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BULGARIA ON HER WAY TO THE EUROZONE – CURRENT STATUS, POSITIVE AND NEGATIVE IMPACTS

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BULGARIA ON HER WAY TO THE EUROZONE – CURRENT STATUS, POSITIVE AND NEGATIVE IMPACTS

One of the very substantial things with a serious financial and economic impact that has been planned to happen in 2019 is the Bulgaria to join t the so called Exchange Rate Mechanism (ERM2) as well as the European Banking Union as a precondition of the entrance of country in the Eurozone.

The ERM II is the European Central Bank's exchange rate mechanism, sometimes referred to as the "waiting room" for the Euro. Bulgaria's government approved on July 18 2018 the formal application for close co-operation with the European central bank (ECB), the first step towards joining the ERM II. The agreement on ERM II preparation includes several additional commitments, which will help support financial sector supervision, improve SOE governance, and strengthen the anti-money laundering (AML) framework. Completing these commitments and joining ERM II and the banking union would further underpin the credibility of policies, in addition to many benefits that the EU membership has brought.

The "Eurozone waiting room" is a jargon that appeared about 20 years ago. The idea is that when countries did not have a very fixed exchange rate between themselves before entering the euro, they had a minimum of 2 years of preparatory period in which the exchange rates were expected, the interest rates to get closer. If everything is normal at the end of the 2-year period, they can enter the Eurozone. In the case of Bulgaria there is no such problem for Bulgaria because we have a successful currency board for 22 years now, where we have a fixed exchange rate so according to many of the experts Bulgaria is ready for the Eurozone. But is that enough?

Bulgaria is a member of the European Union (EU) since 2007 but has not yet joined the Eurozone. Bulgaria's official intentions to secure the necessary foreign policy support for entry into the Eurozone were announced in 2007 as it joined the EU. Since that the political and economic environment in the world and the EU has changed completely. The attitude of the experts towards Bulgarian inclusion in the Eurozone is contradictory since they reveal not only positive but also negative effects on the Bulgarian economy.

Since 2007 in the face of systemic problems stemming from the legacy of the old socialist regime, Bulgaria's economy and banking sector have been crippled by widespread corruption and cronyism.

Bulgaria has, however, worked hard to lower rates of inflation and debt, as well as meeting other criteria for joining the Eurozone. What lays ahead for the Bulgarian government is a round of stress tests for its financial system that will be performed by the European Central Bank. The results are expected in July 2019 and will play an important part in determining whether or not Bulgaria is able to take steps that bring it closer to officially joining the Eurozone. The earliest and most optimistic estimates have mentioned 2022 as a likely target date for Bulgaria to become a part of the common currency.

The Eurozone is called the group of Member States of the European Union that have adopted the euro as their official currency. It was established in 1999. At present, Eurozone member countries are Austria, Belgium, Germany, Greece, Estonia, Ireland, Spain, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, Finland, France. In addition to a common currency, the euro area countries also have a single monetary policy conducted by the European Central Bank.

While speaking at an annual business conference on January 29, Bulgaria's Prime Minister Boyko Borisov reaffirmed Bulgarian intent to enter the Eurozone by July 2022.

Integration into the Eurozone topped the agenda at many economic forums this year where Borisov and other government officials discussed the benefits that the country would experience if it moves into the European Union's Exchange Rate Mechanism, namely, that the Bulgarians would enjoy further financial security with the oversight of the European Central Bank as well as increased investment.

This is the most recent move by the Bulgarian government as it moves to solidify its position as a member of the European Union, while at the same time focusing on their deeper integration into the core of the bloc.

The adoption of the euro theoretically gives countries higher rates of growth and more stability, as well as improves the choice of goods for consumers and more opportunities for businesses that have easy access to an integrated market.

Conditions to be met by Bulgaria as a member of the Eurozone

The practical results that Bulgaria must achieve before its inclusion in the Eurozone are that its national economy maintains indicators in accordance with the Maastricht Treaty (1992). They suggest:

1. Implementation of monitoring of the stability of the Bulgarian national currency (lev) - ERM II. EU Member States that have not adapted to the euro will have to be subject to a minimum of two-year monitoring as required by ERM II before being admitted to the euro zone. Under ERM II, national currencies may fluctuate against the euro by +/- 15%;

2. Average inflation rate of less than 1.5% against the three countries with the highest Consumer price index CPI growth rate;

3. low long-term interest (yield on annual government securities - 10.5), which does not exceed by more than 2 percentage points the yield in the three EU countries with the lowest interest rates;

4. a budget deficit of less than 3% of GDP, except for short periods and under the terms defined by the Maastricht Treaty;

5. government debt lower than 60% of GDP, except for countries pursuing a sustainable finance policy and fulfilling all other criteria.

When in June 2018 Bulgarian government decided to take the road to ERM II, Bulgaria met all the criteria of Maastricht. This was stated in the May 2018 ECB Convergence Report. But there was a special warning to the country about inflation. The report stated that *"Looking ahead, there are serious concerns about the long-term sustainability of convergence in terms of inflation in Bulgaria, taking into account the recent increase in unit labor costs,"* ECB highlighted. To see if these concerns about price stability are realistic, we should know how the Maastricht inflation criterion is calculated. Accordin to the Eurostat annual inflation in Bulgaria in the year 2018 is 2.6 percent. At the same time, the three lowest Eurozone Member States with the lowest inflation in 2018 are Ireland - by 0.7%, Greece and Cyprus - by 0.8%. Thus the average arithmetic basis for calculating the Maastricht criterion is 0.76 percent. Adding to it the set normative surcharge of 1.5% suggests that the maximum allowable inflation rate is 2.26 percent to meet the Maastricht criteria. And according to Eurostat in Bulgaria, it is higher - 2.6% or in other words the country already has a problem with the fulfillment of a Maastricht criterion.

This may be an insurmountable obstacle on Bulgarian way to ERM II, even reviewing asset quality to show that banks in Bulgaria are in perfect condition. Of course, in its final decision on Bulgaria's bid, the ECB may take another period for calculating annual inflation - for example June 2018-June-2019, where the end result would be more favorable to the country, but anyway an indicator may be a serious stumbling block.

Sofia meets the nominal criteria to adopt the single currency, with low inflation and healthy public finances as well as the currency peg, but is also the EU’s poorest state and also one of the most corrupt.

It also needs to prove its banks are healthy before it can get a green light to join ERM-2 and the banking union. The European Central Bank recently is carrying an asset quality review and stress tests on six Bulgarian banks and is expected to give results in July 2019.

Commitments made by Bulgaria related to the plan for the country to join the Eurozone are seen as a positive factor. Beyond that, the task is to push ahead with broad-based reforms to strengthen institutions and public goods provision, to improve education and healthcare sectors, and to address labor market bottlenecks. Sustained reforms in these areas will help slow emigration and stimulate productivity growth, the IMF said.

Output is estimated to have grown by 3.2 per cent in 2018, unemployment to have fallen to close to five per cent, and the current account to have recorded another sizable surplus.

Prospects for 2019 are for real GDP growth of 3.3 per cent. However, the downside risks to this outlook have recently risen, owing to a sharper-than-anticipated slowdown in global trade and unsettled financial markets.

Basically the waiting process involves a series of comprehensive assessments focused on six major Bulgarian banking institutions. These assessments concentrate on asset quality review and stress tests on the banks, as a precursor and prerequisite to establishing formally “close cooperation” with the European Central Bank.

The assessments were commenced in November of last year by the European Central Bank, and are slated to be complete by July 2019.

As early as 2003, the ECB decided that countries with a currency board should not go through regime change, that is to leave the board and go to ERM II only to re-fix their rates later. Therefore, the ECB has ruled that it is possible for these countries to maintain their fixed exchange rate and currency board while participating in ERM II, but as a one-sided commitment. The ECB and the other countries have no obligation to intervene to maintain a fixed exchange rate, this will be a unilateral commitment by Bulgaria. But it does not imply a change from the current regime (the currency board's magic is in automatic adjustments and the trust of the audience).

In short - there is no need to change the exchange rate.

Eurozone members are automatically part of the Banking Union, and other member states have to join as a condition for joining the Eurozone. Its establishment aims to strengthen the banking and monetary union within the community. The European Banking Union has four main strands that have been phased out since 2014, including:

1. Single Rulebook;
2. A Single Supervisory Mechanism - With it for the first time in the Eurozone a powerful supranational regulation is created over the European banking system. Its subject is the ECB. It aims to harmonize rules and norms and to impose a comprehensive common approach to managing the entire European banking system.
3. A Single Resolution Mechanism

4. Unified Deposit Guarantee Schemes

So what are the possible **positive or negative impacts** on Bulgarian economy from the entrance of the country in the Erozone?

Experts' opinion on Bulgaria's accession to the Eurozone is too polarized - from many positive expectations to total disapproval.

Positive Expectations

- facilitating access and reducing the cost of attracted financial resources. It concerns both business organizations and the population. But firmly, the business expects more interest in reducing interest rates on loans. Now Bulgarian interest rates exceed three times those offered in the Eurozone countries. The high interest rates of the banks are a barrier to the economic development of Bulgaria and harm the welfare of the Bulgarians.
- Reduction of "transaction costs" for business and currency risk (transaction costs resulting from exchange rate fluctuations in the exchange of euro levs and related commissions). However, according to experts, these benefits are not significant and leading.
- Increase of foreign investments in the country, as a result of the depreciation of attracted financial resources and reduction of transaction costs. Due to its low taxation and good business environment, Bulgaria is one of the most favorable jurisdictions in the EU for opening a business. It is believed that after joining the Eurozone, Bulgaria will be recognized as a first class business destination in Europe.
- Release of funds blocked by the currency board. It is expected that these funds will enter the country's economic life and generate investment growth.
- Impact on the economic growth and business of the country. Facilitating payments for Eurozone citizens would increase their tourist interest in Bulgaria.

Negative expectations

- Possible shocks in the economy and social life of the country as a result of accession. In Bulgaria since 1997 a currency board has been operating. Responsibility for observing financial discipline in the banking sector lies with the BNB. According to Steve Hanke, the "father of the currency board," the removal of this responsibility and its transfer from the BNB to the ECB would shake the financial discipline in the country creating a sense of impunity.
- The principle of setting quotas in the European Stability Mechanism (ESM). It was created to provide liquidity support to the banking system of the countries of the Banking Union. ESM installment quotas do not take into account the debt status of the

Eurozone members and benefit rich countries and indebted countries. The quotas are calculated on the basis of a share of the respective country in the total EU population and a share in the EU's total gross domestic product, both of which have the same effect. It is the paradox that the poorest countries have the highest percentage of GDP. Bulgaria has the highest percentage of the ESM quota of GDP ratio of 16.9%, although it has one of the lowest debt-to-GDP levels of 14.7%. For comparison Greece has a contribution of 6% of GDP.

- There are concerns about the long-term sustainability of convergence in terms of inflation for Bulgaria. The assumption that the process of catching up with euro area countries' incomes and economies can lead to higher inflation rates and violations of the Maastricht criteria set out is not meaningless. Creating an appropriate policy to avoid excessive price pressures would save us from negative ratings and fines.

- Expected negative price effect. EU practice shows that, with the introduction of the euro, commodity prices are rising. According to specialists supporting joining the Eurozone, this effect is insignificant and temporal. However, experience shows that in the countries that have introduced the euro, market adjustments do not return the old price levels.

According to sociological surveys among the Bulgarians most people (42%) support the future membership of Bulgaria into the Eurozone, while 24% disagree with this and 33% don’t know. At the same time however, when asked if they support replacing the Bulgarian lev with euro only 22% are supportive of it, 56% are against it and 21% don’t know. Nearly half (45%) of respondents, who stated their support to Eurozone membership are against the replacement of the Bulgarian lev with the Euro.

Conclusion

The Eurogroup welcomes the intention of the Bulgarian authorities to put in place the necessary elements for a successful entry into ERM II. Following constructive discussions with the ECB, the Commission, the euro area Member States and Bulgaria has taken a number of commitments in policy areas which are of high relevance for a smooth transition to, and participation in, ERM II. With regard to, in particular, banking supervision, Bulgaria is expected to send a request to enter into close cooperation with the ECB in line with the existing procedures, and will undertake the necessary preparations accordingly – including support to the ECB’s comprehensive assessment. Such reform efforts towards a more robust financial sector, stronger institutions and more efficient economic structures will contribute to the successful participation of Bulgaria in ERM II. The ECB and the Commission will monitor the effective implementation of these commitments acting within their respective areas of competence as provided for by the Treaties and secondary legislation. This would imply that Bulgaria simultaneously joins ERM II and Banking Union.

In line with the relevant secondary legislation, Bulgaria will also participate in the Single Resolution Mechanism (including the Single Resolution Fund) from the date of entry into force of the ECB decision on close cooperation.

However, Bulgaria has to solve a complex equation with at least two important unknowns.

The first is related to the review of the bank assets of six Bulgarian banks, which are carried out not by the BNB and the ECB. Its result depends on whether the ECB will accept that Bulgaria can join the EU Banking Union under the Close Co-operation Mechanism. If the country does not get this approval, it will not be close to ERM II either. Bulgaria do not even comment on the pessimistic option that the ECB thinks it is not ready to join the banking union. But it is not impossible.

The realistic option is for the review to end with feasible supervisory recommendations for one or more of the banks audited. And set deadlines of three, six or nine months for their implementation. It is logical for the ECB to open Bulgarian door to the Banking Alliance and together with ERM II, only after the recommendations are met. In this case, however, the deadline set by the Prime Minister for July is unrealistic.

Moreover, a delay of several months is irrelevant if the ultimate goal - entry into ERM II - is fulfilled. But even if there are no remarks to Bulgarian banks comes the second unknown in the equation.

And it is whether Bulgaria fulfills all the criteria of Maastricht. Prime Minister Borisov argues that this is the case. There are, however, serious reasons for doubting these words. The Maastricht criteria are in a five-budget deficit below 3% of GDP, the government debt is below 60% of GDP, inflation does not exceed certain values, and interest rates on long-term government securities do not exceed 2 percentage points interest rates on the long-term government securities of up to three countries with the lowest inflation. The fifth criterion is related to the stability of the national currency against the euro, but as long as the lev is fixed against the euro, Bulgaria fulfilled this criterion by presumption. But as it was already shown there is a high risk Bulgaria to not fulfil this criteria as well.

So weather Bulgaria will be able to join ERM II and the European Bank Union by July 2019 and eventually the Eurozone by 2022 is something still under a question mark and demands on the how the entire economy will develop during this year.