Issue 7 August 2011

expat compass

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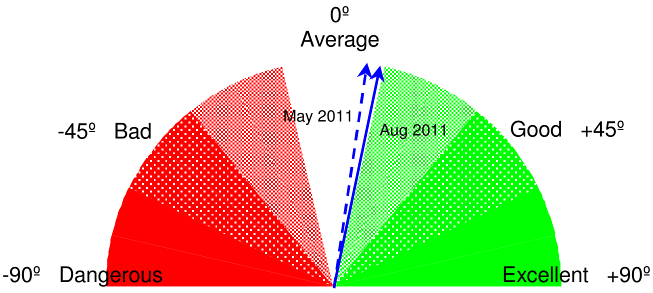
EXPAT CURRENCY BOARD WATCH



OUTLOOK: STABLE/POSITIVE

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

GUEST COMMENTS:

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THE BUDGET AND THE CURRENT ACCOUNT ARE BETTER THAN EXPECTED

We are moving the needle of the compass in a **positive direction** again, for the following reasons:

1) **Moody's** has just raised Bulgaria's credit rating to Baa2 with a stable outlook. Considering the disaster in many other countries, this is excellent news.
2) The **budget** has only seen a small deficit year-to-date. We are lowering our year-end forecast from -3% to -2.5% deficit.
3) The **current account** has been almost balanced year-to-date. This follows a decade of major deficits.
4) A successful concession deal for a part of the **Port of Burgas.**
5) Bulgaria has made some progress in implementing the policies of the so-called **Financial Stability Pact.** We hope this trend will continue.

HOWEVER, OUR GENERAL CRITICISM REMAINS

1) No decision has been made yet whether the **Belene** nuclear power plant will be built or not. We do not expect any decision at all.
2) No other **privatization or concession** deals
3) **Negative FDI** year-to-date. Very disappointing
4) **No reforms**
5) Nothing interesting in the **capital markets**

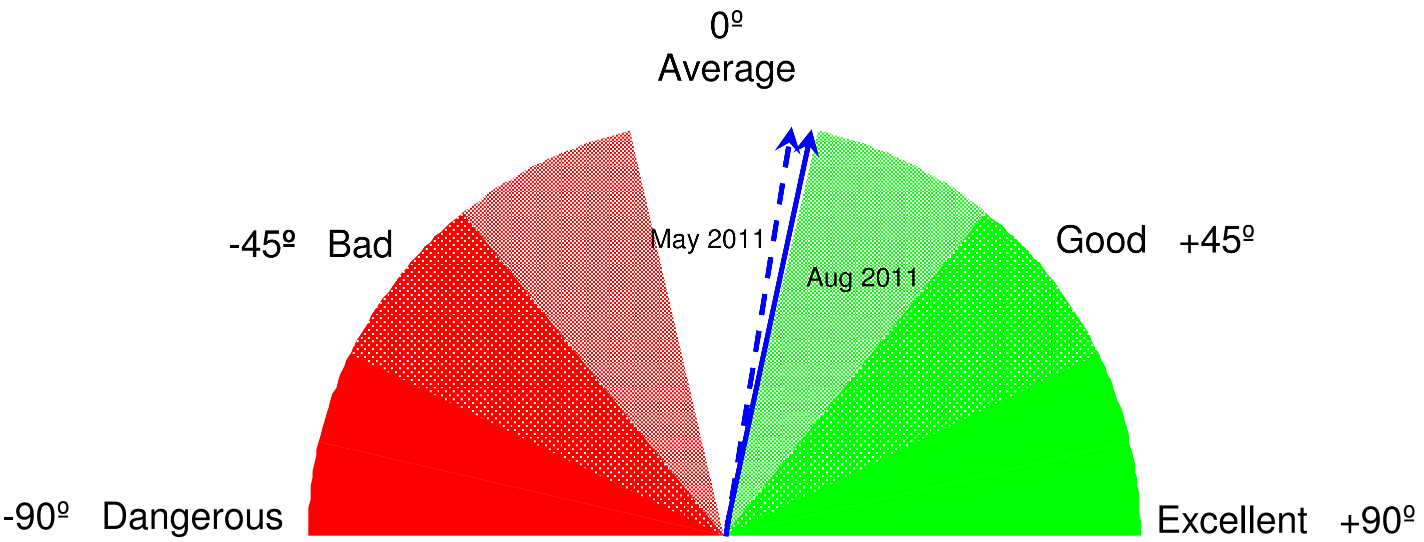
THE DEBT CRISIS DOMINATES THIS ISSUE

Please contemplate on the following fact: China has achieved a budget **surplus** of US$ 200 bn year-to-date. What will the 2020 news read?

The government debt crisis is the most important global economic issue for 2011. We are publishing one article about the US debt, as well as three articles about Greece. Although all these articles were published 1 or 2 months ago, we think that their validity has not changed and will not change by the small steps and pieces of news which happen on a daily basis. This is a long-term trend which resembles the effects of global warming.

EXPAT CURRENCY BOARD WATCH

OUTLOOK: STABLE/POSITIVE



In the last year, the main issue of concern for the business community in Bulgaria and globally has been the debt crisis, including in Greece. Bulgaria has not been directly hit by these tremors. While Bulgaria has not started moving on a growth path yet, 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
August 2011	+12º	+2º	Small budget and trade deficits

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	-	--	Average
12. Strength of the banking system	+	+	Average
IV. External balances			
13. Current account deficit, trade deficit	+	+	Improving fast
14. Foreign direct investment	-	---	Negative
15. Revenues from international tourism	++	++	Moderate, rising in 2011
16. Foreign exchange reserves	++	++	High

Legend: Good Bad

1) The first change we are making in the table relates to the **FDI** which has been negative year-to-date. Very disappointing. Hence, we are lowering our 2011 FDI forecast from above EUR 1 bn to EUR 500 mln. At levels around 0, the FDI trend is difficult to forecast as any small inflow or outflow might change the number from positive to negative or vice versa.

2) The second change is related to **unemployment.** While the unemployment in Bulgaria is not as dangerous as in Spain or Greece, it crept up during the winter. Although the absolute numbers are now falling for seasonal reasons, the 2011 census has just changed the base. Due to the population decrease, the June 2011 number is 9.56%, or 375 thousand people. We would place this number on the high side of 'average'.

3) Otherwise, the trends in the economy have not changed since May. **GDP growth** and business sentiment are weak. As we expected in May, we are now reducing our 2011 GDP growth forecast from +3% to +2.5%.

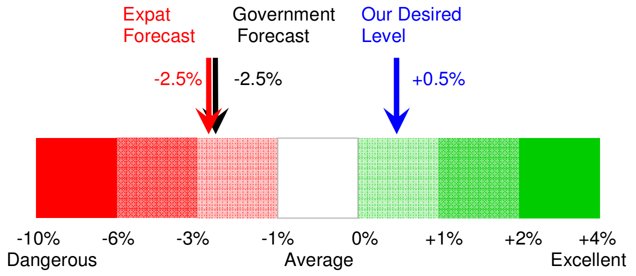
4) The **budget** has been in a better shape than last year, and in line with our expectations. H1 2011 deficit: BGN -650 mln, -0.9% GDP. Our 2011 forecast: -2.5%, improved from the previous -3%. We think that the H2 budget risks are on the expenditure side and are related to the Oct-Nov elections.

5) The **current account** has seen a surplus during some of the months in 2011 – for the first time for over a decade. This is both due to the rising exports and to the low domestic demand. This is excellent news from the point of view of the currency board.

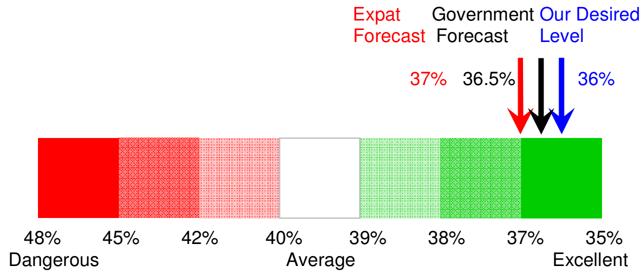
6) However, this is coupled with net capital outflows due to the **repayment of foreign liabilities** by the private sector – a logical and good trend by itself, but not positive for the forex reserves.

INDICATORS, 2011

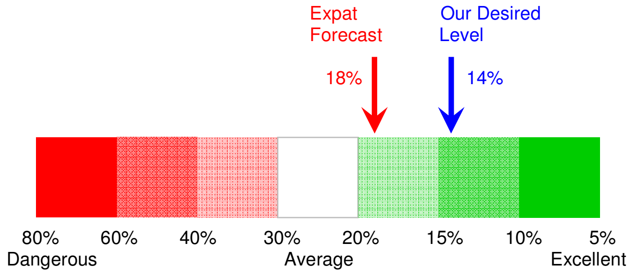
I) Budget Surplus/Deficit, % GDP, 2011



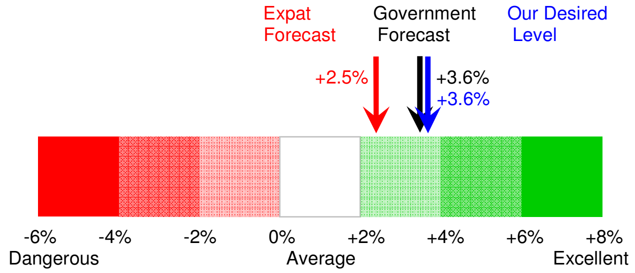
II) Budget Spending, % GDP, 2011



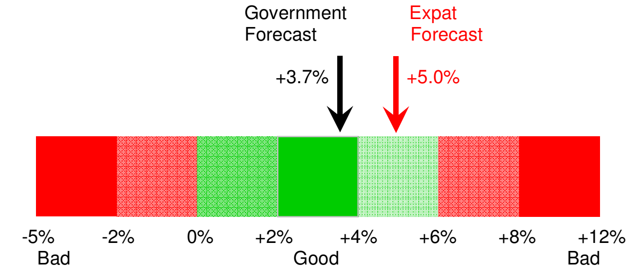
III) Government Debt, % GDP, 2011, Year-End



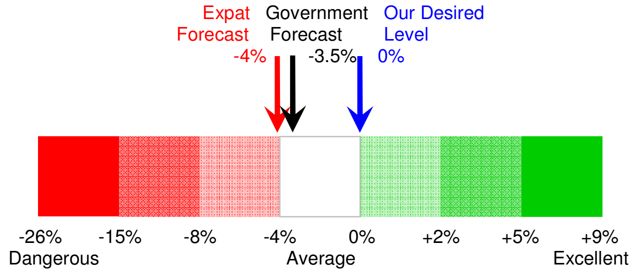
IV) Real GDP Growth, %, 2011



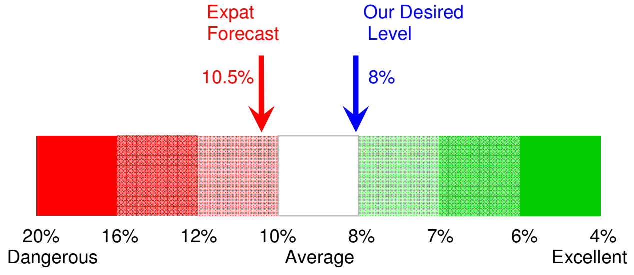
V) Inflation, %, 2011, Year-End



VI) Current Account Deficit, % GDP, 2011



VII) Unemployment, %, 2011, Year-End



ANALYSIS

REFORM WATCH (1): SECTORS

1) Minimum wage up by 12.5% – moderate

Bowing to some pressure from the unions, the government has increased the minimum wage from BGN 240 to BGN 270. It had not been changed for over 2 years. Although we might question the appropriateness of such a move, the effect on the budget is not large. We are more worried about the secondary effects, such as the possible upward pressure on private sector wages.

2) Widow(er) pensions up by a third

In a similar move, the pensions for widows (a fraction of the deceased spouse's former pension) were increased by a third. The change should cost the budget some BGN 132 mln per year.

Our comment:

Our readers must have noticed our very conservative position as far as budget spending is concerned, with a special attention to pensions. In the previous issues of *Expat Compass,* we repeatedly argued against any increases of pensions. Our view is that pensions were raised unreasonably in 2007-09, and that the budget is spending too much on this. Thus, we have supported the government's otherwise unpopular policy of freezing them since 2009. Gradually, inflation and the nominal increase of GDP should reduce the pension spending as % of GDP – positive for the budget.

In view of all this, such a small increase only of certain pensions would raise the total pension spending by less than 2% per year. We consider this a very small gesture to the public pressure. As long as this is not just a prelude to future increases, we do not consider this a big problem. However, in a [financial] earthquake, the first tremor is usually followed by additional ones.

3) The concession deal for a part of the Burgas port seems to be successful…

A part of the country's largest port has been given on concession to Navibulgar (BMF) – the large Bulgarian sea shipping company. Very good.

4) …However, there are no other notable privatization or concession deals

This government might finish its term with the smallest number of deals and reforms. Even the leftist and otherwise disastrous Videnov cabinet in 1996-97 had many privatization deals.

5) Overall: no reforms

Nothing important can be mentioned in any of the sectors below:

- pensions (crucial for the budget)
- healthcare (crucial)
- education and science (important)
- capital markets

REFORM WATCH (2): THE FINANCIAL STABILITY PACT AND THE EURO PLUS PACT

We support budget discipline

On this issue, we continue to support the government, as well as the Finance Ministry's position. Let us remind you of our previous articles. In the February 2011 (#5) issue of *Expat Compass,* we expressed our approval of measures which would:

- put a ceiling on budget deficits *(we favor balance budgets)*
- make increases of direct taxes difficult *(we support low direct taxes)*
- limit government spending as % of GDP *(we prefer low budget spending)*

In the May 2011 (#6) issue, we wrote comments about the EU's Euro Plus Pact, and supported most (not all) of the measures:

- abolition of wage/salary indexation systems
- mutual recognition of diplomas
- adjustment of the pension system to the demographic development (read: limit the growth of pensions)
- debt alert mechanism in the constitutions

The latest developments in Bulgaria

1) The Parliament has passed the 3 rules in the so-called Organic Budget Law:

- the budget deficit should not exceed 2% of GDP *(we would have preferred 0%)*
- the budget spending should not exceed 40% of GDP *(we would have preferred 36-37%)*
- it will be difficult to raise direct taxes

2) The Parliament is expected to debate and possibly write the same three rules into the Constitution. Whether this Parliament will manage to ensure a 2/3 majority to pass these changes remains to be seen. We would strongly welcome such a step, and will then move the needle of the Compass further to the right.

Limiting the size of the state administration

The Council of Ministers has passed an ordinance regulating the size of the state administration. In future years, the government should not be able to increase the number of employees at the ministries. If one entity has to be enlarged, another administration will have to be simultaneously reduced.

This is a revolutionary step, if implemented properly. Past experience shows that governments often find ways to circumvent all similar rules – in the way Mr. Parkinson described. With or without rules, limiting the size of the state administration is mostly a question of political will. Fortunately, the last two Bulgarian governments have managed to reduce the number of employees in the administration by some 25,000 people. 17,000 of these cuts were achieved 2005-09.

IN JUST SEVEN WEEKS AMERICA COULD RUN OUT OF BORROWED MONEY

RICHARD WOLF

USA Today, 17-19 June 2011

Exactly one month ago, the Treasury Department began issuing IOUs rather than bonds to some government pension funds. That allowed for continued auctions of so-called risk-free Treasury bonds until August 2. Unless Congress acts by then, the world's richest nation – unable to borrow $4 billion a day to pay its bills – would risk default.

OR WOULD IT?

To hear Treasury Secretary Timothy Geithner tell it, interest rates would spike, stock and home values would sink, savings and investment would dry up, jobs would disappear, businesses would fail, and everything from tax refunds to troops' salaries would go unpaid.

Federal Reserve Chairman Ben Bernanke says it would lead to "severe disruptions" in financial markets, lower credit ratings and damage to the dollar and Treasury securities. The centrist Democratic think tank Third Way claims that gyrations in labour financial and stock markets would cost 642,500 jobs, add $19,175 to every mortgage in process and lop $8,816 from the typical 401(k) account.

Others say the doomsday scenarios are hogwash.

Sen. Pat Toomey, R-Pa, says it would take a simple law laying out who gets paid first when the government no longer can borrow 41 cents of each dollar it spends. As long as bondholders collect interest on time, he says, there would be no default – just "sudden, drastic spending cuts" such as furloughing federal workers or delaying welfare payments.

Virtually no one expects this to happen. But to date, the White House and Congress haven't found a way to avoid it.

During the past six months, Washington has faced partisan showdowns over tax cuts, then spending cuts.

Now comes the need to increase the government's $14.3 trillion debt limit – the amount of money it can owe creditors ranging from China to the Social Security Trust Fund. The ceiling was reached on May 16, and only action by a reluctant Congress can raise it.

The federal government relies on borrowed money like a fish needs water. Threaten to take it away, and you risk a global crisis with economic, political, diplomatic and even moral implications.

What happens if America can't pay its bills?

"Nobody knows what would happen, but why in the world would you want to try to find out?" says David Walker, the former US comptroller general now heading the fiscal watchdog group Comeback America Initiative.

"At least we experimented with nuclear bombs before we dropped one."

In the past half-century, Congress has acted 78 times to raise, extend or revise the debt limit – the amount of money the government can borrow to repay bond holders. The red ink has risen 49 times under Republican presidents, 29 times under Democrats. It's gone up 10 times since 2001.

Lawmakers often find ways to make the vote less damaging politically. Since 1980, the House has "deemed" a higher debt limit 15 times when passing a budget resolution, without spelling it out in the legislation.

In 1985, Congress attached a system of automatic spending cuts that would apply when the deficit exceeded annual targets. It lessened the blow for skittish lawmakers, only to be cast aside when the cuts proved too stringent.

This time is different.

The House must take a stand because of a change in its rules. And not since the postwar years after World War 2 has the debt been so damaging – nearly the size of the entire $15 trillion economy. That has Republicans calling for spending cuts at least equal in size to any increase in the debt limit.

Says former Democratic congressman John Tanner of Tennessee: "The debt ceiling issue is a live-fire exercise."

Both parties share the blame

How did we get $14,300,000,000,000 into debt?

For three decades after World War 2, the nation's debt grew only incrementally, fuelled mostly by interest costs. In 1981, the debt was still less than $1 trillion, and just one-third the size of the economy – manageable by any standard.

The Obama administration has taken to citing Ronald Reagan's promotion of debt ceiling increases as proof that it's not just a Democrat's desire. Indeed, it was Reagan's defence buildup and tax cuts, along with a major recession, that helped triple the debt on his watch, to nearly $3 trillion – half the size of the economy at that time.

George H.W. Bush oversaw an increase to more than $4 trillion, nearly two-thirds the size of the flagging economy then. From a deficit-fighting standpoint, even that was a victory, fuelled by Bush's reluctant agreement to raise taxes in 1990 – a decision that helped make him a one-term president.

Four years of economic boom at the end of Bill Clinton's administration produced historic budget surpluses and reduced the debt as a percentage of the economy to 56%. But the accumulated interest costs still caused the debt to rise to $5.7 trillion.

From there, it took off.

George W. Bush's tax cuts, wars in Afghanistan and Iraq, and expansion of Medicare to include prescription drugs were deficit-financed, sending the debt past $10 trillion.

The recession and Obama's economic stimulus package in 2009 sent it higher still. And in December, Obama agreed to extend the Bush tax cuts through 2012.

Today the debt isn't just a problem because of its size. Nearly half of the $9.7 trillion "public" debt – as opposed to the $4.6 trillion held by the Social Security Trust Fund and other government accounts – is owned by foreign investors. Nearly half of that $4.5 trillion can be traced to two countries, China and Japan.

Perhaps the biggest problem is the burden of the debt itself: $225 billion in interest costs, projected to grow to $800 billion in 10 years. That money doesn't buy a thing.

Because of those rising interest costs and a growing, aging population, even the deficit-reduction plans floated by Republicans, the White House and various outside groups wouldn't stop the debt from growing.

The most draconian – House Republicans' plan to slash $4.4 trillion from the deficit in the next decade, then transform Medicare into a voucher-like program – projects a $16.2 trillion debt next year. By 2021, even with all the cuts, it would be $23 trillion.

"This problem," says Sen. Mark Warner, D-Va, a leader of a bi-partisan Senate effort to control the debt, "just gets exponentially worse."

Republicans are in the driver's seat

For now, the nation's ability to borrow money is the big problem.

The Treasury Department makes about 1 billion payments a year, 80 million a month. Without borrowing authority, some payments couldn't be made. Obama and Senate Democratic leader Harry Reid control two-thirds of the negotiations, but Republican House Speaker John Boehner is in the driver's seat.

He's demanding that federal spending be trimmed by more than the debt ceiling is raised – perhaps $2 trillion or more, if the ceiling is to be raised enough to get past the 2012 elections.

Republicans are insisting that entitlement programs such as Medicare and Medicaid be included in the cuts, but that tax increases be left out.

Obama wants to target tax breaks enjoyed by oil companies and others, and he's pushing for a "debt cap" aimed at locking in the savings over five years by forcing automatic reductions if needed.

House Majority leader Eric Cantor, R-Va, says more than $1 trillion in spending cuts already has been identified by GOP and Democratic negotiators meeting regularly with Vice President Biden. Some of the proposals cited by both sides include reducing farm subsidies, overhauling the federal pension system and capping non-security spending for several years.

As Aug 2 nears, it becomes less likely that a deal to raise the debt limit can get through Congress in time. That means a short-term extension would be needed to avoid default.

The deadlocked debate has spooked financial markets and all three major financial ratings agencies. Pimco, the world's largest bond investor unloaded its U.S. government debt in March.

"It's a very dangerous game of roulette that we're playing right now," says Neel Kashkari, Pimco's managing director.

Standard & Poor's put the government on notice in April that its triple-A rating was in jeopardy. Moody's Investors Service warned this month of a similar downgrade. Fitch ratings say Treasury bonds could be rated as "junk" by August.

Among the world's nearly 20 AAA-rated nations, "the U.S. really is the only one that has not yet adopted a serious plan to reverse the upward path of debt", says Steven Hess, senior credit officer at Moody's.

Default clocks and payment plans

That failure has at least some lawmakers preparing for default – something Congressional Budget Office director Douglas Elmendorf calls a "dangerous gamble".

One school of thought: it would never happen. The Treasury Department would find some way to extend the clock. Geithner's Aug 2 deadline isn't real.

Geithner counters that as soon as the nation failed to pay any of its bills on time – from salaries and contracts to tax refunds – "the world would recognize it as a first-ever failure by the United States to meet its commitments."

As the deadline gets closer, raising the specter of "default clocks" on cable television for all the world to see, some lawmakers have introduced legislation that would determine who gets paid and who doesn't.

Toomey has proposed that principal and interest owed to bond holders take priority. Sen. David Vitter, R-La, wants Social Security benefits given the same priority. Rep. Martin Stutzman, R-Ind, would add military spending to the mix.

What actually would happen in the event Congress doesn't raise the debt limit is unclear.

Would federal workers be laid off, and would they be rehired and paid later? Would Social Security benefits be delayed? Would federal "prompt payment" rules require the government to pay interest on late payments?

The whole mess could be avoided if Democrats and Republicans agree to work together – something Senate GOP leader Mitch McConnell says would prevent either side from gaining political advantage.

"We can do something important for the country together, and this is the opportunity," he says. "That's the importance of this debt ceiling moment."

WELL DONE TO THE GREEKS – HOW NICELY THEY WERE MILKING AND WILL CONTINUE TO MILK EUROPE

IVAN TODOROV, PhD, LAWYER

Published in Novinar (daily newspaper), 1 July 2011

Ivan Todorov is a PhD in Law and Managing Partner at "Georgiev, Todorov & Co".

He has diverse legal experience, especially in the fields of investment vehicles, licensing, privatizations and administrative procedures. He advises major companies investing in Bulgaria and major Bulgarian and foreign institutions and companies already established in our country.

Greece has attracted such amounts of EU resources, which none of the newly accepted EU members could even dream about. We remember well the cases when, related to the European financial support per agricultural unit area, it turned out that the Greek territory was three times larger than the real one. And this is the reason why the EU member in 'crisis' – Ireland – found out how to trick the system – there the rocks were painted white to look like sheep from the satellite.

We should take an example from the solidarity of the Greeks. The people there have received colossal funds from the EU, including applying serious and already mythologized fraud. Nevertheless, nobody says that there are corruption problems there. Also, Greece has been a member of Schengen for a long time. At the same time here, we caught a ridiculously small bribe at the Road Agency, we peddled for it, and the EU stopped the entire funding. Usually, when a fraud is revealed, one should be patted on the shoulder rather than penalized. But we do not have the Greek lobby…

Things are the same with our neighbours' foreign debt.

It is extremely shameless to take loans, spend over 150% of GDP and then to protest because you do not want to repay them. Greece was not under a dictatorial regime when it was taking this money. And this money was spent on Greece and the Greeks. How exactly they have divided it among themselves is their problem. There is no one else to repay on their behalf. And it is not instructive for future similar situations. Not to mention that Greece systemically violated the requirements of the Eurozone for budget deficits.

As a result, Greece built its infrastructure with all these hundreds of billions of euro. Highways are built everywhere. The price per kilometre is extremely high. This means that Greek companies have received a piece of the pie, too. Those companies are not Turkish, they have Greek employees. In the 1980s, Papandreou Senior nationalised large loss-making private companies and refinanced them. Thus, a uniquely large and highly paid public administration was created. Before the crisis, the Greeks had higher salaries that those in Italy. They built many modern hospitals and other projects.

Bulgaria barely spends under EUR 300 million to build new roads and highways. With only one fiftieth of Greece's public debt, its neighbour Bulgaria would transform all its main roads into highways. And with one hundredth of Greece's public debt, Bulgaria would be perfectly clean for a hundred years ahead. Well done to the Greeks – they have taken all they could, they have spent and collected as much as they could, they lived well, built a nice country – and now others should rescue it. And the Greeks are quite right to laugh at us that it is dirty in Bulgaria, and that we are stupid for not fighting for our rights. The new EU members such as Bulgaria must only learn from them.

It is not clear how Greece will be able to repay EU|R 330 billion – the amount of their whole public debt, even given the relatively low interest rates after the EU acquired the debt. This makes approximately EUR 66 000 debt for every working Greek. This means that Greek should pay over EUR 600 per month for 20 years. If this does not include the shortfall in the pension system amounting to nearly EUR 500 billion. Guess how the Greeks will pay their debts.

With EUR 100 million revenues at the Greek railways only the salaries are EUR 300 million. How could this institution be reformed, or who would buy it privatised? How could you lay off at least half a million unnecessary civil servants? Will they not die of hunger – they are not used to working, besides, there is no work to do.

In Greece, tax evasion is a national sport. The Greeks franticly protest against the government's weak current measures. And no way would they agree to repay the entire debt. The opposition is also categorically against the new passed by the Parliament measures – budget cuts, privatisation and higher taxes.

Do you think Greece has taken adequate measures to create confidence that the country will be able to pay its restructured external debt to the EU? Nothing like that. Despite the cuts of state, municipal and other public employees, there will still remain nearly 900,000 servants – more than three times over the normal rates. Instead of at least straitening the budget, Greece continues to accumulate debts and with an expected budget deficit for this year (according to the IMF) of about 8.4%.

In this case, at first glance it seems better for Greece to declare bankruptcy. Thus, the country could easily remove some 50% of its liabilities and reschedule them during further negotiations. However, let us look at the structure of the Greek debt. According to the Bank for International Settlements, the largest private creditors (banks, pension funds, etc.) are French (75 billion), Swiss (64 billion), German (43 billion), and Greek (105 billion).

The problem for Greece is that a significant part of its liabilities are owed to Greek banks and pension funds. And they will just simultaneously go bankrupt, if Greece refuses to pay its debt. At present, Greece has no money to pay even only its Greek creditors. Such a massive bankruptcy would collapse the entire economy. This is the main reason why Greece is seeking for European support to restructure its debt. It is also questionable whether, without significant refinancing by the ECB, the participation of the Greek banks targeted at the EUR 28 billion in debt restructuring would be ensured. In the restructuring, the European countries will take on a substantial part of the payables to the Greek pension funds.

So, in this case Greece can more easily twist arms, threatening to declare bankruptcy – Europeans will be the only victims. As there will be no way out for them after the restructuring, they will be forced to reduce and reschedule, until the Greek debt melts down significantly. Due to their large exposure to Greek debt, it is quite natural for France and Germany to look for ways to solve their problems – note, THEIR OWN problems – via postponing the Greek bankruptcy. They are trying to dump the weight onto their next governments and onto the rest of the Eurozone and EU members. This is a problem for those countries which did not implement the necessary regulatory control over their financial institutions when they invested in Greek debt. The investors made their investments, heavily relying on the support of their governments when the situation in Greece goes bad. So, the investors were buying Greek bonds, made profits, earned fees, no one controlled them, and now someone else should pay the bill.

That is why some wise and therefore successful countries such as the Czech Republic and Slovakia refused to support Greece. How come someone who was spending rationally and received very moderate EU funds should support someone else who was spending recklessly, knowing that he would probably be unable to repay. It is not normal that the poor and thrifty should pay for the rich and wasteful. In light of these obvious facts, in March Bulgaria decided to join the Euro+ Pact, the purpose of which is to finance countries in crisis such as Ireland, Greece and Portugal. We are going to rescue the Irish who earn over ten times more than us!? Is it interesting who has agreed that the Bulgarian participation in this project should be 17% of our GDP – nearly three times more than some developed countries such as Austria.

Even taking into account the reduction by half for the first twelve years, we are again paying proportionally much more than the rich. It turns out that although we are poor and we have been saving for the future, it is us who will rescue the rich who have lived lavishly. Although the Euro+ will only be activated for Bulgaria after its accession to the Eurozone, it is dangerous for our country because of the possible forced increase of direct taxes. The low direct taxes are one of the main reasons for attracting foreign investors to produce in Bulgaria for exports. The EU treats is quite equally on the spending side as far as Bulgarian payments to the EU are concerned. However, this is not true about EU funds – for example, our farmers receive ten times smaller subsidies per hectare that their Greek fellows.

Financially, since the beginning of our EU membership, the inflow of EU funds into Bulgaria is comparable to our payments to the EU. Besides, we have to pay for a huge administration which processes piles of paper related to European projects. Not to forget the huge waste of time for private companies fighting with the bureaucracy of EU funding. It is not a surprise that many Bulgarian companies consider it worthless to participate in such projects.

It is a quite separate issue that the EU is extremely useful in many areas for us (and for all member states) – starting with the common market, continuing with the freedom of movement and the pressure for reforms – the main driver for changes in Bulgaria for the time being. But that is another storyline.

ACROPOLIS ADIEU*. IMPLICATIONS AND LESSONS FOR BULGARIA

NIKOLAY VASSILEV, CFA

Standart (daily newspaper), 27 June 2011

** A famous song by Mireille Mathieu*

[In this short article, I am not intending to deeply analyze the Greek economy. Rather, I would like to draw conclusions and lessons for Bulgaria.]

All of us Bulgarians like Greece – the sea, the ouzo, and the music at the least. We all admired the 2004 Athens Olympics and Greece's amazing success at the European Cup in the same year. We all envy the climate, the lifestyle, and the living standards.

While some people claim that earlier in the 20th century Greece had not been much richer than Bulgaria, and possibly poorer, Greece definitely took off after it joined the EU in 1981, 26 years before Bulgaria. Due to the normal conversion processes, the higher growth, and the large influx of European funds, Greece accumulated wealth and developed management skills. The country became a major foreign investor throughout the Balkans and elsewhere. It is a home to many respected multinational companies, as well as to diverse consultants roaming in the region. Summer tourism has been a major success. The infrastructure is superior (just take a drive from Igoumenitsa to Alexandroupolis)… Coming out of the old system and entering two deep crises in 1990-91 and 1996-97, Bulgaria seemed light years away from its southern neighbour, whatever the question.

Table 1: Greece's dominance in the level of development

Indicator	Greece		Bulgaria	
Wealth, incomes	Higher, rising	++	Much lower, rising faster	-
Strength of the corporate sector	Very good	++	Weak	--
Investments abroad	High	++	Almost none	--

So, what has happened since 1997 and especially over the last several years, that today the Greek crisis is major news globally?

Table 2: Greece and Bulgaria: reform checklist, 1997-2011

Indicator	Greece		Bulgaria	
Privatization	Slow	-	Much faster	+
FDI inflows	Low	--	Very high	++
Competition in the economy	Lower	-	Higher	+
Budget discipline	Disastrous	--	Excellent	++
Public debt	Astronomical	--	Very low	++
Public sector, share in GDP	High	-	Low	+
Number of civil servants	Very high	--	Low	+
Unemployment	Rose dramatically, lately	--	Fell sharply in 2001-2008	+
Strikes and protests	Frequent and large	--	Rare and small	+

Well, Greeks believe in many contemporary myth and legends

1. EU funds will always flow in, and at an accelerating pace. The European Commission will always be closing its eyes on any misdoings
2. It is ok to spend more and more through the budget, as well as to live beyond one's means
3. It is ok to run enormous budget deficits and underreport them to Brussels – over 15% in 2009, over 10% in 2010
4. It is ok to pile up unthinkable amounts of public debt, and this can be sustainable – almost EUR 350 bn, almost 150% of GDP
5. It is ok to run many overstaffed and loss-making state-owned companies, never to restructure or privatize them due to the lack of political will and the inevitable protests
6. It is ok to have powerful trade unions able to shut down the whole country multiple times a year, protesting just against everything
7. It is ok to discourage foreign investment and international competition in a number of industries
8. It is ok to then blame all the pain resulting from the lack of reforms on everyone else: Brussels, the IMF, the ECB (European Central Bank), and the creditors.

In contrast, Bulgaria crashed so badly in 1996-97 that it learned a number of lessons, the hard way

1. In order to avoid future hyperinflation and the lack of monetary discipline, a currency board was introduced in 1997. You think that has been popular with the population?
2. In order to avoid the accumulation of new debts and to repay some of the old debts, budgets were almost balanced during some of the years (±1%), or even had large surpluses in 2004-2008 (is there a Greek word for *surplus?).* You think that has been pleasant for politicians?
3. In order to restructure the economy, many of the state-owned enterprises have been privatized. You think everyone was happy with that?
4. Significant FDI has flown in – over EUR 30 bn in a decade – partially due to the super-low direct taxes. Bulgaria has been among the champions in the world in terms of FDI as % of GDP. You think this is because of our blue eyes?
5. Bulgaria today has much less state administration. In addition, in Greece, even the employees in the state owned companies have a civil servants status, which means they have the same huge privileges and cannot be dismissed. Besides, the employees in our public sector have limited rights to strike – unlike many other countries. You think making the Bulgarian society more liberal and reformed than most of Western Europe has come for granted?

As experience showed, high spending does not equal high wealth

It is traditionally difficult for ruling politicians and for economists to persuade the public that fiscal discipline and macroeconomic stability are useful. Most populists always argue for higher pensions and salaries, for larger budget spending of any kind. They believe in the myth that if the government spends more, the nation will certainly become richer, overnight. The usual argument is that 'Bulgaria is still the poorest country in the EU'. As if this can be suddenly changed through some miraculous abracadabra.

Some countries (Greece, Hungary, most of Europe, the US) ran disastrous deficits in the last decade – even when the global economy was booming. Interestingly, they did not achieve higher growth rates than Bulgaria. Our country learned the lessons of the 90s, swallowed the sometimes bitter pills of the IMF, and gained. We have simultaneously achieved:

- the lowest direct taxes in Europe
- above-average growth rates
- incomes tripled in euro terms within 8-10 years, quintupled in dollars
- the highest FDI as % of GDP in Europe for most of the period
- the second lowest public debt/GDP ratio in the EU (EUR 5-6 bn for Bulgaria versus EUR 350 bn for Greece)
- the biggest drop of unemployment between 2001-08: by 13 percentage points

POSSIBLE SCENARIOS

1) Happy end – IMF style

- Greece realizes that creditors deserve to be paid back – this is logical to us but not obvious to the Greeks.
- A real austerity package is passed, leading to a budget surplus of, say, +5%. What even CNN calls 'extremely harsh austerity measures' have reduced the deficit from -15% to -10%, still a super large deficit.

If you weigh 350 kilos and want to get slimmer, you actually have to start losing weight, not just gaining less than before. Gaining 'just' 10 kilos this week after having gained 15 kilos the week before can hardly be considered a worthy achievement. A million Greeks periodically go to the streets – protesting against what exactly?

This would be the best scenario, but I doubt it is possible at all because we have no reasons to believe the politicians will find political will. The Greek public does not seem ready to face the reality. By the way, what has happened to all the privatization promises?

2) Bailout – Merkel/Sarkozy style

- The European taxpayers are somehow fooled that Greece is doing the right reforms, and pay another 12-digit bill

However, such European leaders would be crucified for their solidarity as time will show that in Greece not much has changed. The Northern cousins from the European family would see no reason to work even harder so that other can continue enjoying a lavish lifestyle.

This problem is called 'moral hazard'. If Greece is bailed out, why would the other Southerners have to be disciplined? It is much easier to spend, and then Aunt Angela will eventually sign the cheques.

3) Default – Russia 1998 style

If you own Greek government bonds and you do not get paid as promised, you would not be fooled by nice-sounding words such as *restructuring* or *voluntary*. If you do not get paid, this is called *default*. It is very difficult to guess how this is going to develop. My predictions would be:

- German, French, American banks, and other investors will suffer a deep 'haircut' of, say, 50%.
- The ECB has recently bought large amounts of Greek debt. That means losses, too.
- However, there might be a special deal for the Greek banks which could be protected from some of the losses, or recapitalized by the state. No bank failures.
- Sell euro, buy dollars. A lot of shame for the Eurozone.
- Speculators will be stimulated to consider 'checking out' other warm European countries which produce nice wine.
- Continuing recession in Greece. No investments flowing in for a long time.

WHAT SHOULD BULGARIA DO?

Keep cool. I do not think any banks in Bulgaria will sink. Some exports to Greece will have to be postponed. The border might be blocked by Greek protesters again. Not such a big deal. If Bulgaria's diplomacy is smart, we should be able to demonstrate that we are not always the worst relative in the family. On the contrary, we may publish books on fiscal discipline and indulgently give them to the Europeans. However, we are usually not very good at international PR.

CONCLUSIONS

Fiscal and monetary discipline is difficult to achieve and might be painful, but it produces results. Incomes and production are rising, albeit more slowly than everyone desires. Life sometimes shows that if you progress at a moderate pace, you might still overtake the others, if they fail. This can be true in business, in sports, and also about the relative performance of countries. True, Greece is still much richer, but the difference is decreasing. We learned much from our neighbours in the last years. Many Bulgarians can dance sirtaki. May be it is time for the Greeks to learn some Bulgarian horo. At least as far as economic policies are concerned.

OUZO AND TEARS

NIKOLAY VASSILEV, CFA

The article was published in the Banker (weekly newspaper) under the title “Deficit Leaders”, 16 July 2011

The lessons (un)learned from the Greek crisis

What are we going to remember about the administration of G. Papandreou – too little, too late

This is a government of the Greek left party PASOK, but with international pressure and support it is heroically trying to implement restrictive policies and reforms, regardless of the spectacular strikes and protests. Thank God, we do not remember those for a long time in Bulgaria. Although the direction of the reforms is correct, they are late by 5-10 years and not enough at all. There was supposed to be privatization, but I still have not noticed any for the last two years. Not to mention the missed last 20 years. Allegedly, the budget cuts are dramatic, but still there is a colossal deficit.

How could one consider a budget <u>deficit</u> of 8% (or 5% according to the IMF) for 2011 sufficient, after 15 and 10% for 2009 and 2010? With such a deficit the debt will <u>increase</u> by 15-20 billion euro (!) this year, after it had been increasing by tens of billions during the last years. I would suggest a budget <u>surplus</u> of at least +5% of GDP annually, so that the debt burden would start to <u>decrease</u>, not just to increase more slowly. Is it possible that no one in Athens apart from the Government and the fragile parliamentary majority understands this simple arithmetic? It is like the car is going fast towards an abyss, and we are just pushing the gas less instead of jumping sharply and dramatically on <u>the break</u>.

The Government might leave prematurely. Probably, it will be remembered mostly with the fact that during its term the country declared bankruptcy. The heroism and efforts in politics rarely get appreciated. The opposition, which today irresponsibly refuses to support the required measures, will probably win the next elections and will blame the previous government for <u>not</u> having conducted the necessary reforms, and thus allowing the bankruptcy.

What is the situation in the other countries?

Bulgaria was rescued by the IMF in 1997 with the micro amount of about US$ 1 billion. Not aid, but a loan serviced regularly. That is probably the most successful operation of the Fund. Only 7 years later, the previously ashamed “poor student” joined NATO, after 3 more years joined the EU, and today we have the second lowest public debt as % of GDP in the Union. Only Estonia is before us, but just two decades ago it was a newly established country with zero debt, while Bulgaria, even after the forgiveness of part of the debt in 1994, was <u>the most indebted</u> country in all of Europe with over 140% of GDP.

Today, our public debt is about EUR 6 billion, 1/6 of our GDP. And the currency reserves of the Bulgarian National Bank (BNB) are double that. I.e., the bank deposit of the family is twice bigger than the mortgage – great! Greece with a population of more than 10 million has debts of some 350 billion. What about Spain with three times larger debts? Italy with EUR 2 trillion? The US with over US$ 14 trillion? And Japan with the incomprehensible to me 225% of GDP?

As a former minister, who throughout the years has jealously and unpopularly resisted all budget deficits and precipitated income increases, now I feel like in a world of crooked mirrors where the crazy people consider the normal ones crazy. I really do not understand how during one of the strongest decades for the world economy (until 2007-8) most of the governments around the world went mad and allowed such astronomical deficits and debts, instead of using the good times for their reduction.

I.e., not only Greece has acted short-sightedly. Many others have done the same, too. Probably, the future history textbooks will say that the mankind has allowed an economic disaster commensurate with the climate changes due to pollution.

Are there reasons to admire our neighbours?

Recently, you have probably heard statements like 1) “The Greeks know how to unite and to protect their rights – unlike us”. Or 2) “They will get better quicker than us again, and we will remain poor”. Or 3) “What does the ordinary Greek care that the country has debts, he is still living well”.

I do not share such superficial and static opinions.

1) According to me, the protesters are numerous but they do not know what they want and do not have reasonable proposals. They are against every correct decision: budget restrictions, restructuring of enterprises and privatisation of assets, restraint of excessive incomes. About one thing they are absolutely right: they are blaming the whole political class for the disaster. But about another they are not right: instead of clenching their teeth and starting to work, they just want to dole from the state. What is more, 5-10 times more than us.

2) Yes, Greece will not die after this crisis – as Argentina did not die after 2002. But in Argentina incomes fell several-fold, measured in dollars. Greece will recover someday, but deep scars will remain:

- Recession, lower incomes, shortage of investments
- Outflows of Greek capital towards safer destinations (London) and destinations with lower taxes (Bulgaria)
- Lack of trust of foreign investors
- Forced and very belated sell-outs of assets – from islands to shares

- Collapsed national pride and a lot of shame. I do not know how to measure this – just remember where you were and how you felt in 1996-97. At that time, I was a student in Tokyo and Boston, everybody knew what the situation in Bulgaria was, and I was really ashamed.
- Colder attitude of the Europeans towards this part of the continent.

I do not know when and how the neighbours will "get better", but to them, the world will not be the same for at least one more generation. This is a chance for countries like ours to pull forward and to catch up with those who are now running backwards.

3) The ordinary Greek will understand that he will live in a country with high unemployment – no wonder over 20-25%. That his incomes during the next 10 years will be frozen and periodically cut. And he will care about what the government is doing.

It is not the rating agencies' and the speculators' fault

I have never shared the opinion that the "the bad" speculators are guilty for the failures of a country. The so called speculators are the large global funds and banks – investors who have purchased Greek bonds, after that trade them in the markets and then expect to get paid. If somebody does not like how financial markets operate, he should not issue bonds because they are traded in financial markets, not in a grocery. When bonds are issued just before elections in order to raise salaries – investors are welcome. And when their faith shakes up – they become bad. The fault for this crisis is of the governments which maintain chronic deficits, not of the investors for whom trading securities is business.

The same applies to the credit rating agencies. They exist to tell the truth. It is possible that in a few percent of the cases they prove wrong or are slow in their analysis, but this does not change the whole benefit from their work. In the majority of the cases they are right. For instance, they have given Germany a higher rating than Zimbabwe. Could you imagine the opposite?

This is like a statesman who does not get ashamed if the media prove he is corrupted, but anathematizes them as "the bad guys".

I am disappointed that prominent European politicians propose the dismantlement of the rating agencies – because this week they lowered the rating of another European country in trouble – instead of implementing the required budget reforms on the continent.

Why did Bulgaria not collapse?

I hope that the readers feel the difference between the silent heroism of the teams of Sofiyanski, Kostov, Simeon II, even Stanishev, and partly Borissov's cabinet, on the one hand, and the irresponsible blindness of many other countries, on the other. After the collapse in 1996-97, a series of our governments have followed a combination of correct policies:

- super-fixed exchange rate via a currency board already for 14 years
- balanced budgets (±1%) in 1998-2002, significant surpluses (over +3%) until 2008. From 2009 onwards we have deficits, which I do not approve
- low budget expenditures – usually below 40% of GDP. In my opinion, the optimum is 35-38%, then growth would be higher in the long term
- low direct taxes – the lowest in the EU at the moment

Every politician – be it a Prime Minister, Finance or Social Minister – wants to announce a sharp increase of pensions and salaries. In an election year or not. Slipping down the slide of populism is very easy. The countries which tried it got poisoned and paid a very high price – remember Hungary in 2006. Paradoxically, they did not become richer, but poorer. All the Bulgarian governments during the last 14 years conducted responsible policies, although this will not be appreciated – until now, none of the Bulgarian Prime Ministers has been re-elected. Their anonymous reward is that today Bulgaria will not collapse financially.

The sceptics would say: we are still the poorest in the EU, why should we care about this stability? The truth is that for the period of 1998-2008, Bulgaria gradually and consistently reduced the gap with other countries. I do not know whether during the peak of the hyperinflation in the 1990s the salaries were 3 or 5 dollars, but since 2001, the average income has tripled in euro and has increased 5 times in dollars. If someone knows how to increase it 10 times for such a period of time, "let him apply to the Armenian school", as an anecdote says.

Scenarios and issues in Greece

For a long time, there has been no doubt for me that the outcome is lethal. There are several questions:

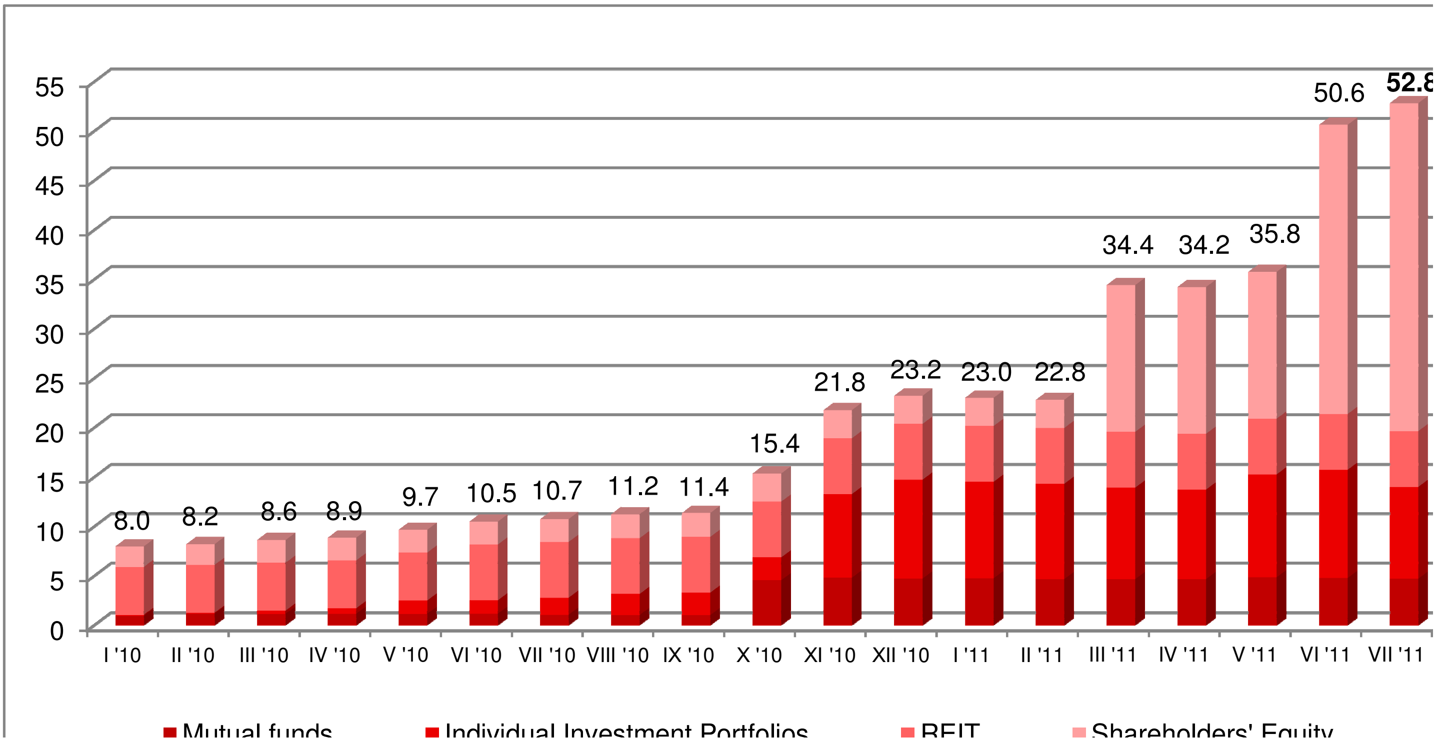
1) **When?** According to me, soon. Actually, the brain death could already be certain, but the relatives have not been informed yet.
2) **Will Greek banks collapse?** In my view, neither Greek, nor other. The cunning way would be to choose such a form of bankruptcy which could hit mainly the foreign players, the European governments, and the ECB, but to show partial mercy to the Greek banks. Or someone should recapitalise them as a part of the agreements. All that remains to be seen is whether the surgeons will not mix up the patients by mistake.
3) **How much water will the investors swallow?** Let us try to guess – a loss of some 40-50%.
4) **Will other countries follow?** It is hard to say. But the more time passes and the more money the EU is pouring into Greece, the less resources will remain to save others.
5) **Will the European and the world politicians wake up and balance their budgets?** I do not see that happening at all for now. It may be good for the current generation of "deficit leaders" to leave and for new ruling people to come, who belong to the IMF school. Taking Bulgarian advisers such as Velchev and Oresharski would not be a bad idea.

EXPAT CAPITAL HAS ACQUIRED 20% OF EUROHOLD AD, EXPAT'S ASSETS UNDER THE MANAGEMENT ARE NOW OVER BGN 52 MLN

In June 2011, Expat Capital acquired 20% of the shares of Eurohold Bulgaria through a transaction on the Bulgarian Stock Exchange – Sofia, at a price of BGN 1.215 per share, totalling BGN 26.4 mln (EUR 13.5 mln) for the whole package. As an important strategic shareholder, Expat Capital received representation at the management bodies of the company – one member in both the Supervisory and the Management Board.

After this transaction, and as a result of other successful transactions, by the end of July 2011 the assets under management of Expat Capital and its related companies have reached BGN 52.8 mln (EUR 27 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, 2010-2011 (BGN mln)



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