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ENTERING THE EUROZONE: COMMITMENTS AND CHALLENGES TO BULGARIA IN TERMS OF FINANCIAL CRISIS

Establishing the currency board arrangement (CBA) in Bulgaria played a key role in overcoming the results of the last and pointed as one of the worst financial and economic crisis. This decision still remains a serious factor for Bulgaria in the terms of European Union membership. Related to the act of accessing EU the obligations Bulgaria undertook, are partially provided by the fiscal stabilization, successfully achieved thanks to the currency board arrangements introduced in the state. Price stability, however, further remains an impediment towards economic policy. It is tightly connected with the next main challenge: to overcome the inner obstacles for fulfilling the Convergence Criterion for a proper entering the Euro zone under the conditions of spreading world-wide financial crisis. This article aims to summarize the recent background which led to the nowadays economic development and related to it future advantages and challenges.

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1. Background

In the months and years to come, Bulgaria will face many challenges concerning the latest development of world-wide negative tendencies in the financial sector and similar to those which the rest of the world will. Only the impact on the Bulgarian economy is expected to be different and it could be relatively less affected than the more developed financial markets. For a better view of latest economic challenges, it could be useful to review the recent historical development.

The Bulgarian banking system as a whole operated on one horizontal level until 1989 when its economy faced the challenge to be transformed from a planned one to a market-oriented. Along with the processes of reorganization and privatization in the real sector, banking system went through a general transformation also. It gained the right and obligation to relocate the free capital from the economic subjects holding savings surpluses to those with liquidity deficits.

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Bulgarian National Bank (BNB) obtained the functions of a typical central bank. Most of its territorial divisions were transformed into commercial banks in a joint-stock manner. The boom in these transformation processes came in 1990 when The National Bank gave licenses for banking activity to 61 commercial banks. In these conditions of a new developing market-oriented banking system, the legal framework was of a crucial importance for the proper functioning of the economic system as a whole. For example, as of 1991 Bulgarian National Bank performed as independent authority, but through the State Budget Act it was given a legal option for a governmental pressure in order tied loans to be issued and in this way the independency of the National Bank seemed to be just formal. This happened to be one of the options for the system to gain bad loans.

On the other hand, in the period 1990-1996, most of the small and medium-sized commercial banks were consolidated. The biggest part of the sector remained public until the end of 1997. In commercial banks' portfolios liabilities were accrued because of financing public debt and public enterprises not yet privatized and in pecuniary difficulties.

In the sphere of the private part of commercial banks a boom was recorded in the period 1991-1993 because of the liberal license conditions. Firstly, a legal chance was given for starting a private commercial bank with loaned capital from the public ones. According to the law in force, there were no obstacles for a bank to issue loans to its owners and related to them persons. And in case of liquidity difficulties, the bank itself could have been refinanced by the National bank. This, on the other hand was a channel for relocation of capitals and another precondition for the later crisis development. Of course, most of those legal flaws were instigated by the general transformational processes and the lack of experience related to acting in liberal market environment.

Another segment of the banking system was the foreign commercial banks' branches in Bulgaria. Although their share was varying but not exceeding 18 percentages in the period before 1997 and their contribution to the negative situation development was of no consequence.

All the above reviewed conditions and processes in the banking system led to serious difficulties related to the sector and increasing negative balances in the most banks' portfolios. Most of the banks faced liquidity problems and by the beginning of 1996 they became unable to assure their depositors with money on demand after the governmental decision referring to the National Bank that had to stop pouring refinancing flows in them. In the spring of 1996, 14 commercial banks, holding around a quarter of all the assets on the banking market, lost their licenses. The trust in the financial institutions in the state rapidly decreased. Besides, these negative tendencies became obvious yet in the beginning of 1996 and developed till the end of the same year when the economy faced serious instability ahead with privatization obstacles and hyper inflation affecting the financial stability which transferred to the real sector as well.

The evolvement of crisis led to the necessity of quick and reasonable measures to be taken. The government admitted its incapacity to deal with thus developed situation by inner means. The financial stability could only be retrieved by implementing the rules of a Currency board arrangement. Along with the economic, there were certain political preconditions and will for gathering around decision of following the International Monetary Fund (IMF) recommendations.

As a result of the negative tendencies and processes a caretaker government was the one to take the new policy course of financial and fiscal discipline. It was 10th of June 1997 when the 38th Parliament passed the new Law for the Bulgarian National Bank, establishing the Currency Board arrangements in the state in a more flexible framework than the typical (orthodox) model of Currency board as general.

2. Before and after establishing Currency Board

For a clearer vision of the results of Currency Board arrangements in Bulgaria a table is given below containing basic macroeconomic indexes for a seven-year period before and after the year of establishing its rules. As it can be seen, the inflation had reached enormous rates (average values for the period), which respectively affected the economy as a whole and all the other relative macroeconomic indexes. For the both compared periods before and after adopting the rules of Currency board the positive influence is more than obvious. The most visible difference could be sought in the inflation rates, which decreased from three-figured to single-figured numbers. In the early 1997 the national currency lost positions against the United States Dollar, and for a little more than a year (end of 1995-beginning of 1997) Bulgarian Lev was undervalued against US Dollar more than 25 times. This on the other hand contributed to the sensitive decrease of import and export flows in and out of the state. Such dramatic future fluctuations had been prevented by fixing the national currency of Bulgaria to a reserve one. The growth of investments in the state on the other hand increased from negative basis to almost three times higher and positive amount. The budget deficit was decreased from more than 6 percentage points of GDP to almost balanced (zero) revenues. Along with that, the GDP growth increased from minus 4.6 percentage points to the plus 4.55 percentage points. Another significant index is the growth of broad money, which decrease was of about 80 percentages for the compared periods.

Indicators	Period 1990-1997	Period 1998-2005
Inflation (%)	210.1	7.27
GDP growth (%)	-4.6	4.55
Investments growth (%)	-8.8	20.1
Budget Deficit (% of GDP)	-6.3	-0.1
Average growth of Broad Money M3 (%)	103.7	20.0

Sources: National Statistic Institute, Bulgarian National Bank, Ministry of Finances of Bulgaria, own calculations

The table above and comparing the data before and after establishing the rules of Currency board in Bulgaria clearly shows this was the right line to be followed. The achieved stabilization played a key role during the years to follow and on Bulgaria's way to accessing the European Union.

3. Bulgaria in the European Union and the Eurozone perspectives

From 1st of July 1997 on, the Bulgarian Lev was first fixed to the German mark, later substituted with the Euro currency in exchange rate of 1.95583 for one Bulgarian Lev. This measure came to show the pro-European course Bulgaria had undertaken and which has been followed until today. This step was very important for the stability of the exchange rate since Bulgaria is a small open economy.

As a result of many years of preparation for the accession, at the beginning of 2007 Bulgaria became a full-fledged member of the European Union. The Bulgarian Lev remained fixed to the Euro and this clearly showed once again the course of passive following the monetary policy of the Union, since in the conditions of Currency Board arrangements Bulgaria does not apply an autonomous monetary policy.

Along with the accession to the EU, Bulgaria undertook the obligation to adopt European Union's common currency. For this purpose it is necessary the Convergence (as known as Maastricht) criteria to be fulfilled. They can be divided in few major groups observed in more details in the next few paragraphs.

The most stable criteria fulfilled by now concerns sound **government finance**. The statistics clearly show the position followed by the government in the field. As it can be seen in National Statistical Institute official data, since the accession of Bulgaria in the European Union, the percentage of **government and government guaranteed debt** to GDP is far below the values of reference defined by the Convergence Criterion, namely 60 at most. The revenue of Bulgarian government debt to GDP in 2007 is 19.8 percentages and 15.9 percentages for the third quarter in 2008 according to the statistics.

The other item related to the sound government finances according to the Stability and Growth Pact concerns the **annual government deficit to GDP**, which should not exceed 3 percentages. In the recent years Bulgaria follows stable tendency of reaching surpluses. Namely – 3 percentages in 2006, 0.1 percent in 2007 and the targeted for 2008 3 percentages and very likely to be reached and even exceeded. Both these indexes are measuring the stability and buffers Bulgaria has and the policy of stable and transparent financial policy followed after The Currency Board's arrangements. This stability could play a key role for the months and years to come under the financial crisis influence. And, of course, these tendencies could contribute to a quicker and smoother entrance and convergence in ERM II and respectively the Euro zone.

Concerning the **exchange rate** as a precondition of a proper entering the Euro zone, according to the Treaty for accessing EU, Bulgaria had signed, the state should have been in the Exchange Rate Mechanism (ERM) II for at least two consecutive years

without devaluating its national currency against any other member-state's currency. This can be taken as a test for the national currency's stability. This, on the other hand is necessary for the national currency in case it should be a part of a stable supranational one. In the Bulgarian case, however, this stability has already been proved by the followed principles of Currency board for more than ten years, which do not allow any fluctuations in the exchange rate.

In the sphere of **Long-Term interesting rates**, as second main condition for entering the Euro zone, stable revenues of this index are recorded. According to the Maastricht Criterion it should not reach more than 2 percentage points higher than this in the three lowest inflation member states for the year, preceding evaluation.

According to the Bulgarian National Bank's data, for November and December 2008 this indicator is respectively 6.0 and 7.76 percentages, following an increasing tendency. According to Eurostat's data the three lowest inflation states in European Union for the same period are Luxemburg, Portugal and Germany. The average of their revenues is 4.08 and 3.74 percentage points and adding to them two more percentages the calculated result is 6.08 and 5.74 percentages. If this trend remains, another gap will be opened and Bulgaria will have to catch up the convergence level necessary.

The third requirement is one of the most debated one since its fluctuations are publicly very tangible, namely **inflation rate** measured with Harmonized Index of Consumer prices. The lowest rates of Harmonized Index of Consumer Prices in EU are reached in Luxemburg, Portugal and Germany. The average value, measured as reference is 0.86 percentage points for November and December 2008 which shows dramatic decrease from 3.2 percentages in August 2008. Bulgaria's data for the same months, according to the National Statistical Institute is also sensitively decreasing in the last months of the year but still much higher respectively 8.8 and 7.2 percentages for the same periods.

This criterion remains not yet fully reached and is pointed as most problematical. In the dynamics of developing financial crisis, this index is fluctuating sensitively. In the next months, the forecasts are related to its decrease. Still the issue of replacing higher inflation rates with lower GDP growth remains. According to the IMF forecasts this indicator will decrease from 6.3 percentages in 2008 to 4.2 percentage points in 2009. This relatively low growth would be followed by a decrease in the trade balance deficit and current account of the state. On the other hand, the recent tendencies of lowered credit activity on bank's part comparing to the last year will regularly lead to a shrinking in the domestic demand (especially in the demand of luxury goods and investments). All other things being equal, the above mentioned shrinking would decrease the inflation rates in a long term.

These effects, on the other hand, will impact the labor market as in particular sectors the unemployment will undoubtedly increase. In this scenario, rates of inflation would probably decrease, along with higher levels of unemployment and lower rates of GDP growth. However, the tendencies, mentioned will not be seen only in Bulgaria. In the case of comparing values with the three lowest inflation rate

states in EU it remains an open issue how should the development of financial difficulties affect the European union as a whole and where should these effects be seen most obviously.

4. Advantages and challenges related to the Eurozone accession

The expected advantages for accession of Bulgaria to the Euro zone could be put in the hypothetical framework. At first place to be mentioned is the stability and awareness of the public in relation of the main course of the policy followed. In that defined framework the households and business could plan activities strategically. Especially what concerns the dynamic force in the face of business and entrepreneurs whose loans in their larger extend are in Euro currency.

The transaction cost in the trading activities could be saved if the sole currency replaces the national. But, on the other hand, this could lead to speculative rounding off the prices as a whole and thus to an increasing in the inflation rates. Taking both these effects, the total result could be doubtful and depends on which effect would prevail. On the other hand, the negative trend of higher prices and inflation based on the currency changeover may be eased if following the example of Slovenia as one of the states lately introduced the Euro currency in 2007, followed by Cyprus, Malta in 2008 and reaching the number of 16 as of 1 January 2009 by Slovak joining the Euro zone. Measures such as dual price display in the ERM II period for few months (in the case of Slovenia – more than four months or 16 days as in the so-called “big-bang” scenario Slovakia will perform) could be used for more transparency and minimizing the speculative rounding off. This measure gave Slovenia a result of only 0.3 percentages euro inflation for the year following the currency changeover.

The last years’ trend of GDP growth based on extend flow of foreign direct investments mostly involved in the construction market was provoked by the fact that Bulgaria was a trustworthy destination of good perspectives for economic development. Along with this the low currency risk and stability of Currency board turned Bulgaria into a promising field for investing free capital. On the other hand, in the circumstances of decreasing of foreign direct investments and more carefully choosing of their destinations, this low currency risk could play a key role for softening the negative effects. According to data provided by Bulgarian trade banks’ dealers, the estimation of the currency risk is 12-14 percentages.

The more comfortably comparable prices of goods and services in Bulgaria as part of European Union market are serious advantage for the business and households. Along with saving transaction costs this factor could improve the business climate significantly. Moreover, the latest sociological researches show that states such as Denmark where a new referendum is under consideration because the financial crisis clearly showed Denmark pays high economic and political price for staying out of euro zone and for this reason should join it. Similar position is shared also by Sweden and even Iceland after losing national currency positions. In this relation, it becomes more obvious that the Euro zone is a stability factor in times of world wide financial instability.

Positive influence could be mentioned also on a governmental level. Transferring the national monetary policy on a supranational level gives an opportunity for more flexible fiscal policy. Of course in the spirit of Currency board arrangements, the monetary tools are reduced to minimum, but though not missing as a whole. And the fiscal policy of discipline and straight budget buffers is one of the advantages that could play a key role in preventing much of the negative influences other states would examine in the context of crisis development.

The most serious arguments against adopting sole currency are BNB and the government losing incomes from seigniorage. Latest public discussions were provoked by the issue of one-sided euroisation and replacing the national currency with the common Euro. The given arguments for and against this step in times of financial instability should be carefully considered since it has the character of breaking the Treaty for accessing the European Union and the resulting from this consequences for the state. In this regard, tense relations later could be of a crucial significance for the state. However, these political decisions have to be taken carefully with as wider as possible observation in a long term. In the circumstances of indefiniteness, originated from the latest financial crisis' development, many of the risks have to be minimized.

5. Readiness for joining the Eurozone

The official position, the Bulgarian government and the monetary institution in charge – The Bulgarian National Bank, have taken is to adopt the Euro currency and enter the Euro zone in the shortest term after accessing European Union. This was targeted by joining the ERM II as quick as possible after the date of accession and preserving the currency board arrangements with the current exchange rate. This position was clearly underlined by the Bulgarian institutions even before the 1 January 2007. The ambitions of the Government in adopting the Euro currency were to stay in ERM II for the minimum period required and to replace the national currency by 2009 or latest 2010. Even the goal of two year period in ERM II seems hard to be achieved both in view of the current situation of the possibility to fulfill the inflation criterion by Bulgaria, and the financial and macroeconomic crisis in the Euro zone.

The Maastricht Criteria, related to the inflation rates in Bulgaria as mentioned in the paragraph above remains the criterion most distant from the convergent revenues. This is one of the main reasons, pointed by the President of European Central Bank (ECB), Jean-Claude Trichet, underlining that the price stability is one of the main direct benefits, achieved by establishing the Euro Currency ten years ago. Connecting this official ECB position with the necessity for Bulgaria it must be pointed out that lowering inflation rates by disciplined fiscal policy and long-term structural measures were accomplished by Bulgaria far before its EU accession. But currently, it comes clear that the Convergence Criterion will be more strictly applied for the new Euro zone members, in order for the achievements in the area to be preserved stable. Thus it would be even harder for the Central and Eastern European countries to join the Euro area. As a proof of this statement the Lithuanian and

Estonian positions to remain out the Euro zone because of inflation rates could be taken also under consideration. .

The regular Convergence Report on Euro readiness, adopted by the European Commission in May 2008 (in which Bulgaria was examined for first time) high rates of inflation, measured with HICP were pointed as a serious gap to be filled. These high inflation tendencies, on the other hand are partially result of the sought convergence in the emerging economies of the new member-states like Bulgaria after 2007. The wages and incomes are rising, which naturally provokes higher rates of demand and of course inflation. In this regard, the issue on how adequate Maastricht Criterion is becomes quite disputable. The regular Convergence report clearly shows the positions of ECB and EC both on economic indexes and legal convergence of the states with derogation which in 2008 points that Bulgarian law also does not comply with all the requirements for Central bank independence and legal integration into the Eurosystem

This position of ECB and EC, within a world spreading financial crisis, could be expected to be even more conservative and cautious accompanied by not accepting more members of the Euro zone for a certain period of time. And the institutional ambitions and inflation challenges in front of Bulgaria still remain. The more likely and realistic horizon for introducing the Euro currency for Bulgaria for now remains the year after 2011-2012 if Bulgaria manage to overcome the financial crisis showing stability.

6. Instead of conclusion

In short term, the following months and probably year Bulgarian economy will have to face the effects of global financial crisis. The fiscal stability in terms of financial instability will play a key role in the economic development of the state. According to the forecasts of respectable institutions such as Bulgarian National Bank and the Agency for Economic Analysis and Forecasting the macroeconomic indexes in the following periods will be sensitively worsened because of the financial crisis' impact. Proof of this is the implemented forecasts in the National 2009 Budget Act where publicly discussed and serious buffer amount was stipulated in both optimistic and pessimistic scenarios on the crisis' future development.

Two years after Bulgaria became a full-fledged member of European Union, the debates of accessing the ERM II still remains. In the optimistic scenario of 2007, Bulgaria could have been part of the Euro zone by the beginning of next year and under the circumstances of global financial crises to be able to ease part of the external shocks expected. But, two years later, even a green light for entering ERM II is not disputable in ECB or ECOFIN. This regularly brings up new discussions about one-sided introduction of Euro currency. The above assessing of pluses and minuses following such one-sided decision to be taken shows that from the present point of view the negative political and economic consequences would sensitively exceed the positive ones. And the more reasonable option remains working on the inner obstacles Bulgaria is still facing on its way to converging with the rest EU member states.

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