB Bank.

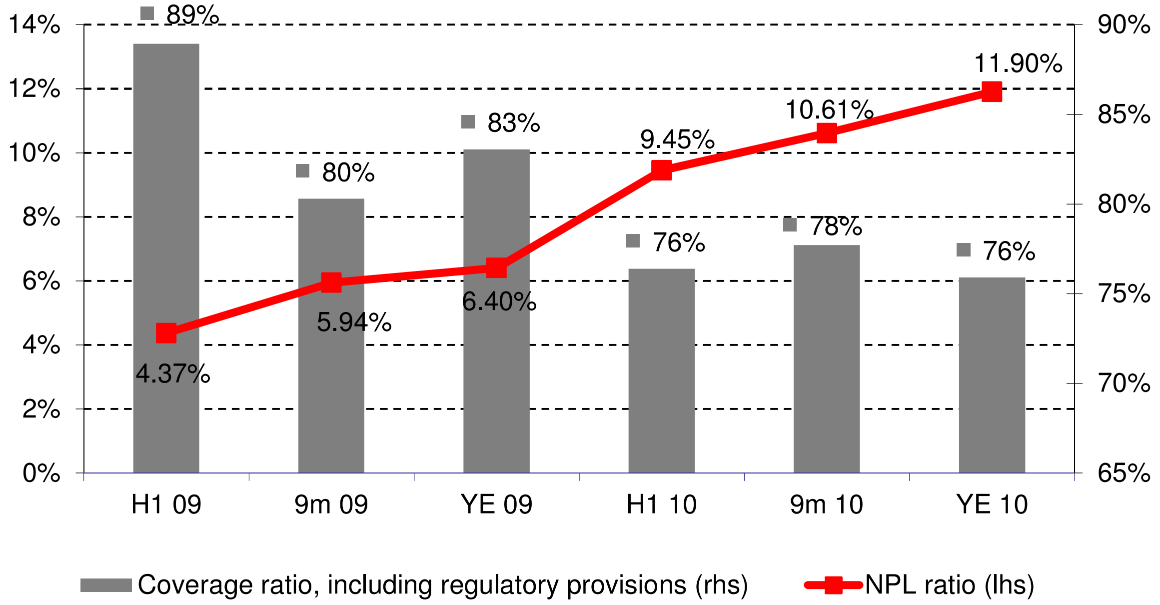
The ROE of the banking system edged further down to 6.36% as of 2010YE, down by 2.3 pp YoY. As of 31 Dec 2010, NIM remained stable at 4.6%. In 2011 we expect to see a gradual improvement in profit margins on a positive development of interest spreads (with rates on deposits falling faster than rates on loans).

The NPL bucket expanded to 11.9% in Q4'10

The quality of the loan book continued to deteriorate whereby bad loans reached BGN 6.2 bn and represented 11.9% of the loan book as of 2010YE. Our view is that NPLs will continue to elevate at least until the middle of 2011 and eventually peak at ca. 15-16%. The MoM growth pace in impaired loans (NPLs and renegotiated loans) has alleviated significantly with a registered increase by a monthly 0.9% in December 2010, versus 3.9% average MoM pick-up in the previous 6 months.

However, in spite of the fact that GDP grew for three quarters in a row, the recovery has not been strong, and business entities have not yet felt the effects of economic growth, while households are pressed by the low income (av. monthly salary in the country of EUR 353, NSI data for Dec 2010) and the high unemployment level (9.78% in January 2011).

Chart 9. NLPs



Deposits continue to accumulate

Domestic demand remained suppressed, which in combination with the relatively high deposit rates – 5% on average for term deposits (still 1-1.5 pp (percentage points) above the pre-crisis levels) supported the propensity of the population to save. The new retail deposits collected by banks in Q4 2010 reached BGN 1.3 bn. The retail deposits base expanded by 13% for the whole past year to reach BGN 28 bn as of the end of December. This reduced the Loans/Deposits ratio to 104% from 109% a year ago, as the loan book advanced modestly by 3% on the year. At the same time, the gross external debt of the banking sector contracted to EUR 6.8 bn as of end-November 2010, down to 19% of GDP compared to 24% at 2009 year-end.

The loan book advanced humbly on a quarterly basis

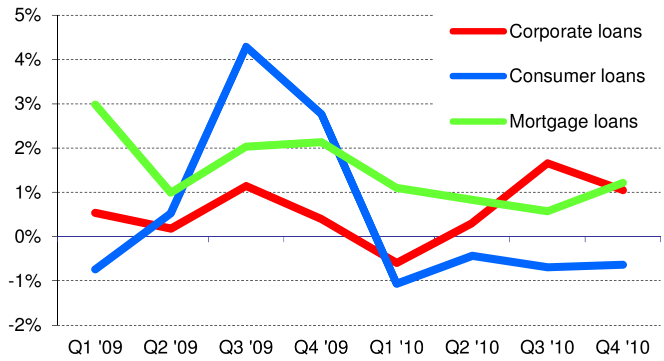
We expect to see further GDP growth acceleration in 2011 (FFBH forecasts pointing to a 2% GDP rise), driven by a continuing increase in exports and a recovery in domestic demand dynamics, more vividly in the second half of the year. A continued pickup in consumer demand would be the key factor to reviving the credit activity in the country. Currently, the rising inflation and high unemployment hamper local consumption, and the corporate and consumer segments are virtually at a standstill. Mortgage lending, however, grew by 0.9% QoQ in Q4 2010, and we expect it to grow at a more pronounced pace in 2011 for two main reasons:

1) Banks are much more inclined to give out mortgage loans as they are considered more secure.

2) Many people would consider the opportunity of buying homes having in mind the fact that property prices have fallen substantially – by 30% on average, compared to the pre-crisis levels.

Our own expectations are that the loan book at the banking sector level will expand within 5 to 10% in 2011 and will not in any case surpass the growth pace in deposits.

Chart 10. Loan book growth



Capital and liquidity ratios remain sound

Capital buffers remained at healthy levels with a slow decline to 17.48% CAR ratio as of December 2010 versus 17.80% at the end of September, and 17.04% at the end of 2009. CAR ratios are high enough to comply even with heightened Basel III requirements. Liquidity was also abundant with a liquid assets ratio of 24% at the end of 2010 (calculated as per Ord. 11 of BNB).

INSTEAD OF THE IMF'S GOAD – THE EURO PLUS ONE

KRASSIMIR KATEV

Published in 24 Chasa (daily newspaper), 28 March 2011

Krassimir Katev is Managing Partner at Avrora Capital and Chairman of the Board of Prime Capital Management – asset management and investment advisory companies. He has extensive experience in the fields of banking and finance. He was a member of the Board of EIBank, a member of the Administrative Council of the Council of Europe Development Bank (Paris), Vice Governor at the Black Sea Trade and Development Bank (Thessaloniki). In 2001-2004 he was Deputy Minister of Finance and Alternate Governor of IMF for Bulgaria. He actively participated in the privatisation procedures of Biochim and DSK. Katev had also worked at AIG International Inc. and Daiwa Europe Limited in London, as well as in the London and New York offices of Paribas Capital Markets. He graduated from the London Business School, the State University of New York, and the Budapest University of Economic Sciences.

The decision for Bulgaria to join the newly created Euro Plus Pact mechanism has been maybe one of the most important strategic decisions of GERB's government since the beginning of the mandate.

What is this pact and why is it extremely important?

In general, it is binding for the Eurozone countries and voluntary for the EU member states outside the Eurozone. The pact is a serious attempt to respond to the crisis spread in the Eurozone in the past year, provoked by the immense debt and structural problems of countries such as Greece, Ireland, Portugal, Spain.

The voluntary member states to this pact are Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania. What is common between them is that they see their future in the Eurozone sooner or later, and some like Bulgaria, Lithuania, and Latvia have currency boards pegged to the Euro, and strive to adopt the European currency as national, as soon as possible.

To put it in simple terms, the Euro Plus Pact's target is the closer coordination of the economic policy of the Eurozone countries and the ones striving for it, with a couple of main goals:

1. Supporting competitiveness
2. Improving employment
3. Achieving steady public finances
4. Supporting the financial and banking stability.

Since our country is one of the excellent examples of macroeconomic stability in the EU, the additional measures should not cause much stress; rather, they will give a credit of confidence and a push for reforms.

Although some of the already mentioned goals may sound like a quote of the Bulgarian Socialists Party's April Plenum decisions, in practice these are concrete measures and mechanisms, which should ensure – whether peacefully or not (or with outside pressure from Brussels, if necessary) – that the member states of the pact will hold to reasonable long-term economic and fiscal policies and will resist cheap populism.

This means a new fiscal and economic board for our country, aiming at the acceleration of structural reforms and ensuring fiscal discipline, which will let us enter the Eurozone more quickly. The EC and ECB can now officially play the role of a bad cop in the arguments with trade unions or when passing unpopular reforms. In other words, the Pact's goad replaces the IMF's goad.

In practice, every year the government should present concrete measures to Brussels, the implementation of which will be under constant monitoring.

More concretely:

- The salaries may increase with the productivity growth. I.e., farewell to 'the concessions to the unions' – if we want to earn more, we have to work harder and more efficiently. This ensures the long-term competitiveness of our economy, but prevents unreasonable pre-election salary increases.
- Different programmes will be activated, probably through the European funds, for the reduction of unemployment, taking the labour market out of the grey economy, encouraging employment, investments in education and R&D.
- In order to achieve stable public finances, we at least have to pass a law stipulating that the budget deficit should not exceeding 3% (in normal economic conditions), and maybe the restriction for the government debt not to exceed 60% (of less) of GDP should be written in the Constitution. The subject of restricting the budget deficit is quite delicate, and mechanisms for flexible reaction should be introduced, as well as exceptions from the rule in times of crisis or unexpected outside and economic shocks. In other words, a more predictable and conservative (more flexible) fiscal policy is ensured.
- As far as the pension sector and healthcare reforms are concerned, one can expect pressure for the gradual increase of the retirement age in line with the demographic factors. The aim is to avoid a collapse in the public finances due to the aging population and the constant pressure for pension increases and other social and health gains.
- In the tax area, direct taxes definitely stay in the realm of sovereign competence of the Pact countries. Only coordination of the tax policies will be accomplished in order to avoid vicious practices and tax fraud. As far as corporate taxes are concerned, the target is to gradually equalize the basis for corporate taxation, as the change in individual rates stays in the scope of local legislation. In other words – one should not expect changes in the flat tax rates.

The following step should be the renovation of discrete, but solid diplomatic pressure for our acceptance in the Eurozone waiting room ERM II in 2012.

HOW TO KILL A SECTOR or WHY BULGARIA DOES EXACTLY THE OPPOSITE TO WHAT GERMANY DOES

NIKOLAY NIKOLOV

Nikolay Nikolov is Executive Director South East Europe of Island Renewable Energy. He has been focusing his efforts on originating, funding and developing renewable energy projects since 2008. Nikolay serves as a board member on a number of small technology businesses, as well as Board of Trustees of the American University in Bulgaria. Prior to joining Island in 2009, Nikolay had been involved in the inception and development of a number of start up businesses. He is former Executive Director and Board Member of Mobiltel, Bulgaria's leading mobile telecommunications company, and former Deputy Minister of Transport and Communications. Nikolay is an Economics and Business Administration graduate from the American University in Bulgaria.

On Friday, April 15th, the German Chancellor Angela Merkel met with the Prime Ministers of Germany's 16 *Bundesländer* and two other cabinet ministers in Berlin. 'I think we all want to move away from nuclear energy as quickly as possible and switch to renewables', she told the summit. She laid out a six-point plan and said one of the country's most important efforts over the next decade would be the heavy investment in more efficient energy grids.

Merkel's broad six-point plan, presented at the meeting on Friday, includes:

- Expanding renewable energy. Investing in more wind, solar, and biomass energies will try to raise the renewable energy share of Germany's total energy use – from a baseline of 17 percent in 2010.
- Expanding grids and storage. Building a much larger storage and delivery network for electricity – particularly wind energy, which can be generated in the north but must be carried to the south – will be a main focus.
- Efficiency. The government hopes to improve the heating efficiency of German buildings – and reduce consumption – by 20% over the next decade.
- 'Flexible power'. The government wants to build more 'flexible' power plants that can pick up the slack from wind or solar energy when the weather fails to generate enough electricity during peak demand. The obvious source of 'flexible power' for now, besides nuclear energy, is natural gas.
- Research and development. The government will increase its support for research into better energy storage and more efficient grids to a total of EUR 500 mln between now and 2020.
- Citizen involvement. The government wants to involve its sometimes recalcitrant citizenry due to ongoing resistance against wind generators and the installation of an efficient new power line grid in some regions.

As a sharp contrast, we saw the Bulgarian Parliament making a U-turn on the sector and making last minute revisions in the Renewable Energy Law that would effectively halt all investment activities in the sector and put Bulgaria at odds with the EU directives. Alarmingly, this was combined with statements from government officials that renewable energy is expensive and nuclear is not.

The logic of the ruling party MPs, supported quietly by the Energy Minister, is that the current feed-in-tariff mechanism (FIT) has created the opportunity for abnormal returns in the solar sector, and this, combined with a very high number of connection contracts signed by the National Electric Company, (in excess of 5,000 MWs for both wind and solar projects) has created an unsustainable pipeline of renewable projects. Unfortunately, instead of using a simple market mechanism to address the issue by decreasing the feed-in-tariff to a reasonable level, the ruling party has decided to simply kill the sector and reboot the system.

How to kill a sector?

After more than 6 months of public hearings and reviews of the new legislation and a broad support from the industry, after the first reading in parliament and 8 sessions of second reading in the Economics and Energy Commission and when the law had already reached the transitional provisions, the ruling party suggested a group of texts to be re-voted and changed:

1. Reducing the period for the FIT from 25 years to 20 years for Solar and from 15 years to 12 years for Wind. This would place Bulgaria at the very bottom of European nations together with only Latvia, Luxembourg, and Slovakia. In all three countries, the too short term has led to the complete stop of wind energy development.
2. Allowing for the FIT to be fixed only at the time the wind/solar park has already been constructed (combined with the right of the national regulator to freely determine the FITs once per year – in the current Law, the FIT allows for a change by +/-5% annually, thus, providing sufficient security.).The second last minute change means that in the future RES projects will only know what feed-in tariff they will receive after they have been constructed. This would mean that investments of dozens of millions would have to be made without any security about the future income. This stands in harsh contrast to conventional power stations which often secure their tariffs years before they complete construction or rely on market prices that are not subject to political interference. This would create risks that the financial experts would agree with: no serious bank, investor or developer would take such risks, and it would again lead to the complete stop of the entire renewable energy market.
3. Providing that all existing projects at an advanced stage (i.e. having a preliminary or final grid connection contracts) will have to pay BGN 50,000 per MW deposit but will have their FIT fixed only after the project is build (Act 15).

What are the implications?

1. Respectable international investors will pull out of the country and will explain the reasons for that. Bulgaria will destroy its fledgling image of a reliable investment destination where EU directives are followed and the regulatory environment is stable and predictable. Only for the renewable sector, this will mean that more than 1bln EUR of foreign investment will be lost in the next 2-3 years. The consequences for the other sectors are difficult to quantify but will be significant.
2. The country will not be able to meet the EU climate targets, which means that Bulgaria will have to statistically import RES surpluses from other countries, and its consumers in Bulgaria will have to bear the costs for this which will amount to several hundred million euro per year.
3. Lastly, these last minute changes will increase the chance that the already started infringement procedure by the European Commission will result in financial penalties for the government as early as this summer.

Renewable energies are the most important pillar of Europe's independent energy future. Europe is the leader in renewable energies, and the people all over Europe have made a clear choice for renewable energies and energy independence.

Unfortunately, this political decision turned out to be a giant step backward on the way of the European development of Bulgaria.

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THE EURO PLUS PACT: GREAT, BUT DO NOT RAISE DIRECT TAXES

NIKOLAY VASSILEV, CFA

The Financial Stability Pact (FSP) in Bulgaria

In the previous issue of Expat Compass, I expressed support for the Finance Ministry's 'FSP', with some nuances. My views about what to write in the Constitution can be summarized as follows:

1. No budget deficit
2. No increases of direct taxes
3. Government spending up to 37% of GDP

All of the above can be overruled by a 2/3 majority in parliament.

If passed, these changes should ensure the long-term financial stability and competitiveness of the Bulgarian economy – in sharp contrast to what is happening in dozens of other countries.

The Euro-Plus Pact in the EU

In an attempt to fight the severe debt, deficit, and confidence crisis in most of the EU, Sarkozy and Merkel have suggested a new 'Competitiveness Pact', later renamed to 'Euro Plus Pact'. It is too early to draw conclusions as the details have not been finalized. Nevertheless, here are my current comments, as of March 2011:

1. Abolition of wage/salary indexation systems – GOOD
2. Mutual recognition agreement on education diplomas and vocational qualifications for the promotion of mobility of workers in Europe – GOOD
3. Foreseeing the creation of a common assessment basis for corporate income tax – NOT GOOD, CAN BECOME WORSE
4. Adjustment of the pension system to the demographic development (i.e. average age of retirement) – GOOD
5. Obligation for all member states to inscribe the debt alert mechanism into their respective constitutions – GOOD
6. Establishment of a national crisis management regime for banks – WE HAVE TO SEE DETAILS

To summarize, the EU is not likely to be competitive in the 21st century, unless is dismantles its welfare system (points 1 and 4), improves labour mobility (p. 2), strengthens the banks (p. 6), and fights budget deficits (p. 3 and 5). There is nothing to argue about diplomas (p. 2). The other components resemble the FSP debate in Bulgaria – see the first paragraph.

Points 1 and 4: The European welfare model is unsustainable

Leftist politicians criticize the government for trying to dismantle the welfare state. Reformist economists (I hope to be one of them) criticize the government for NOT dismantling the welfare state.

Automatic wage indexation mechanisms and early retirement were probably appropriate for the years after World War II when:

- the population was young and growing
- the European economies were among the most stable and successful in the world, while most of Asia was called 'the third world'
- the Cold War was the main agenda. Western and Eastern Europe had to compete in the area of social benefits to the citizens

Today's realities are the opposite:

- the population in Europe is ageing and shrinking, immigration is a separate issue
- Asia is growing much faster and is likely to economically dominate the 21st century
- the Cold War is gone, and there is no debate about who won it and who lost it

Given these realities, Europe's priorities should be:

- reduce and eliminate budget deficits
- reduce public debt
- stabilize the common currency

To achieve this, Europe should:

- lower the growth of real incomes in order to make the economy more competitive (point 1)
- reform the pension systems in a direction which is unfavourable to pensioners (point 4)

Point 6: Do not anathematize the banks

I have NOT been a supporter of the somewhat simplistic view that:

- the banks are the only culprits for the economic crisis
- if we overregulate the banks, we will solve all future problems

Let me point out that there has been no other period in economic history with more regulation than today. There is no evidence, in my mind, that more restrictions on financial institutions will automatically produce better results. Thus, we have to see the details of the measures proposed before we make conclusions.

Point 3: The real risk for Bulgaria and Eastern Europe

For a number of reasons, countries in 'New Europe' have introduced much lower direct tax rates than the old EU members. Hungary has been one of the last to introduce a flat personal income tax rate of 16%, while Bulgaria has enjoyed the lowest flat rate in the EU of 10% for 4 years now. The low direct tax policy has resulted in large investment flows into Eastern Europe. Usually, this has resulted in *higher, not lower* tax revenues. Almost by definition, the introduction of a flat tax rate goes together with the simplification of the tax code. Bulgaria has eliminated a number of exceptions and exemptions.

Taxation policy might be one of the few examples where Old Europe can and should learn from the experience of New Europe.

Now, France and Germany want to harmonize the tax base. Not equalize the tax rates, yet. I see two problems with this:

- Germany and France are not likely to copy the more efficient East European model. Rather, they would try to impose their more complicated and outdated system on the East
- The harmonization of the tax base is likely to be just the first step towards a future attempt to equalize *(read: to raise)* the tax rates

Well, I think this would be wrong.

Additional issues for Bulgaria

1) Such an important topic should have been widely discussed in Bulgaria before the government committed its support for the Pact.

Often, it is important not only what you do but also how you do it. The Euro Plus Pact, if implemented, will obviously have enormous long-term effects on Europe, as well as on Bulgaria.

That is why, there should have been a discussion first.

2) Bulgaria should not be among the victims but among the authors of such policies.

True, we are the newest members of the Union. However, we are not among those who are being bailed out. On the contrary, we are likely to be **the largest contributors to the Pact (!)** as % of GDP. As such, we should have a stronger voice when such policies are designed. We should be among the doctors, not among the patients. If anything, Western Europe should learn from our tax policies.

3) It is unfair for the poor to pay more than the rich.

It is difficult to believe, but according to the initial version of the Pact Bulgaria would have to contribute a much higher percentage of GDP than the other member states. The reason is that the formula for the calculation of each country's contribution included a 'per capita' component. By definition, this component means that the lower the GDP per capita, the higher the % of GDP that the country has to contribute.

While the countries which caused the debt crisis will be recipients of the Pact's financial assistance, Bulgaria would have to contribute a disproportionate amount to it. Some analysts calculated that our contribution might reach some EUR 6 bn, or 17% of GDP. This is more than Bulgaria's total public debt. True, this will only happen after we join the Eurozone.

A basic principle taught by economic textbooks is that of **moral hazard** (or 'the prisoner's dilemma'). The more a country overspends in contradiction to all Maastricht-type rules, the more the others will have to bail it out. So, some would say, 'Why be disciplined?'

My conclusions

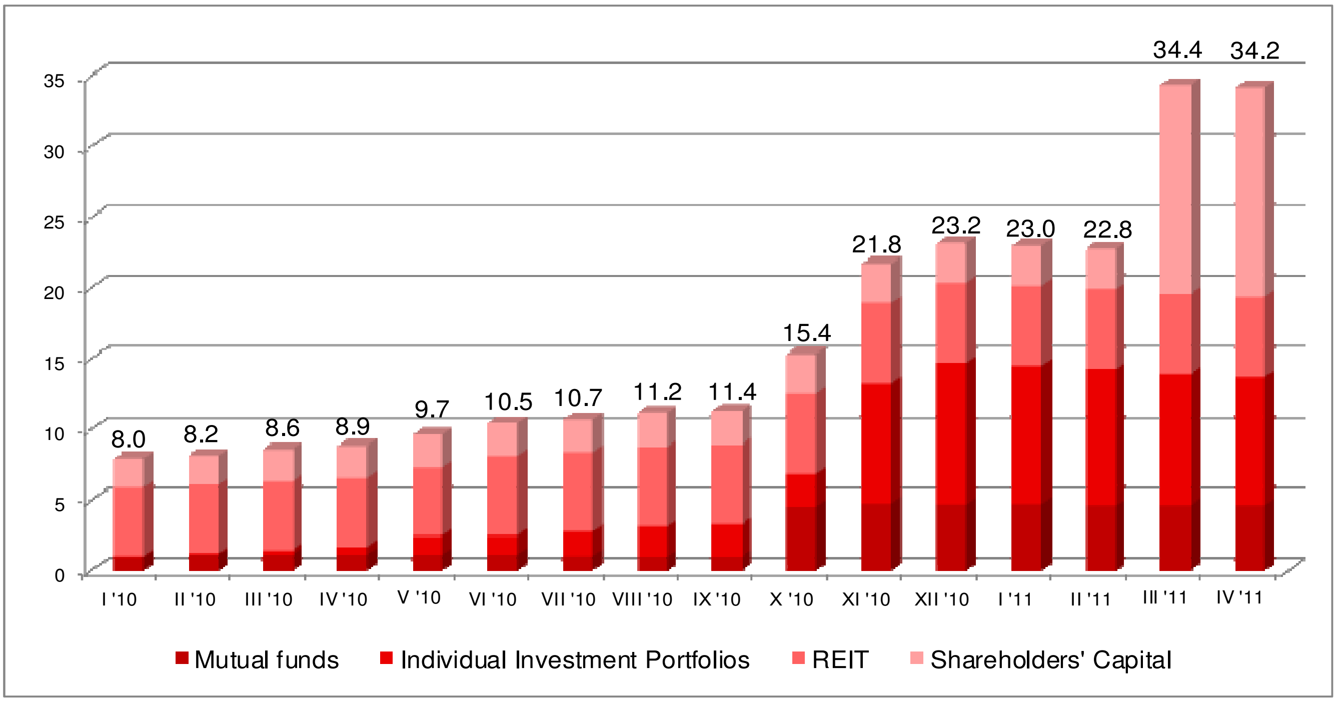
1. It would be positive for the EU to adopt the Euro Plus Pact, except point 3
2. Bulgaria should be among the leaders in the European discussions
3. The Pact should have been widely discussed before the government expressed its support internationally
4. Bulgaria should oppose any future attempts to harmonize, i.e. raise, tax rates

EXPAT NEWS

EXPAT CAPITAL ASSETS UNDER MANAGEMENT HAVE REACHED BGN 34.2 MLN

As of the end of April 2011, the assets under the management of Expat Capital and its related companies have reached BGN 34.2 mln (EUR 17.5 mln). This amount includes the three mutual funds (Expat New Europe Stocks, Expat New Europe Properties, and Expat Bonds), the individual investment portfolios, the two real estate investment trusts (Expat Beta and Expat Development Fund), as well as the shareholders' equity in Expat Capital and the related companies.

Assets under management (BGN mln)



THE EXPAT COMPASS TEAM

Author:

Nikolay Vassilev, CFA
Managing Partner, Expat Capital

Guest Contributors:

Galina Lokmadjieva

Krassimir Katev

Nikolay Nikolov

Tereza Trifonova

Editors:

Iva Popova, Research Analyst, Expat Group

Maria Divizieva, Managing Director, Expat Group

Design:

Natalia Dimitrova, PR & Advertising Manager, Expat Capital

Economic Data:

Nadezhda Gogova, Head of Unit

EXPAT CAPITAL

1000 Sofia, Bulgaria
96A Georgi S. Rakovski Str.
Tel.: +359 2 980 1881; Fax: +359 2 980 7472
E-mail: compass@expat.bg
www.expat.bg