CHRISTINA SAKALI

PhD Candidate

Department of International and European Studies

University of Macedonia, Thessaloniki, Greece
EMU accession issues in the context of the global economic crisis: the case of Bulgaria

Abstract:

The objective of this paper is to reflect on EMU accession issues in Bulgaria, with a special focus on recent developments of the global economic crisis. Both successes and challenges of the Bulgarian economy in the light of EMU accession are assessed, in a discussion about Bulgaria’s prospects to enter the eurozone. Although Bulgaria has shown signs of nominal convergence and was therefore hopeful about adopting the euro by 2013, this goal has now become distant because of issues the global economic crisis brought up. In particular the crisis has revealed and accentuated the vulnerabilities of individual countries such as Bulgaria and Greece, as well as the possible inefficiencies of the nominal convergence criteria.

Keywords: Bulgaria, EMU accession, currency board, nominal and real convergence, global economic crisis

I. Introduction

Bulgaria’s transition to a market economy has been tough and uneven, characterized by serious turn backs (especially in the first years of transition), as well as great political and economic instability. The collapse of the economy in 1996-97, which extended in the fiscal, monetary and banking sectors of the Bulgarian economy, has led to the adoption of a currency board arrangement, in order to stabilize the economy and boost growth. The adoption of the currency board regime, as well as the choice of the Deutsche Mark (DM) and later the Euro as the reserve currency, have been reflecting a political decision, which was taken in the light of the country’s long-term strategic goal of accession into the European Union (EU) and consequently later into the Economic and Monetary Union (EMU) (Petinakis and Flegkas, 2009). Bulgaria has been among the so-called second wave candidate countries and along with
Romania, has taken part in the second wave enlargement, which took place on the 1st of January 2007.

Since the country entered the EU in January 2007, among Bulgaria’s top priorities have been the maintenance of the currency board regime and taking the necessary actions that would ensure the country’s smooth path towards EMU membership. Those priorities have been repeatedly confirmed by the current Bulgarian government and Prime Minister Boiko Borisov, who won the last parliamentary election on 5 July 2009. After being elected, the government adopted the Convergence Programme for the period 2010-2012, which would guide the country’s efforts in the years until Bulgaria is finally ready to adopt the common currency. The Convergence Programme focuses on dealing with the economic crisis and recession, while at the same time maintaining fiscal discipline and reducing the country’s large external debt. The reforms that are included in the Convergence Programme were designed in the light of Bulgaria’s aspiration to apply for the Exchange Rate Mechanism (ERM II), the so-called Eurozone’s waiting room, during the first months of 2010. Countries must stay within ERM II mechanism for at least two years before they adopt the Euro. Bulgaria was therefore hoping to adopt the common currency by 2013.

However, the detrimental effects of the economic crisis, which has now converted to a sovereign debt crisis in the weakest member countries of the Eurozone, have recently made Bulgaria’s goal for EMU accession more distant and difficult to achieve. Bulgaria’s entry into recession in 2009, which has put its fiscal position under strain, and an upward revision of the budget deficit due to previously undisclosed government procurement deals, have obliged Bulgaria to abandon aspirations for euro adoption by 2013. Those negative developments are now being accentuated by the increasing skepticism of Eurozone’s member states about future enlargements of the zone, which was cultivated due to the dramatic effects of the economic crisis. More precisely the economic crisis and recession have revealed the underlying vulnerabilities of the weakest member countries (with Greece at the forefront), and has made Eurozone members much more cautious about future enlargements. As a consequence the country will now have to wait at least until 2011 before it can hope to apply to join the eurozone’s ERM II mechanism and officially enter the path to the euro adoption.
II. The convergence criteria

In order to qualify for EMU membership, Bulgaria has to meet the convergence criteria, as outlined in the Maastricht treaty for the European Union. The convergence criteria (also known as the Maastricht criteria) refer to nominal convergence, which is the adjustment of nominal variables to threshold levels set by the Maastricht treaty. As a consequence, the convergence criteria are predominantly stability-oriented. Their purpose is to ensure macroeconomic stability, which is reflected in low inflation and low interest rates, fiscal discipline and a stable currency. The Maastricht criteria do not require ‘real’ convergence of the new member states’ economies before they join EMU, although it is generally expected that acceptable levels of real economic growth should be achieved through structural reforms, in order that the new member states are able to survive increased competition within the EU and the Eurozone (ECB, 2000).

The degree of convergence candidate countries must achieve in order to qualify for EMU membership is therefore assessed on the basis of the following criteria:

- “The achievement of a high degree of price stability”, which is demonstrated by an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most the three best performing member states in terms of price stability”. The best performing member states in terms of price stability are those with the lowest inflation rates, given that these rates are compatible with price stability.

- “The sustainability of the government financial position”, which is demonstrated by a government budgetary position with a deficit which does not exceed 3% of GDP, and a government debt which does not exceed 60% of GDP. Exceptions can only apply in cases when those ratios have been substantially declining and approaching the reference value, or when the excess over the deficit reference value is exceptional and temporary and the ratio remains close to the reference value.

- “The observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State”. More precisely candidate countries must participate in the European Exchange Rate Mechanism (ERM II) for at least two years before the examination, with their exchange rates remaining close to the central rates of the ERM II.

- “The durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest rate levels”. The interest rate criterion is demonstrated by “an average nominal long-term interest rate, observed over a period of one year before the examination that does not exceed by more than 2 percentage points that of, at most, the three best performing member states in terms of price stability”. The reference value is therefore applied by using the arithmetic average of the long-term interest rates of the three countries with the lowest inflation rates.

With an apparent focus on macroeconomic stability, the convergence criteria were designed in order to safeguard the long-term future of the EMU and the viability of the common currency, by ensuring that member states avoid using divergent economic policies. The viability of the Euro depends on currency stability among the member states, which in turn depends on convergence of interest rates across the Eurozone. In order to maintain a common reference interest rate across the Eurozone, it is necessary that member countries achieve similar rates of inflation and disciplined fiscal policies. Those requirements instilled the conception of convergence criteria and became the cornerstone of EMU integration efforts of candidate countries.

In spite of the fact that the convergence criteria were conceived to promote the viability of the single currency venture, they became subject to extensive criticism, mainly for the inherent contradictions between nominal and real convergence, the complications that arise from the simultaneous pursuit of both those goals, and the possible incompatibility between the exchange rate and inflation criteria, due to the
Balassa-Samuelson effect (Halpern and Wyplosz, 2001; Szapary, 2001; De Grauwe and Schnabl, 2005; Hein and Truger, 2005).

The convergence criteria were also criticized for being designed by (and for) countries which at the time of their accession disposed characteristics largely different than the countries which are now striving to integrate into the monetary union. Big differences exist not only in levels of economic development, but also in economic structures, the development of the banking and financial systems, the welfare state, gender gaps etc. (Halpern and Wyplosz, 2001). As a result compliance with convergence criteria poses a much greater challenge for current candidate countries and entails a much greater price to be paid in terms of output and employment losses, living standards and social hardship (Rossi, 2004).

### III. Macroeconomic performance of Bulgaria in light of EMU integration

Bulgaria provides a case of a country which underwent major transformation since the beginning of its transition to a market economy, particularly in terms of institutional reforms and convergence with Western institutions. “No former Soviet satellite in Eastern Europe has posed so many problems for those willing to systematize and explain the outcomes of post-Communist transformations. It is rather easy to unearth from the literature widely diverging, mutually exclusive interpretations of the Bulgarian case” (Ganev, 2007, p. 28). Bulgaria suffered frequent and serious setbacks in the first years of its transition to a market economy and three severe economic crises during the 1990s, before it eventually succeeded to stabilize its economy and integrate into the EU on 1st January 2007.

#### IIIa. The Currency Board

According to Dobrinsky (2000, p. 588) the Bulgarian economy suffered a “triple drain crisis” in 1997, which seriously affected the public finances, the banking system and the exchange rate. It is actually difficult to believe what Bideleux and Jeffries (2007)
describe as facts of the 1997 crisis, given the progress the Bulgarian economy has made in the following years and its EU integration only ten years later:

The crisis reached its apogee in February 1997, when the monthly inflation rate was 242.7 per cent, the payment of rapidly depreciating wages, salaries and state pensions fell increasingly into arrears, turf wars between rival gangs and ‘mafia’ groups escalated into a major violent crime wave, and unemployment increased dramatically. By late 1996 soup kitchens had become necessary in many towns to feed growing numbers of malnourished and unemployed inhabitants (Bideleux and Jeffries, 2007, σελ. 104).

The collapse of the Bulgarian currency (lev) and the dramatic surge in inflation resulted in the Bulgarian currency suffering a dramatic loss of its value as a means of exchange, while at the same time there was a flow of deposits from Bulgarian banks and most transactions were being made in foreign currency (Petinakis and Flegkas, 2009). Moreover the collapse of 14 Bulgarian commercial banks revealed the weaknesses of the monetary policy that was being followed by the Central Bank, as well as the inherent weaknesses of the banking system. The Bulgarian economy was in emergency mode, with the consequences extended also to the political and social levels. In such an emergency situation it was decided to impose strict monetary discipline and to adopt a currency board arrangement.

Through the currency board, the Bulgarian currency was pegged to the Deutsche Mark (DM), while after the introduction of the Euro in 1999 the single currency replaced the DM and the exchange rate of the lev against the Euro was set at 1.95583 to 1 (1.95583:1). The exchange rate has remained fixed since the introduction of the currency board, through the buying and selling of foreign currency reserves by an independent authority within the Central Bank. The currency board arrangement is set to remain in place until the eventual adoption of the single currency, as it is thought to contribute to macroeconomic stability and provide a cushion against the detrimental effects of the current global economic crisis. In order to fully grasp the current strengths and weaknesses of the Bulgarian economy in light of its preparation towards EMU accession, it is worthwhile pointing out the advantages and disadvantages that stem from the adoption of a monetary regime based on a currency board.
In general, the advantages from the introduction of the currency board as a monetary regime can be summarized in the following:

- Recovery of public confidence in the local currency, as well as in the banking system of the country which adopts the currency board regime. This can lead to a considerable decline in interest rates, while at the same time there is an overall improvement in the business climate, which promotes the inflow of capital and foreign direct investment and favors economic growth.

- Currency stability, which contributes to a decline in inflation rates and overall macroeconomic stability, especially in cases of hyperinflation, caused by a collapse in the value of the currency.

- Restoration of monetary discipline through the restriction of excessive money printing, which can feed hyperinflation.

- Especially in the case of Bulgaria the introduction of the currency board also restrained the uncontrolled supply of credit to loss-making and over-indebted state enterprises, a problem which was related to political corruption and was largely responsible for the collapse of the banking system in 1997.

On the other hand, the possible threats for the economy which chooses the adoption of the currency board regime may stem from the following:

- The successful implementation of the regime requires a sufficient amount of foreign currency reserves, hence foreign capital, which means that the success of the currency board is exposed to capital flow fluctuations and faces serious danger in case of capital inflow ‘stops’.

- Countries with large current account deficits are particularly vulnerable, especially when those deficits are financed by short-term capital, rather than long-term, safer forms of capital such as FDI.

- The maintenance of a fixed exchange rate, when accompanied by high inflation rates leads to currency appreciations in real terms, which adversely affects competitiveness and the country’s current account position. This was observed in
most countries of Central and Eastern Europe (CEECs) after pegging their currencies to Western currencies (Wyzan, 1998).

- The local currency of the economy adopting the currency board follows the fluctuations of the currency or currencies to which it has been pegged. This can create problems in the value of the local currency against other currencies. For example in the case of Bulgaria, the devaluation of the DM against the dollar in 1997 produced higher inflation, as well as difficulties in public debt servicing, most of which was being taken out in dollars (Wyzan, 1998).

The advantages, as well as the possible threats from the adoption of the currency board in Bulgaria in 1997, have been the subject of extensive discussion, with analysts warning about the dangers lurking in the countries of CEE, particularly those with currency board arrangements, and comparing their economic indicators with those in Mexico and Thailand just before the currency crises of 1994 and 1996 respectively (The Economist, 1997). Indeed, despite the macroeconomic stability and the greater credibility in the currency that is pegged, the currency board regime does not leave much room for macroeconomic and particularly monetary maneuver, which means that the development of fiscal and external imbalances could put in serious danger the viability of the regime and thus result in currency crises. The crisis in Mexico (1994), East Asia (1997) and Argentina (2001), as well as the example of the Baltic States, which were affected by the current economic crisis harshly, are all cases in point.

However in Bulgaria the introduction of the currency board regime in 1997 has proved beneficial in the efforts to stabilize the economy and boost growth (Wyzan, 1998). Since then there has been a considerable decline in inflation and achievement of monetary and fiscal discipline, while 1998 was the first year that Bulgaria recorded positive real GDP growth rates (IMF, 2010). Bulgaria’s adoption of the currency board has helped the country achieve macroeconomic stability and has facilitated the road towards European integration. It has been shown that countries with hard pegged exchange rate regimes exhibit stronger nominal convergence and they are in a better position to satisfy the Maastricht convergence criteria than countries with floating exchange rates (Kutan and Yigit, 2005). Moreover, Bulgaria’s commitment to
sustaining the currency board and adopting the euro has required fiscal contraction, which the country has been hoping to guarantee its smooth and fast EMU accession. Bulgaria’s currency board regime has also so far proved to be stable, viable and capable of protecting (to an extent) the Bulgarian economy and its financial sector from the detrimental effects of the current economic crisis (RZB, 2009).

**IIIb. Recent macroeconomic performance vis-à-vis the convergence criteria**

The success and the sustainability of the currency board arrangement in Bulgaria have been due to the policy choices made in the recent years and more particularly the strict fiscal discipline which has been imposed by the latest governments, through the achievement of budget surpluses over consecutive years. As a result, the public debt has been considerably reduced from 80% of GDP in 2001 to less than 30% of GDP in 2005 and only 16.1% of GDP in 2009 (BNB, 2010; Eurobank EFG, 2010). Bulgaria has, until recently, maintained a strong and healthy fiscal position, which has largely contributed to the sustainability of its hard pegged exchange rate regime and has been representing the country’s ‘ace in the sleeve’ in negotiations for accession into the EMU.

Bulgaria has also managed to maintain low levels of interest rates, thanks to the increasing inflow of capital and particularly FDI in the 2000s, as well as the repeated upgrading of the country’s credit rating, up until the end of 2008. Bulgaria’s long-term sovereign credit rating was recently affirmed by the Standard & Poor’s (S&P) credit rating agency at BBB, which places Bulgaria two steps into investment grade. In October 2008 S&P downgraded Bulgaria’s credit rating from BBB+ to BBB, which has remained the same until the present day, while the outlook on the rating was changed to stable from negative, reflecting improved economic growth prospects for 2010 onwards.

Among the factors supporting the sustainability of the currency board and EMU accession prospects is also the current significant pool of international reserves, which were estimated at 12.2 billion dollars or 36.3% of GDP in late March (Eurobank EFG,
Moreover the banking sector is relatively stable and well capitalized, although it may be put under risk if the share of bad-performing loans continues to increase. Finally the progress that has been made in structural reforms and the adoption of the legal framework of the EU, have resulted in Bulgaria’s integration into global capital markets and a greater flexibility of the labor market (Papazoglou, 2005). Those factors translate to increased flexibility of the Bulgarian economy, which may potentially allow for a more successful coping with macroeconomic imbalances and disturbances.

Along with the progress and successes of the Bulgarian economy in recent years, there are also a number of significant challenges, which are due to the economy’s structural problems, as well as the consequences of the global financial and economic crisis, the impact of which will be discussed in greater detail in the following section of this paper. A primary problem of the Bulgarian economy has been the size of the external debt, which largely is a legacy from the first years of the Bulgarian transition, but it is also due to the country’s continued inability to reduce its current account deficits.

One positive factor is that the current account deficits have been largely financed by long-term, safer forms of capital such as FDI, which however, have been declining as a result of the global slowdown of economic activity. Moreover the decline in domestic demand due to the recession is expected to reduce the current account deficit from 25% of GDP in 2008 to 10% of GDP in 2010 (EIU, 2009). Nevertheless, that figure is still large and the Economist Intelligence Unit (EIU) does not rule out the possibility that Bulgaria may eventually require financial help from the IMF and the EU.

That possibility may be strengthened in case of a significant decline in capital inflows due to the global recession. Both the financial and the non-financial sectors of the economy are highly indebted in foreign currency, which increases the vulnerability of the financial system in case of a dramatic decline in capital inflows that may contribute to an increase in bad-performing loans. The high indebtedness of the private sector, coupled with the current economic circumstances is therefore likely to threaten the macroeconomic stability Bulgaria has managed to sustain in recent years.
Under those circumstances the maintenance of the currency board acquires a special importance as it prevents a currency devaluation and contributes to the credibility of the banking system.

Another worrisome issue has been the rise of the real exchange rate, fostered by the inflows of capital and the high rates of inflation, which has not been possible to efficiently control in the last years. The annual inflation rate has been 12% on average in 2008, while the fall in domestic demand due to the recession has affected it downwards to 2.5% year-on year in 2009 (IMF, 2010). The rise of the real exchange rate is hitting the country’s competitiveness and intensifies the problems associated with the current account deficits and the external debt.

Finally the contraction of the Bulgarian economy by 5% in 2009 has been exerting pressure towards laxity of fiscal discipline, while at the same time the one-dimensional focus on fiscal discipline, in order to sustain the currency board regime and achieve an early EMU integration, is adversely affecting economic recovery and future growth prospects. Recovery is not expected before 2011, as external demand from the EU remains flat and austerity measures weigh down domestic demand. In 2010 the country’s real GDP is expected to remain stagnant or post a small decline, compared to the previous year (IMF, 2010).

As a conclusion we could say that Bulgaria, amidst the economic crisis, is not in an extremely weak position; however there are a significant number of threats lurking. The high growth rates of the previous years, coupled with budget surpluses over consecutive years and the currency stability due to the introduction of the currency board, have had a positive impact on the maintenance of macroeconomic stability and the attraction of long-term capital in the form of FDI. As a consequence the country has been exhibiting a satisfactory level of performance on most of the convergence criteria stated by the Maastricht Treaty. However, the global economic crisis is possible to undermine the country’s macroeconomic stability, hamper its growth prospects and seriously delay its EMU integration, unless attention is being paid to individual issues which could prove decisive for the robustness of its economy.
IV. The impact of the global economic crisis

The economies of CEE have been affected by the global economic crisis and recession deeply and in many ways. Although most of the countries in CEE recorded high rates of growth in the recent years prior to the crisis, much of that growth was based on the extensive availability of credit, which generated unsustainable domestic booms and large external deficits. Economic growth in the region of CEE was also dependent heavily on FDI inflows and the export markets of Western Europe, which has been the region’s main trading partner. As a consequence, the credit and liquidity crisis that broke out in the Western part of the world was quickly transferred to the economies of CEE. High rates of economic growth came to a halt and CEECs fell into deep recession. Apart from their general detrimental impact on the economies of CEE, the global economic crisis and recession have also revealed the vulnerabilities of individual countries, both candidates (such as Bulgaria) and members (such as Greece) of the Eurozone, and have seriously affected prospects for EMU integration of candidate countries.

Bulgaria is at the moment the poorest member of the EU, with a real GDP per capita (based on PPP) at less that 35% of the Eurozone average (calculations from IMF, 2010). As a consequence the issue of real convergence is especially important for Bulgaria and should really be the focus of its convergence programme on the road to EMU accession. The lowering of FDI and trade due to the recession are now making that issue even more important for Bulgaria, whose economy has gone from high growth to deep recession in only one year. However economic recovery and eventually growth in order that the Bulgarian economy catches up with its Western neighbors will require fiscal stimulation of the economy and will also create strong inflationary pressures, especially if Bulgaria joins the Eurozone before real convergence is achieved. It is therefore unrealistic to believe that Bulgaria can pursue the goals of nominal and real convergence at the same time, especially given the current economic circumstances, and it will find it increasingly difficult to meet the requirements for EMU integration.
Moreover Bulgaria is burdened by a large current account deficit which makes the country especially vulnerable to external shocks. The fall in domestic demand and imports due to the contraction of the Bulgarian economy may have temporarily improved the country’s current account position, however the global recession has also seriously affected external demand and therefore Bulgaria’s exports have also significantly declined. International trade and the volume of exports have now started to slowly recover in a number of countries; however this growth is still extremely fragile and therefore economies with low competitiveness and chronic external imbalances will struggle under increased competition and the current economic circumstances.

To make matters worse, the retirement of foreign capital and especially FDI inflows has put severe extra strain on countries which have been increasingly relying on foreign capital inflows to finance their current account deficits. The decline of FDI in Bulgaria is putting the country under the risk of a currency crisis, in case foreign reserves decline significantly and the Central Bank is no longer capable of supporting the exchange rate and thus the regime of the currency board. A number of CEE countries have already required bailouts from the IMF as a result of sharp downturns and the development of unsustainable external imbalances (e.g. Latvia and Romania).

The integration of CEE economies into global capital markets is also influencing their banking sector, a very large share of which is controlled by parent banks in Western Europe. As a result, the global economic crisis which has now been converted into a sovereign debt crisis in Europe could result in a banking crisis with detrimental consequences over the whole Europe. Under the risk of a banking crisis and increasing liquidity problems, CEE subsidiaries are finding it increasingly difficult to secure capital from their parent banks and this creates more financial pressure on banks, which already see the number of their bad performing loans to increase. Bulgaria is currently under risk because of the high levels of foreign currency debt of its private sector as well as the existence of the currency board, which requires a sufficient amount of foreign currency reserves in order to remain in place. If the banking sector faces a piling up of foreign currency loan failures, this will put strain on the foreign reserves held by commercial banks and the Bulgarian Central Bank, with serious consequences on currency and general macroeconomic stability.
Furthermore, the global integration of capital markets creates diffusion channels through which the impact of the crisis on individual countries can quickly expand to other economies. As a result, the problems of the Greek economy that came to the surface due to the economic crisis and more recently the sovereign debt crisis, can seriously affect the Bulgarian economy in mainly two ways:

- If Greece eventually resorts to debt restructuring this could put pressure on a number of Greek and other European banks which are highly exposed to sovereign debt through billions of Greek bond holdings. A banking crisis in Greece or some other European country could easily diffuse to the Bulgarian banking system through a domino effect of bank failures, as Greek and other European banks hold significant stakes in the Bulgarian banking sector. Moreover there are important trade links between the two countries, with a significant share of Bulgarian exports being directed to Greece. The recession of the Greek economy, which is expected to continue in 2010 and 2011, may adversely affect trade with Bulgaria, which in turn would deteriorate the current account position and growth prospects of the Bulgarian economy.

- EU policymakers have started to realize that the focus on nominal convergence criteria is alone not enough to prepare a candidate country for the competition it is going to face once in the EU and especially the Eurozone. Poorer member countries with problems of competitiveness, such as Greece, are now struggling under the effects of the economic crisis. As a consequence, the Eurozone’s current member states are now becoming increasingly cautious about future enlargements and stricter on the requirements for accession, reflecting the need to more broadly assess a candidate country’s economic performance and competitiveness. This in turn adversely affects Bulgaria’s aspiration to join the Eurozone because despite its budgetary rigor and on-going macroeconomic stability, Bulgaria remains the poorest member of the EU and among the EU countries with the largest current account deficits.

In fact over-emphasis on nominal convergence criteria may halter real economic growth and delay real convergence, which is especially important for Bulgaria, with
GDP per capita at only 35% of that in Eurozone. Those contradictions, inherent in the requirements in order for the candidate countries to qualify for EMU membership, are now being accentuated by the global economic crisis, which makes it even more difficult for candidate countries to pursue nominal and real convergence at the same time. Given the existing economic conditions, it is bad timing for Bulgaria to make EMU integration its top priority, for two reasons:

- The state of the Bulgarian economy does not leave much chances for that happening as soon as the Bulgarian government would have hoped in any case, and

- The struggle to maintain strong fiscal discipline, coupled with the detrimental consequences of the global recession on capital inflows, the volume of trade and domestic demand, will seriously hamper prospects for economic growth now and in the future. Indeed, the strong political commitment to EMU integration has been among the factors that contributed to the large contraction of the CEE economies (the only exception being Poland) in 2009, with the Baltic States being the most remarkable examples.

Moreover, fast-track integration into EMU and excessive focus on nominal convergence may motivate countries to resort to various techniques in order to demonstrate satisfactory compliance with the criteria, without having proceeded to the necessary structural reforms that would enable their economies to maintain that performance in the future. An obvious example is lowering indirect taxation in the year that the inflation criterion is assessed. In the case of Bulgaria, the Deputy Governor of the Bulgarian National Bank, Tsvetan Manchev, openly stated at the Congress on Central and Eastern Europe in November 2005 in Frankfurt, that Bulgaria would potentially apply such an approach, as a “measure of last resort for the fulfillment of the inflation criterion” (Manchev, 2005).

Strict application of the convergence criteria may finally induce what Szapary (2001) calls the “weighing-in syndrome”:

Like the boxer who refrains from eating for hours prior to the weigh-in only to consume a big meal once the weigh-in is over, the candidate country will maintain very tight monetary policy and resort to all sorts of techniques (freezing of administered prices, lowering of consumption taxes, etc.) to squeeze down
inflation prior to accession only to shift back gears after it has joined the EMU
(Szapary, 2001, p.12)

This is especially important for CEE candidate countries and Bulgaria, since the large disparity of income levels between them and the rest of the Eurozone will undoubtedly lead to strong inflationary pressures once they join the EMU. A similar weighing-in syndrome may also occur in regard to the fiscal criterion, especially if, as in the case of Bulgaria, a candidate country has retained a very strict fiscal policy for years prior to the euro adoption. Governments which have managed to maintain a strong fiscal position in order to qualify for EMU integration may well loosen up their fiscal policies once they join, in order to boost growth and alleviate some of the social hardship associated with a tight fiscal budget.

V. Conclusions

Bulgaria’s strong political commitment to sustaining the currency board and adopting the single currency has motivated policymakers to adhere to strict fiscal and monetary discipline, which the country has been hoping to guarantee a smooth and fast EMU accession. Indeed Bulgaria had been able to meet most of the convergence criteria set out by the Maastricht treaty for the European Union, which refer to a stable currency, low interest rates and fiscal discipline. The criterion for low inflation has been a more difficult one to achieve, not just for Bulgaria but also for other CEECs which are currently on the road to adopting the euro.

Many writers have discussed the contradictions between nominal and real convergence and the fact that the real ‘catching up’ of the CEE economies will unavoidably create inflationary pressures due to Balassa-Samuelson effects (De Grauwe and Schnabl, 2005; Szapary, 2001). Recently though, the decrease in aggregate demand due to the global recession has forced prices down and inflation in Bulgaria fell to 2.5% in average for 2009. As a result, the country was being optimistic about applying to enter the ERM II by the end of March 2010 and therefore adopt the single currency by 2013.
However the consequences of the global economic crisis, which originated in the developed part of the world, affected the economies of CEE severely, revealing and accentuating the vulnerabilities of individual countries and hampering prospects for EMU integration in a number of CEECs, including Bulgaria. In Bulgaria there is currently a number of threats lurking, associated with the large current account deficit and problems of competitiveness, the banking sector and risk of contagion from Western Europe, as well as the difficulties in maintaining a strong fiscal position under the current economic conditions.

Moreover the global integration of capital markets is creating diffusion channels through which the impact of the crisis on individual countries may quickly transfer to other countries or parts of the world. The problems and vulnerabilities of Greece that came to the surface due to the crisis are therefore affecting Bulgaria by posing a threat to its banking sector through the stakes that Greek banks and other non-financial companies have in Bulgaria. Furthermore the chronic imbalances and structural economic problems of Greece, already a member of EMU, are now making EU policymakers wonder whether Bulgaria is indeed ready to join the Union even if compliance with nominal convergence criteria is achieved.

In fact, it is now becoming increasingly obvious that the one-dimensional focus on nominal convergence and strict application of convergence criteria may seriously hamper prospects for real convergence, an issue which is important for CEE candidate countries and particularly Bulgaria, whose level of GDP per capita is only at 35% of the Eurozone average. The contradictions between nominal and real convergence, as well as the possible inefficiencies that may arise from the strict application of convergence criteria (e.g. the weighing-in syndrome) are now being accentuated by the impact of the economic crisis, which makes it increasingly difficult for candidate countries to pursue real and nominal convergence at the same time.

It is therefore important for Bulgaria to focus on stimulating economic growth and competitiveness, rather than making EMU accession its top priority, especially at this point of time. Economic recovery from the recession is expected to be slow in Bulgaria (its economy will remain stagnant or post a small decline in 2010), which means that an excessive emphasis on fiscal discipline could seriously deteriorate
prospects for economic growth now and in the future, especially given the fact that
the currency board regime does not leave any room for an independent monetary
policy to alleviate the impact of the crisis. Bulgaria also needs to focus on structural
reforms, with a focus on combating corruption and boosting the competitiveness of its
economy. Stimulation of the economy would therefore need to be targeted at areas
that would help increase competitiveness, such as education, new technologies,
research and development, infrastructure, as well as the provision of incentives for
export growth.

References

scenarios for the new member states. Kyklos, 58(4), 537-555.
Economist. (1997). Something horrible out there: will Eastern Europe be the next
region to suffer exchange-rate turmoil? Economist, 345(8039), 71-75.


