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European subsidies from an economic point of view¹

Krassen Stanchev

I should start off by saying that as I write this, Bulgaria is not the country I have in mind. Bulgaria is a separate case. Of course, anyone can use what I am about to say to draw conclusions about this separate case. I will talk specifically about those subsidy effects, which are difficult to see or, if seen, are left unaccounted for (or at least inadequately accounted for).

In order to understand these peculiarities, one has to compare the European funds to pure aid, which supposedly does not exist in the EU, but technically all transfers from the EU budget to the member states (and to the candidate countries) are just that, to a varying degree. In drawing comparisons, I will use the work of several world-renowned economists and a historian. The views of the scholars in question are rather well-known and in this format I would not discuss them in any detail. These scholars are Milton Friedman, Peter Bauer, Mansur Olson, Simeon Djankov and some of his colleagues at the World Bank², and the historian

¹ The article is first published in *Dnevnik* in IME's column "What is Seen and What is not Seen".

² This work deserves a special mentioning: Simeon Djankov, Jose G. Montalvo and Larta Reynal-Querol, Does Foreign Aid Help?, *Cato Journal*, vol. 26, No 1 (Winter 2006), pp. 1-28. It compares foreign aid to other forms of international transfers (foreign direct investment, remittances and loans) in terms of impact

Tony Judt. Their analysis can easily be found on the web, in libraries or in bookstores, and their inferences can be compared to the ones in this article.

Ordinary logic

The main shortcoming of the EU's redistributive mechanism, particular countries, and the international transfer of resources, termed "aid" (excluding the standard emergency solidarity offered after natural disasters) is, first and foremost, the disregard for and even attempted refutation of ordinary human logic or common sense. Here are three ordinary occurrences that illustrate my point.

First, imagine that I spend my personal means on myself. Unless my means are unlimited, then it is very likely that I carefully monitor how much, in what way, and on what I spend my money.

Second, imagine that you spend my means and I spend yours. That, which would concern us most is how much we spend. Since that is easily understood, we would probably have to agree on what and how we spend this money, as well as how we are to inform one another about our actions.

Third, imagine that I spend your money on someone else. Of course, it is possible that you are doing the same. That is beside the point. The

on economic growth and democratic impacts. My original idea was to review the intra-EU financial transfers with the same set of criteria, but collecting needed information requires considerable time and effort. This explains why I deal with only general of economic argument.

important thing is that in this situation everyone, except for the original owner of the means, would be less interested in how and on what the money is spent than he was in the first two scenarios. It is also probable that everyone (except for the owner) would be interested in spending more. Reaching a mutual agreement would be much more complicated, unpredictable and costly.

Expressed a few years ago in a conversation with president Bush, the original idea of describing the process of redistribution in such a way belongs to the Nobel laureate Friedman.

Which of the above-described situations does the distribution of EU subsidies most closely resemble?

You are right – the third. It only somewhat resembles the second and does not even approach the first.

The source of ineffectiveness

The next question, which we should probably ask, ourselves is: in what way does the process of European subsidization differ from the second and third scenarios described above?

Naturally, what comes to mind first is that this process is quite complicated.

On the one hand, the governments of the candidate and member countries alike spend the money of their taxpayers. With respect to the constituents in these countries, the governments are in the situation of the person who spends another's money on a third person. It makes no difference whether this third person is in the "Third World", in Eastern Europe, in Ireland, Malta, Lithuania, Greece or even at home. If one digs in the information on EU transfers to Ireland, on one hand, and Greece or Portugal – on the other and compares the transfers with the economic growth rates, it become obvious that there is no correlation.

At first glance, it seems simple to understand, but actually, it is rather complicated to control the logic of collective action of this kind of money transfer.

At the root of this logic lies the fact described by Mansur Olson, that a small group of people can be organized more easily than a big one. When heavy financing is carried out in the name of taxpayers, the resources themselves and the cost of acquiring them affect a large group of people. When we think about how small the amount is

per person, it becomes clear that he or she has no incentive to inquire about the amount of money, where it goes and how it is spent, regardless of whether there is accountancy at hand or not. This is how the phenomenon of informed ignorance spreads: people know that something is wrong, inexpedient or even foolish, but making an effort to change the situation is so complicated that they do not bother.

This phenomenon has both ethical dimensions and economic alterations: those who use another's money organize relatively easily in order to take more. Naturally, this awakens the resentment of those, whose resources are being taken away, even if they are in small amounts.

But yet, let me take a few moments to talk about the informational awareness of ignorance.

On average, the government redistribution in the EU is above 40% of GDP while transfers to Brussels are fixed at around 1% of GDP. Other thing equal, the reasons to worry about EU transfers are 40 times less important than own government redistribution.

When the organization of a lot of people is easy after all – for example during elections and referendums, the mood that someone seeks more rents and that the rent "we" get is less than that of the "others" always manifests itself somehow.

It seems to me that this phenomenon more accurately explains particular political circumstances. For example, the voting at last year's referendums in the Netherlands and France on the so called Draft EU Constitution Treaty is the product of an accumulation of similar moods, not of outright egoism, nationalism, left or right populism.

On the other hand, effectiveness in general can be defined as the use of someone's resources for the attainment of a certain desired goal with the lowest possible cost or the achievement of the best possible outcome with the resources at hand.

The European subsidies are closest to the course of the third scenario for the use of money described above.

The resources are someone else's. They are spent on someone, who does not correspond to the person who provides them. The methods for tracing their exhaustion are complicated and costly, while ameliorating the situation seems impossible.

On top of that, other details are also present.

Unlike direct investment from private companies and individuals, the resources must be gathered entirely from taxpayers, a decision must be made regarding their allocation, a tender competition has to be organized and a bidder chosen to carry out the job. After all of this, someone has to monitor the company's spending.

It is not difficult to see, that the means, which are subject to transfer to favored countries are 35 to 50 times less than those that the sender's government spends and redistributes at home (depending on the range of government expenditures to GDP).

In the favored country, a candidate or member of the EU, these resources are 10 to 25 times less than those, which the local government redistributes from their taxpayers' means (depending on the range of EU transfers to GDP).

Hence on both sides of the process, the interest in what the government does with taxpayers' resources has a very high opportunity cost: with equal effort (i.e. resources), the results at home would be much better.

Finally, as my colleague Kevin Allen commented in the December 2005 issue of this bulletin³, the European Court of Auditors refuses to sign the financial report for the 12th year in a row because of "significant omissions and inaccuracies." The Commission's excuse is that the omissions happen at the candidate-country level.

In short, the ineffectiveness of European subsidies stems from the fact that someone else's money is being spent on a third person.

Brussels's subsidies for the member states and "aid" for the "Third World"

Is there a difference between them? I think so, but it is insubstantial.

As Peter Bauer says, "Calling official transfers of wealth "aid" confirms an unquestionable attitude. It disarms all criticism, blurs reality and carries through a preliminary evaluation of sorts. Who could be opposed to help offered to the less successful? The term itself allows the supporters of aid to vie for a monopoly on compassion and

to blame the critics for their lack of involvement and empathy."

That which the term "aid" results in, regarding the transfer of resources to countries of the "Third World" in the context of Brussels's subsidies, can be attained with the term "solidarity."

Even renowned historians like Tony Judt find this principle to be an "actual achievement" for the EU. According to them, it has replaced the use of taxes for arms, overcome the Marxist notion of economic predetermination, and ensured the primacy of politics over economics, which is unique in the case of the EU. From an economic point of view this explanation only serves as justification for the ineffectiveness of subsidies and does not necessarily means that mechanism for reduction of political risks is established once and forever. It would logical to expect that it backfires at some point. The question to find an answer to is "when".

Apart from the similar justification, the similarities and insignificant differences between Brussels's subsidies and "Third World" aid are the following:

International transfers of wealth are the matter at hand in both cases,

With subsidies, we see more elements of competition for Brussels's public procurement, but such elements of competition, as well as demands for co-financing (as it is in the context of EU budget transfers) more and more frequently find their way into "Third World" aid,

Incentives for informal coalescence in the exhaustion of the means exist, are created and supported in both cases,

Transaction costs make both types of transfer more ineffective than the transfer of means from private entities to other private entities, whether individuals, families or companies,

In both cases, government consumption increases and the temptation of corruption springs up,

A significant difference is that Brussels's subsidies have never been a cause of war, unlike several cases in Africa where fighting has broken out over aid disputes. In Europe, conflicts are political and are quelled by transfers of influence, the hiring of staff, and concessions regarding public spending. It is very likely that competition for influence, protection and rewards from the "Brussels'" budget is one

³ Kevin P. Allen, Inaction In Action: The Court of Auditors, European Commissioners, and the Problem of Financial Mismanagement, at: http://www.ime.bg.org/pr_en/index.html

of the factors of growing regulatory deadweight and underutilization of economic potential.

The effects of subsidies and aid (analogies)

The above said gives me reason enough to draw some analogies between redistribution within the EU and the empirically studied impact of aid to the “Third World”.

As mentioned, the most detailed of these studies was conducted by Simeon Djankov, José Montalvo, and Marta Reynal-Querol, with results published last year and at the beginning of this year. In summary, the study comes to the following conclusions:

Contrary to expectations, aid does not necessary affect domestic growth positively. It often harms the allocation of resources to the most profitable initiatives and mobilizes administrative and budget resources, which would have better alternative use or is lost due to administrative or auditing ineffectiveness. Reports of the European Court of Auditors unequivocally prove that this ineffectiveness occurs with European redistribution as well. On theoretical (but not empirical) grounds, one can presume that on account of transfer costs and ineffectiveness the abstractly possible positive impact of EU subsidies is highly doubtful.

When it comes to aid, the increase in government consumption, spending, and opaqueness deters foreign investment and has a larger number of negative consequences than loans or foreign debt. In the case of Brussels’s

subsidies, these investments are hardly hindered, but a limiting effect is probable – due to the temporizing of a sponsored resource, lobbying costs, etc.

Aid undermines the nascent democracy in the “Third World” by augmenting the clientelism, opaqueness, and voters’ despair in the region. Ultimately, “payment on account of the need for political stability” yields the opposite result. The main reason lies in the creation of incentives for “privatization” of aid and the structures, which redistribute it following the logic described by Olsen. As far as European subsidies are concerned, various symptoms indicate that something similar is happening. But the size, as was mentioned earlier, is relatively small and the effects are thus less visible. Nonetheless, the referendums in the Netherlands and France brought about instability unknown 10 years ago and motivated a search for undemocratic ways out from the situation.

Finally Djankov and his colleagues come to the conclusion that it is difficult to make aid effective, that conditional grants do not work, because there is no mechanism in place for the punishment of bad, inadequate or even harmful use of resources.

According to economic theory, this is almost certainly the case with European subsidies, too. Until now, no one has empirically examined the process in an objective manner. In order to do so, someone may ask for a subsidy from Brussels.

GDP in First Quarter of 2006

Dimitar Chobanov

Preliminary data for the gross domestic product (GDP) in the first quarter of 2006 have been recently released. The real GDP growth rate for the period has been 5.6 per cent while the real gross value added (GVA) has increased by 6.4 per cent. Thus the trend for annual economic growth close to 5% that started since the first quarter of 2004 continues.

The key factors for this positive development are the following. One of most important is the established and well-functioning currency board. It determines the relative stability of the

Bulgarian Lev from an internal (in terms of goods’ and services’ prices in the local economy) and external aspect (in terms of other currencies). The ability of planning revenues and expenditures at firm level is increased as the total uncertainty in the economy is reduced, thus leading to better business environment.

The next factor contributing to the maintenance of sustainable economic growth is free trade. It is well known that free exchange is a result of the mutual interest of two (or more) sides participating in it. Hence the value each participant places on the thing he or she receives is higher than the value of whatever he or she gives in exchange. Therefore both sides win and

are better off when they are allowed to trade freely.

This is valid for exchange on the internal as well as the external market. The process of removing the obstacles to trade (reducing custom duties and other restrictions) related to the European Union integration of Bulgaria and market liberalization in the country have led to greater freedom for individuals, easier access to deeper markets, expanding opportunities to choose where to buy or sell specific good or service.

Directly linked to the EU accession and the normal functioning of the currency board is capital liberalization. It provides investors with the chance to allocate their capitals efficiently, to diversify their portfolios according to their willingness to take risks and, ultimately, to generate a profit from their investment.

While there has been an improvement in these factors in the last years, the conditions are not so great in terms of property rights protection and rule of law. Although some measures have been taken, reforms are protracted and the judicial system is not effective, which is a significant obstacle to acceleration of growth rates. An incentive for the local as well as the foreign investors is to receive and use the fruits of their efforts, which is not sufficiently guaranteed by the valid legislation and government institutions having to enforce it.

The next factor suppressing faster development in the country is the high level of taxation. Amendments in tax laws during the last years have resulted in change in the structure of revenues in a consolidated budget; the share of direct taxes has declined on the account of indirect ones. But redistribution of the generated income in the economy through the budget has even increased to a level of around 43%, meaning that the government takes large portion of individuals' incomes in one way or another. Creating incentives for labor and entrepreneurship by letting persons decide how to use their money is the way to achieve faster economic growth.

Moreover, the tendency since 2004 is for keeping a large budget surplus, which means that more money is taken from the taxpayers than is needed to finance the excessive consolidated government expenditures that are ineffective. This money (of course, not the whole amount) could be used for investment, which would, in turn, contribute to the acceleration of income growth. This alternative

is missed when posing the argument that a current account deficit should be offset by government saving.

What are the effects of those factors? The positive development of GVA is due to industry (real growth rate of 8.8 per cent) and services (6 per cent), while agriculture has contracted by 2.7 per cent. Basically, the share of agriculture has declined on account of the other sectors, but the seasonal character of agriculture should be taken into consideration. Still, in the next quarters a positive growth could be expected in this sector keeping in mind the low base from 2005 caused by the floods.

Concerning the issue about the engine of economic growth in Bulgaria, it is clearly the private sector. The GVA in it has increased by 8.8 per cent while in the public sector it has fallen by 4.2 per cent. This result for the public sector is indicative, and the negative development during the period could not be attributed to privatization because it has been virtually stopped. So, the efficiency of this sector continues to be low considering ever growing costs.

Final consumption has realized a real growth rate of 4.8 per cent because of growth in individual consumption by 5.4 per as well of collective consumption by 0.1 per cent. Implementing policies aimed at limiting the increase of collective consumption consisting of state administration, defense, scientific research and maintenance cost for the settlements is positive because of low (or zero) effectiveness and lack of reforms thus reducing the chance for any improvement.

The share of consumption in GDP calculated on annual basis has reached 88.9 per cent, which is the highest value for this indicator according to available data. Following that, as well as lower net transfers and income from abroad, gross saving has decreased in nominal and real terms. Its amount on an annual basis is around EUR 3.5 billion and its share in GDP is 15.9 per cent while the value of same indicators for the first quarter of 2005 is EUR 3.67 billion and 18.4 per cent of GDP respectively. It could be attributed to growing propensity of Bulgarians to present rather than future consumption because of easier access to credit.

Investment measured by gross fixed capital formation has grown by 21.4 per cent in real terms, thus keeping the tendency for accelerating this rate in the last two years. The share of

investment has reached 24.5 per cent of GDP on an annual basis that is the highest value of this indicator, and it is a prerequisite for future real income growth. As domestic saving has decreased, a larger share of investment is financed from abroad. The ratio between domestic saving and gross fixed capital formation on annual basis has continued to fall, reaching 65.1 per cent while it was 91.1 per cent in the last quarter of 2004.

As a result of growing import of saving, the current account deficit has widened. Import growth has exceeded that of exports in nominal and real terms. Along with this, the ratio between those components and GDP has also grown as well as the openness of the economy*.

GDP data show positive economic development but the crucial fact is that the government's

policy does not support it. The lack or protraction of reforms lead to keeping growth rates close to current values but not to their acceleration. However, such delays mean missed opportunities in the future in terms of lower incomes and welfare. Apart from this, reforms would be beneficial for the government itself because of the EU requirements that have not been fulfilled yet. Expanding the economic liberty, lower taxes and well functioning judicial system should be the key aspects of government's policies.

* This indicator is calculated as a ratio between the sum of export and import to GDP.

The Magic Formula for Wages

Adriana Mladenova

Social policy minister Mrs. Maslarova is obviously determined to oppose market logic despite appeals from both the IMF and EU for the liberalization of wages and the abolishment of minimal seniority bonuses in Bulgaria. Last month, she proposed a new formula, which aims to link the nominal growth rate of the salaries to certain indicators. This formula would be a compromise solution after the abolishment of the compulsory seniority bonuses and was proposed before the National Council of Three-party Cooperation.

The formula states the following: the basic salary accounts for about 70% to 80% of the remuneration, compensation for hard conditions of labor - between 5% and 20%, and up to 10% of the wage comes from seniority and experience bonuses.

The negative effects of the formalization of the wages have two-sided. On the one hand, the majority of voters are discontented with the proposition, because they believe that the indicators are not reasonable and fair enough and do not match their subjective notions about the price of their labor. On the other hand, such a reform will have a negative effect on the business environment although it will not be mandatory, only recommended for the private

sector. The establishment of rules for the formation of labor costs contradicts the ideas of market economy and established practices even in the European Union, where the labor market is characterized by its over-regulation in comparison to the USA. Such a formula does not encourage workers and employers to negotiate the optimal rate of remuneration rather than relying on government rules. The wage rate should depend on the nature of the work, the abilities and characteristics of the employees. The proposed parameters of the formula are not fair to many people because they perceive themselves as "doomed" to get paid according to the ideas of the government, which may not necessarily match their own ideas. But the fact, itself, that there is such a formula leads to a culture of dependency and makes employees willing to ask the government to protect them against the unjust rate of wages.

Economic justification of the proposition

When a mechanism for government intervention in the market is proposed, an impact analysis should be made for the benefits and costs of it for the general public. So, the question comes – how are the parameters of this formula derived? Why exactly 10% for seniority bonuses, for example? This case is impossible to justify, because there is no sense in trying to determine wage rates on a national level. Modern forms of

work payments in developed countries depend on many criteria such as efficiency, education, experience, and skills, and include various types of compensation, such as employee options and shares of the corporation, result-orientated payment, retirement and healthcare benefits, etc. But unlike the government, company managers are able to evaluate the effects of such strategies depending on the characteristics of their business and the aims they pursue. In short, what is really fair is for everybody to be able to receive what he or she earns and to have the opportunity to climb up the hierarchy ladder based not only on years of experience and formal position characteristics, but also on qualifications and results.

There is no magic formula in the sphere of labor policy and Minister Maslarova should not even try to invent it just in order to receive the approval of a part of the voters. On the contrary, it is necessary to defend and promote publicly the idea that the salaries should be liberalized, should be relieved from all relics of planning, and should be left to the free market and to the negotiation mechanisms between employers and employees. The ruling bodies can assist this process by optimizing the expenditures of the government administration, but not by undertaking activities such as inventing formulae where market processes rule and decrease the ineffective government costs and taxes. This optimization is the fastest, most

efficient and established way to increase the revenues of the population. The same stands for labor unions – they should try to help, not hinder the life of the people whom they claim to represent.

Control over wage rates is to some extent necessary for government-owned enterprises, but this is only one sign of the problems that exist in the management and functioning of state-owned companies. They are characterized by soft budget constraints, inefficient production and management, and financial instability. The problems will be solved only when companies are privatized and enter the competitive environment of private business.

Even if the proposed ordinance is accepted, the formula will not dominate in the private sector and entrepreneurs will find ways to evade it, because market powers are stronger than the attempts at artificial restrictions, which are rather irrational and inefficient. But the public debate on such issues implies ideas that are adverse for the establishment of market processes. Confidence in the free market and in the private sector is vital for the creation of entrepreneurial attitudes and business culture in the economy. One should know that faith in one's own abilities and qualities, not in the state, is the driver of the innovative spirit and economic prosperity.

Impact of the World Cup on the Bulgarian Economy

Veliko Dimitrov

It is generally impossible to make an absolutely exact statement about the cumulative economic impacts that an event like the World Cup (WC) would have on a certain country's economy. It is much more likely to guess which team out of 32 and by what score would win the final game or who would happen to be the best scorer; all this at least because the number of possible outcomes are far fewer than those in regard to the various impacts that the WC could have on the economy. Nevertheless, applying the instruments and logic of economics could reveal in what direction and to what extent that event is influential over the economy.

In general, the impact consists of the opposite dynamic of two macroeconomic indicators: consumption and labor productivity.

Increase in consumer spending

Events of that scale logically generate positive impulses to consumers: first, through enhanced advertising, which leads to higher awareness and propensity to consume, and second, through the inherent higher consumption of certain goods for the time a game is being followed. Of course we should add the increase in consumption of durable goods like flat screen TVs, as well as for symbol articles closely related to the event. All of this accounts for GDP and income growth and finally boosts the economy. Although this should be considered entirely positive, the increased consumption only takes place just in the short run. In the post-WC period, we may

witness a decrease in spending that could be intense enough even to balance out or exceed the previous rise. On the other hand, the time-restricted upward tendency is mainly due to higher spending for non-investment goods (beer, wine, food), which, on its own, is unable to secure higher production and wealth in future.

Decrease in worker's productivity

A downward tendency in labor's productivity or just absenteeism is the other main effect resulting from the WC and people's affection for it. According to a study of the Centre for Economics and Business Research⁴ during the 2002 World Cup held in Japan and Korea, the EU15 suffered a 8,7 bn euro loss of GDP through absenteeism. Harder to estimate are losses resulting from lower productivity, especially for those professions where payment is not directly connected to output. In Bulgaria, like everywhere else, those employers who generally pay with no or little regard to measurable results are suffering much more. However, incurred losses would have been more significant if all or most of the games were broadcasted during the work day, very early or at night (which by the way is the case in Latin America, Australia or Asia).

Ranked on third place, we might also have to mention the negative impact of the WC on the foreign exchange inflow into Bulgaria in terms of fewer visitors, which would mean comparatively higher trade balance deficit. There is for sure a certain number foreigners who if there were no WC, would have spent their holiday rather in Bulgaria, than in Germany. It is expected that over 1 million tourist would visit the host country and spend there over 700 million euro. On the other hand, the spending of all Bulgarians who had joined the WC live in Germany is equal to import of goods and services, which finally will push up the current account deficit.

If we would like to be more specific and convincing about which WC impact predominates – the positive or the negative – let us take a look at what it is in economies, which are supposed to experience the most intensive impact, i.e. the hosts.

Table 1: Cumulative growth in real gross domestic product host countries (1954 - 2002)

Year	Host country	Pre: - 2 years to WC	World Cup	Post: WC to +2
1954	Switzerland	4,4 %	5,5 %	6,4 %
1958	Sweden	2,6%	2,9 %	4,2 %
1962	Chile	4,8 %	4,7 %	4,3 %
1966	England	2,1 %	2,0 %	3,3 %
1970	Mexico	6,6 %	6,9 %	6,3 %
1974	Germany	2,5 %	0,3 %	1,8 %
1978	Argentina	1,5 %	- 3,2 %	4,2 %
1982	Spain	0,6 %	1,2 %	1,8 %
1986	Mexico	- 0,5 %	- 3,1 %	1,5 %
1990	Italy	2,4 %	2,0 %	2,5 %
1994	USA	3,3 %	4,0 %	3,1 %
1998	France	2,2 %	1,9 %	3,1 %
2002	Korea / Japan	2,8 %	3,6 %	3,2 %
Mean		2,7 %	2,2 %	3,5 %

Source: John Irons, [Center for American Progress](#)

As shown in the table (average score), a higher GDP growth rate is registered before and after the WC itself. In the short period before the WC takes place, this is to be interpreted with intensive construction or modernization of stadiums, hotels and transport infrastructure; in the post period, induced effects prevail. For instance, in Germany over 6,2 bn. euro has been invested in relation to the upcoming event.

On average, despite the huge tourist flow and the surge in consumer spending, the WC year registers the lowest GDP growth rate. This is of course to a not inconsiderable degree, due to the lower worker's productivity. Thus, we have to conclude that for host countries the decreased output as a result of lower labor productivity (or mere unwillingness to work) goes beyond the generally positive impact called forth by the increased domestic spending.

In this connection, we have to conclude the following for the Bulgarian economy: there is certainly a downward tendency in labor productivity and an increase in consumer spending as well. All other positive impacts, which are intrinsic for all host countries, however, are not on the table for Bulgaria. After it has been clarified that the negative impact of decreased labor productivity in host countries is more significant than the cumulative effect of all other factors, we can with a very high grade of confidence hold the point that the net effect of the WC for the Bulgarian economy is negative.

⁴ <http://www.cebr.com/>

**Money on the Bulgarian Property Market
(2000 – 2005)**

Svetla Kostadinova

Information about the money invested in the Bulgarian property market is very difficult to consolidate and assess. Nevertheless, we think that it is worth trying to estimate the flows in the market since it concentrates huge interest and funds.

Money on the market

The Institute for Market Economics tried to make estimations for the period 2000 – 2005 of total investments in real estate in the country.

Local investments in real estate

According to data from the central bank and IME assumptions, the total funds invested in property and financed by bank credits and savings are more than 8 billion euro for 2000 – 2005.

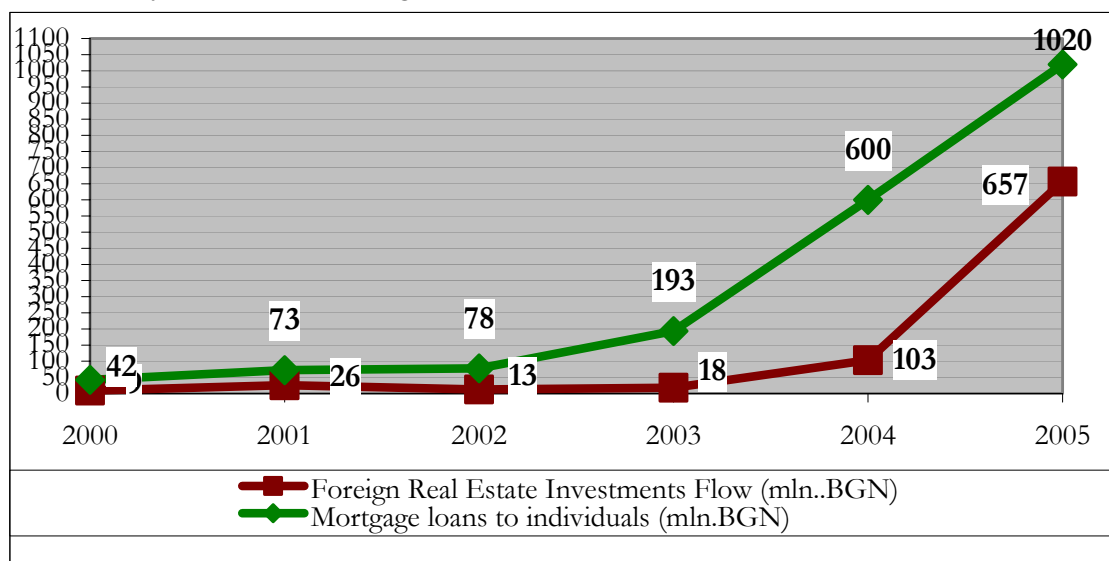
	2000	2001	2002	2003	2004	2005
Banks' loans share in real estate transactions	2%	2%	5%	10%	15%	40%
Housing mortgage loans volume (mln. BGN)	42	73	78	193	600	1 020
Total funds invested in property (mln. BGN)	2 100	3 650	1 560	1 930	4 000	2 550
Total funds invested in property financed by both bank loans and savings 2000 – 2005 (mln. BGN)	15 790					

Source: Authors' calculations based on data from Bulgarian National Bank, IME surveys of housing credit (2004) and IME survey on property market (2005, 2006). Exchange rate 1 Euro=1.95583 BGN

Net foreign investments in real estate

It is very hard to estimate the FDI in real estate since not all of it is registered (the data available is from notaries that should declare every deal with a foreigner involved; however, part of the declarations understate the transaction price). Therefore, we assume that reported data is underestimated by 30% and, bearing this in

mind, we figure that the FDI in real estate in Bulgaria for 2000 – 2005 is approximately 437 million euro. We should note that about 70% of this investment has been made in the last two years that mark the incredibly high growth of the real estate market.



Source: Authors' calculations based on BNB data; Exchange rate 1 Euro=1.95583 BGN

Real estate investment funds

It is worth trying to estimate the value of investment made by REITs in Bulgaria.

First, we tried to estimate the amount of capital raised abroad for investment in property in Bulgaria. The information is very dispersed and hard to compile. We have looked at the Alternative Investment Market in London to reach some assessment since a large proportion of foreign investment in the country comes from UK. The data shows that more than 870 million euro has been raised for investment in property in Bulgaria. We cannot assess what proportion has already been invested, but the figure tells a lot.

On the other hand, since the adoption of the Special Purpose Investment Companies Law in 2003, twenty such companies have been registered. The total amount of registered capital is more than 60 million euro, and several companies have already been raising their capital for some time. The profile of their investments consists of commercial properties, vacation apartments and agricultural land.

In conclusion, the overall amount of funds invested in property in Bulgaria for the last 5 years is supposed to be of more than 9.4 billion euro.

Brief review of the mortgage market in BulgariaPrimary mortgage market

Mortgage lending was effectively resumed in 2000 and has grown at an accelerating pace ever since. Funding of mortgage loans is based largely on deposits. Although mortgage bonds are being issued, they are not used as a primary funding source by banks, although this is changing and mortgage bond issuances are competing more and more with funding from deposits.

Banks provide mortgage loans for new housing, existing housing, rehabilitation, and for business purposes. Mortgage loans are primarily denominated in the local currency and Euros. Terms, which were previously 5 to 10 years, have recently been extended to up to 25 years. The loans have variable rates, with rates updated at the bank's convenience. LTVs generally range

from 60 to 80 percent although effective LTVs may be lower.

Mortgage interest rates for loans in local currency have fallen from 16 percent in 2001 to 9 percent by May 2006. (As a point of comparison, ten-year Government bonds yielded about 3.3 percent in 2005 and 6.7 percent in 2001).

Overall, mortgage loans are performing fairly well and overdue loans represent 7.4 percent (0.3% in 2002). The increase in non-performing loans is basically a result of the credit expansion in past 3 years.

Due to competition, banks are becoming less conservative in underwriting mortgage loans. Third-party guarantees were once typically required, but in recent years the use of this security has declined.

Secondary mortgage market

Better market conditions and growing competition in the primary mortgage market have led to improved terms for borrowers and a renaissance in mortgage lending. Funding of mortgages is still achieved largely through deposits. The *Mortgage Bonds Act* (2000) helped banks finance their operations. It was the first in the region and is very flexible since it does not require special mortgage banks. The first issue was in 2003 and until the end of 2005, there were more than 20 issues with more than 167 million euro raised, of which 22 million have already been redeemed. The interest rate is falling, reaching 5.25% on average at the moment in comparison to 7.75% in 2001. The average maturity is 3 to 5 years.

The *Special Purpose Investment Companies Law* (2003) allows for securitization of tangible fixed assets and receivables, including future receivables, which are transferable assets. The companies do not pay profit tax and therefore are very attractive to both large and small investors.

The reform of the *Central bank credit register* in 2004 that required all banks to report new or renegotiated loans has increased market transparency and allowed for subprime borrowers to have better access to bank credit.

Players in the mortgage market

There are no specialized mortgage banks in Bulgaria. All commercial banks have mortgage credits in their portfolios but ten of them control 75% of the market. The credit expansion since 2003 has led to several major developments: (1) a reduction of interest rate spread; (2) an

increase in credits' volume, but with a more moderate pace in 2006, and (3) the entry of new non-financial intermediaries that facilitate the process such as credit intermediaries, mortgage brokers, etc.

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