"The effects on accession to EU on the credits in Bulgaria and Romania"[1]

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Abstract: *The paper examines the possible problems arising from the growth of credits in Bulgaria and Romania. This is a common trend for all eastern european countries and could be connected to the EU-membership.*

We find that the prospects of EU-membership and the ameliorating credit ratings as well as the overall prospects for the economy do not allow the credits to threaten the financial systems in both countries.

I. Introduction

The recent upswing of the credits in Eastern Europe, and particularly in Bulgaria and Romania, poses many questions upon the sustainability of the monetary policy and especially of the feasibility of the inflation targeting in Romania and the future of the currency board in Bulgaria.

The bulgarian government [1, p21] expects the credits in Bulgaria to rise by 40% in the following year, despite the measures taken by the Bulgarian national bank (BNB) to reduce the amount of credits.

In Romania, the credits also have risen by near 40% between June 2004 and June 2005.

Given the low inflation in the last years, the rise in the credits could eventually endanger the goals of the monetary policy and possibly threaten the stability of the economy as a whole.

Considering the fact, that after joining the EU the economic growth slows down in the new member countries, there is also a possibility of appearance of social problems too, which could lead even to political instability. This can challenge the requirements for sound fiscal policy and falling

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government debt, which will be necessary for a quick integration in the EU and eventual introduction of the single currency.

Thus to the amount of credits in the economy must be given enough attention.

In conjunction with other aspects of the economy, returning of debt could be encumbered with the development of fiscal policy.

Especially in Romania the government (see Popescu-Tariceanu 2005) commits that the collection of VAT is not properly done and a VAT increase is possible. Under this scenario further problems with the repayment of credits are to be expected.

The fact that according to the ratings of the major rating companies both countries have been taken out of the group of "speculative" countries - Bulgaria in 2004 and Romania in September 2005 contributes to lessen insecurity of the debt repayment.

Until recently the countries have conducted different economic policies - the currency board in Bulgaria has limitated the economic policy since 1997 and in Romania the fiscal policy has been more liberal, with beliefs for more real growth.

The launch of inflation targeting in Romania in August 2005 brings more similarities between both countries, such as possible threats to the macroeconomic policies.

The importance of sound public finances arises, as well as future wage upgrades.

Given the firm commitment of the governments to maintain sound and transparent fiscal policy, the main source of concern remain the credits in the economy.

The upswing of the credits is a common trend in Eastern Europe - both EU-member countries and non-EU countries. Since the bank reform is already made, there is much more prudency in crediting, compared with the years before the bank crises in these countries.

But the possibility of systematic crisis in the banking sector remains, especially by the presence of fiscal limitations.

One positive change is that the banking sector is mainly privately owned. The duty to repay the debts falls to the debtors. It will be impossible to help repay the debts and thus save the banks through the budget.

The major part of new credits is given to households and small businesses, so it is very important the real wages to remain at least to the current levels to maintain the stability of the system.

The aim to introduce the euro, the fiscal constraints and the fixing of the exchange rate gives much optimism towards the future levels of inflation.

So we can design a study using nominal levels of wages instead of the reals.

Even with the possible delay to year 2008 the EU-membership is considered for Bulgaria and Romania as short- to mid-term perspective.

Due to the data available, we conduct different studies to both countries, examining the structure of income in Bulgaria, and the regional structure of credits in Romania.

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II. The credits in Bulgaria

In spite of the reality in more advanced countries, in Bulgaria a significant part of the income is non-monetary.

Usually this income is not linked to formal working activities, so it is plausible that the possible threat for the financial system consists only if instability of monetary income is expected.

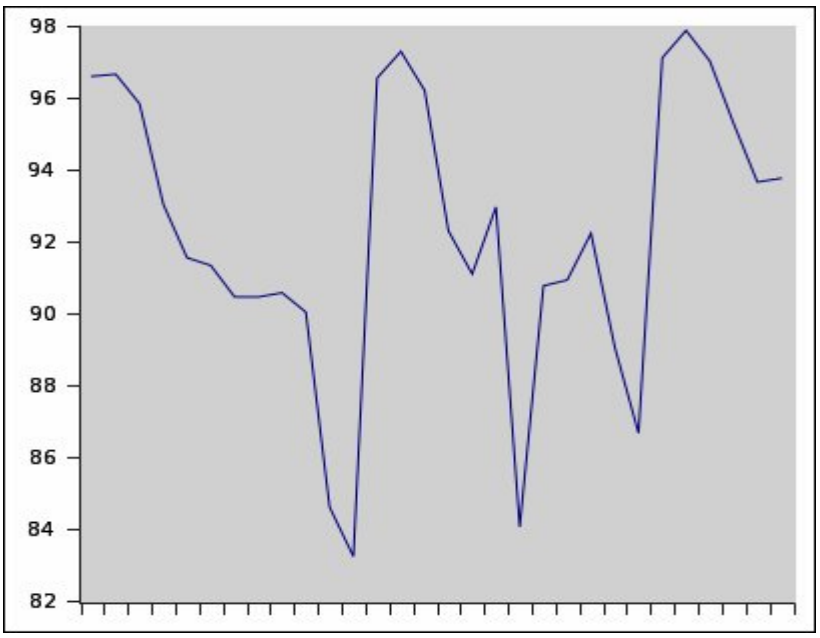


Figure 1 Share of monetary income in total income, in percent, 2003-2005

Data: National Statistical Insitute and own calculations

Significant pattern of the monetary income is the considerable variability over time, consequence of the temporary employment in Bulgaria - especially in agriculture and tourism.

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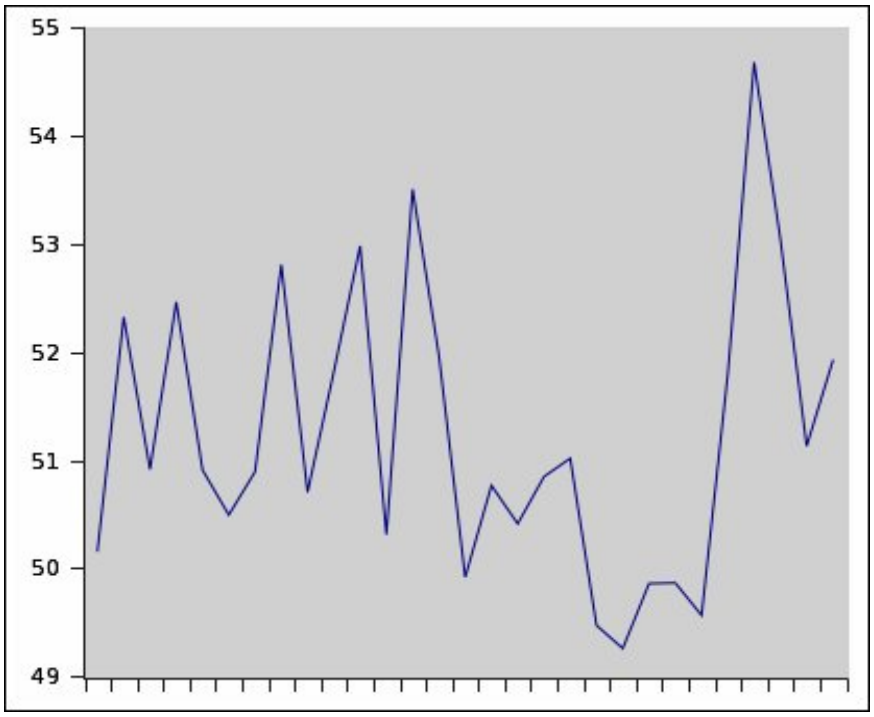


Figure 2 Share of wages in monetary income, in percent, 2003-2005
Data: National Statistical Insitute and own calculations

The wages form about the half of the monetary income in Bulgaria, and are steadily growing - the nominal increase of the wages in 2005 over 2004 is about 9.5% on annual basis. Given the recent trends - growing labour productivity and diminishing unemployment, we can expect the wages to allow the further servicing of debt. The rate of "bad credits" is falling over time, and are under 2% for the year 2005, according to the Bulgarian National Bank.

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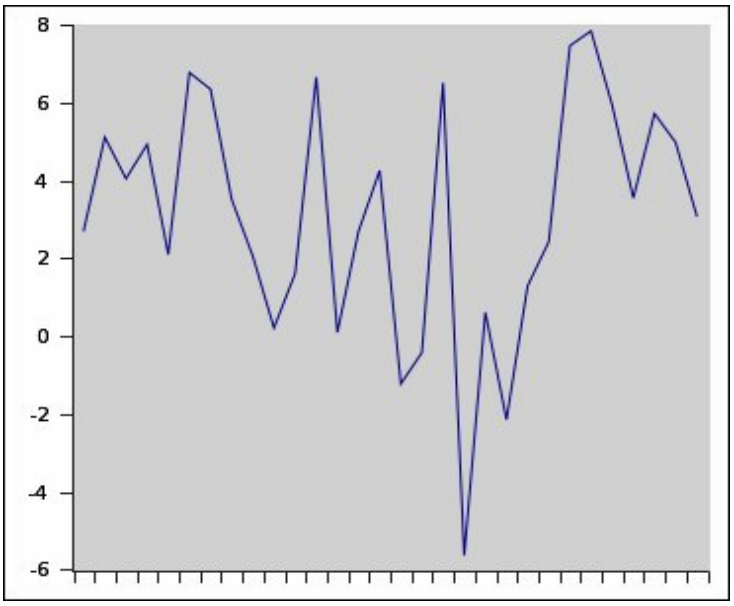


Figure 3 Difference between monetary income and expenses, in percent, 2003-2005
Data: National Statistical Insitute and own calculations

The difference between monetary income and monetary expenses is to be considered as a buffer for coping with unexpected expenditures, particularly repaying debt. It varies significantly over time and is a potential problem. Part of the wages are "invisible", i.e. are part of the "grey economy" hampers the analysis [2].

III. The credits in Romania

In the last years there is a continuous increase of the credits in Romania, as shown in Figure 4.
The commitment of the government, as part of the EU-accession process is to maintain low inflation [3, p49] and restrictive wages policy (ibid, p53). A goal is the wage expenses to continue to grow more than any other expenses [4].
There are major differences among districts, which could lead to problems if the increase of the credits does not corespond with the economic development of the district.

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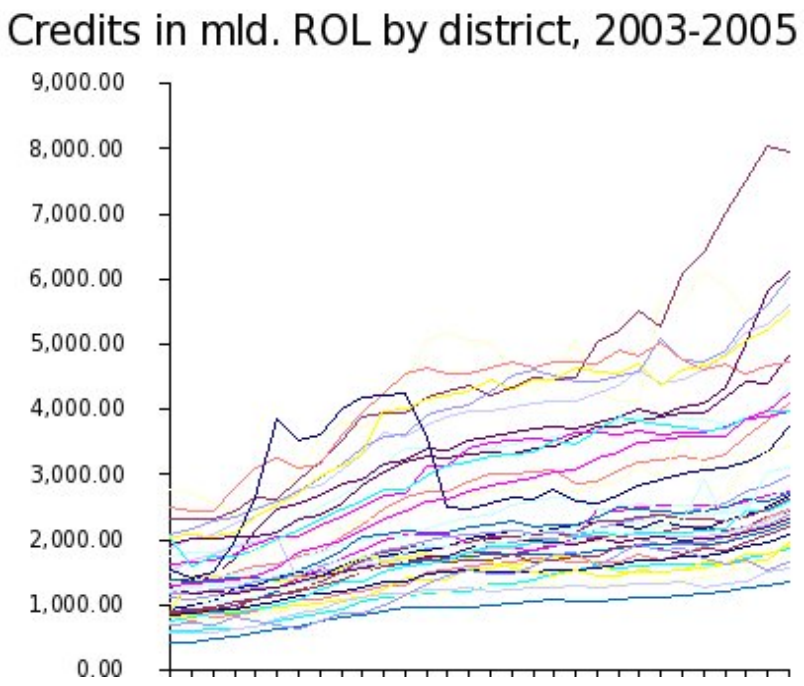


Figure 4 Credits in Romania by district, 2003-2005, with the exception of Bucharest district
Data: BNR and own calculations

We test the link between the amount of overall credits and the mortgage loans, the last considered to reflect the prospects of future growth as well as the debtors future income. Instead of taking the credits in local and foreign currency individually we prefer to take the overall credits, which is supported by the stability of the exchange rate of the leu in the last years, as well as the commitment of the government to maintain low inflation and thus even further exchange rate stability.

The examination of the shares of the district in the overall credits and the mortgage loans shows that the main differences between the shares of both types of credits are in the districts of Cluj, Bucharest and Timis (over 2% difference), which are also considered as the most developed regions of the country.

Therefore, the credits are growing according to the prospects of economic growth in the region and there is no threat to the financial system as a whole. However the situation could change. Most of the credits in Romania are attracted by the district of Bucharest - for the period of January 2003 through June 2005 - 44.91% in average on all credits, and 55.07% on the credits in foreign currency, but this particular district's share diminishes continuously, especially in the credits in foreign currency.

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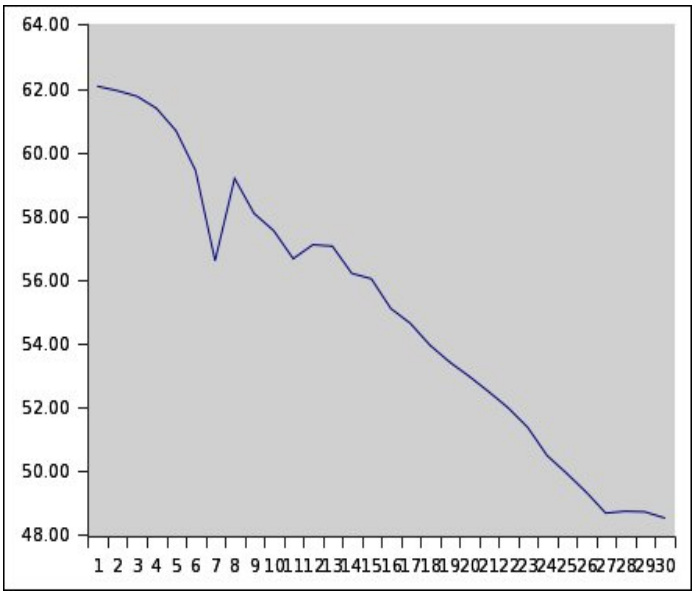


Figure 5 Share of credits in foreign currency to Bucharest region, January 2003 - June 2005
Data: BNR and own calculations

This development could be interpreted as a trend of "spreading the economic growth throughout the country", which leads the question, whether other districts are economically flexible enough to cope with possible negative future developments in the incomes.

IV. Conclusion

Bulgaria and Romania face similar problems, on one hand, the requirements for low inflation and sound public finances, and on the other the strong and permanent growth of credits. Both countries are rated as "non-speculative" by the international rating agencies. This potentially boosts the credits further. In both countries the economic activity and the amount of credits are concentrated in the areas of capital cities. In conjunction with the improving country ratings the growth prospects are rather positive. The recent growth of credits is not to be considered dangerous for the economy, given the current low levels of financial deepening, compared to EU-countries.

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