The Challenges of EMU Integration Under the Global Economic Crisis: The Case of Bulgaria

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Abstract:

The objective of this paper is to reflect on the process of EMU integration for the Bulgarian economy, with a special focus on developments of the global economic crisis. Although Bulgaria has shown signs of nominal convergence and was therefore hopeful about adopting the euro by 2013, this goal has now become distant and increasingly difficult to achieve, 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 inefficiencies of the convergence criteria and the structure of the Eurozone. It is therefore advisable for Bulgaria to focus on stimulating growth and overcoming the current risks stemming from the crisis, rather than making EMU accession its top priority, especially at this point of time.

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, characterised 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 to the fiscal, monetary and banking sectors of the Bulgarian economy, has led to the adoption of a currency board arrangement, in order to stabilise 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 would be presumably ready to adopt the common currency. 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 Eurozone, have recently made Bulgaria’s goal for EMU accession more distant and difficult to achieve. The sovereign debt crisis has revealed the dysfunctional design of the Eurozone, as well as the contradictions that exist between the requirements for Eurozone membership and the way automatic stabilisers operate during a crisis. As the European economies fell into recession, their fiscal deficits went up far beyond the reference value of 3% of GDP, imposed by the convergence criteria and the Stability Pact, with the Central and Eastern European countries (CEECs) being no exception. Even Bulgaria, whose strict fiscal austerity
during the previous years drove its budgets into surpluses, has not been able to retain a budget deficit of under 3% of GDP in 2009 and therefore has been obliged to abandon aspirations for euro adoption by 2013.

These developments have been 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 more cautious about future enlargements and willing to impose stricter discipline on the requirements for accession and membership. As a consequence, Bulgaria should think twice before making EMU accession its top priority, especially given the current circumstances and the difficulties in dealing with the recession and complying with the criteria for EMU accession at the same time.

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 criteria¹:

- “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 1 ½ 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 and alarming, one-dimensional focus on macroeconomic stability, the convergence criteria were designed in order to presumably 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. According to the logic that guided the design of the Eurozone, the viability of the Euro would depend on currency stability among the member states, which in turn would depend on convergence of interest rates across the Eurozone. In order to maintain a common reference interest rate across the Eurozone, it would be 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.

Not surprisingly, the convergence criteria, as well as the logic that moulded the structure of the Eurozone, 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 these goals, and the incongruity between the convergence criteria themselves, with the most obvious example the difficulty in complying with both the exchange rate and inflation criteria simultaneously, due to the Balassa-Samuelson effects (Halpern and Wyplosz, 2001; Szapary, 2001; De Grauwe and Schnabl, 2005; Hein and Truger, 2005).

The convergence criteria were also criticised 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). This is especially true for Bulgaria, which is currently the poorest member of the EU, with a GDP per capita at much lower levels than that of other countries of the EU. Bulgaria lags behind in other areas as well, such as the competitiveness of its economy and unemployment rate, which has been consistently high and reached 9.78% in the first month of 2011, according to the Bulgarian State Employment Agency. As a result Bulgaria’s strive for euro adoption entails much greater challenges for the Bulgarian economy, which are in addition amplified by the current economic circumstances.

The recent developments of the sovereign debt crisis have brought about the revival of the discussion about the problematic rules and structure of the Eurozone, when it became clear that the fiscal and monetary arrangements of the union were incapable of dealing with a sharp decline in aggregate demand and the detrimental consequences that would follow. The Growth and Stability Pact required strict fiscal discipline, which obliged the member states, as well as the countries aspiring to join, to implement pro-cyclical fiscal policies, deepening the effects and the duration of the recession. Furthermore, the lack of a supranational fiscal authority that would protect the weakest member states and the union itself from speculative attacks, has caused a vicious circle of higher risk, higher debt servicing costs, higher deficits and a continuously increasing public debt, despite the strict austerity measures that have been desperately imposed by the European governments.

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 set-
backs in the first years of its transition to a market economy and three severe economic crises during the 1990s. Bulgaria managed to stabilise its macroeconomic environment toward the end of the 1990s and integrated 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. Bideleux and Jeffries (2007) and other writers\(^2\) eloquently describe about the appalling economic and social conditions that prevailed during the Bulgarian crisis in 1996-1997:

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, p. 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, largely a legacy from the communist regime and connected with the continued corruption within the public administration. 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.

\(^2\) Very interesting accounts of the Bulgarian transition and the economic crises of the 1990s are found in Wyzan (1998); Miller (1998); Giatzidis (2002); Crampton (2005, 2007) and Pond (2006).
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, although it also entails a number of significant challenges, as it does not leave room for either monetary or fiscal manoeuvre. In order to fully grasp the current strengths and weaknesses of the Bulgarian economy in light of the economic crisis and its preparation towards EMU accession, it is worthwhile discussing the consequences of the currency board arrangement that was introduced in Bulgaria in 1997, as well the current challenges stemming from the currency board under the economic crisis.

At the time of its introduction, the currency board helped restoration of public confidence in the Bulgarian currency, as well as in the Bulgarian banking system, which was then recovering from a serious and almost universal collapse. This has led to a considerably decline in interest rates and contributed to the improvement of the business climate and the inflow of foreign direct investment (FDI), which was then seen by CEE governments as crucial for the promotion of economic growth. The currency stability has also helped tame hyperinflation, which had been caused by consecutive collapses in the value of the Bulgarian currency, as a result of the crisis. Of course, 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 the summer of 1997 produced inflation in the range 3.5-5.5% monthly, as well as difficulties in public debt servicing, most of which was being taken out in dollars (Wyzan, 1998).

Moreover, the introduction of the currency board and the subsequent independence of the Central Bank have helped restrain the uncontrolled supply of credit to loss-making and over-indebted state enterprises, a problem which was related to
corruption within the public administration and was largely responsible for the collapse of the banking system in early 1997. At the time it was therefore considered that the introduction of the currency board regime in 1997 proved beneficial in the efforts to stabilise the economy and boost growth (Wyzan, 1998). Since then there has been a considerable decline in inflation while 1998 was the first year that Bulgaria recorded positive real GDP growth rates since the beginning of its transition.

However the introduction of the currency board regime and the need to retain the value of the currency fixed can give rise to various economic complications, primarily because it does not allow the deployment of monetary and fiscal policies, especially when they are needed to alleviate the economic consequences of an economic crisis and recession. In other words it does not leave room for monetary and/or fiscal manoeuvre according to the structural problems in the economy and hence can leave it extremely vulnerable to situations which tend to accentuate those problems, such as the current economic circumstances. This means that the development of fiscal and external imbalances can put in serious danger the viability of the regime and thus result in a currency crisis. The crisis in Mexico (1994), East Asia (1997) and Argentina (2001), which all employed different kinds of fixed exchange rate regimes, as well as the example of the Baltic States, which were affected by the current economic crisis harshly, are all cases in point.

The greatest vulnerability of the currency board regime stems from the fact that its successful implementation requires a sufficient amount of foreign currency reserves, hence foreign capital, which the Central Bank can use to support the value of the currency at times when the currency is in risk of devaluation. This means that the success of the currency board is exposed to capital flow fluctuations and faces serious danger in case of capital inflow ‘stops’. However, even in countries with a significant pool of international reserves, such as Bulgaria with approximately 12.7 billion euros of foreign reserves at the end of 2010 (BNB, 2011), the risk of a currency crisis cannot be possibly ruled out. That is because at times of crisis, when the currency starts to lose its value, foreign reserves can dissolve very quickly as a result of the intervention of the Central Bank. That was the case in Thailand and other East Asian countries which despite the significant amount of foreign reserves in their Central
Banks, they were not able to avoid the crisis when their currencies came under serious attack.

Countries with large current account deficits are of course particularly vulnerable, especially when those deficits are financed by short-term capital, rather than longer-term forms of capital such as FDI. However the dependence of the domestic economy on FDI creates yet another vulnerability, as was so accurately confirmed by the current economic crisis and recession. Economic growth in the region of CEE has been heavily dependent on FDI from Western Europe, which has been the main source of FDI inflows for CEECs. As a consequence, the fall in aggregate demand and the consequent recession have brought about the abrupt retirement of FDI in CEE, with a series of negative consequences on growth rates, the balance of payments and the banking system. Bulgaria is among the CEECs with the largest current account deficits (-23.1% in 2008 and -9.9% in 2009) and heavily dependent on FDI, with an FDI stock comprising 92.2% of the Bulgarian GDP in 2008 (BNB, 2010; UNCTAD, 2009). Particularly alarming has been the fact that FDI inflows fell by more than 60% in the period 2007-2009 (own calculations from BNB, 2010), while the full consequences of the economic crisis have not yet ceased to unfold.

The currency board system also entails significant challenges related to the employment of fiscal policies. Obviously in countries where a large budget deficit is reflected in the current account deficit there is a greater difficulty in supporting the value of the currency and a greater risk of developing a currency crisis. As a result, the regime of the currency board requires fiscal discipline to be employed in order to maintain macroeconomic stability and reserve the success of the regime itself. This of course accentuates vulnerabilities at times of an economic crisis, as countries do not have the flexibility to employ counter-cyclical fiscal policies, according to the circumstances. Moreover, automatic stabilisers during the recession cause the budget deficit to widen, which in turn further increases the risk of a currency crisis.

The case of Latvia has been the most representative example of that kind of vulnerabilities arising due to a fixed exchange rate. With a double deficit and an unprecedented contraction of its economy in 2009 (-18%), Latvia has not been able to sustain the fixed peg without the financial aid from IMF/EU. This means that the
Latvian economy will be kept under further fiscal discipline for the following years, with weak growth prospects for its fragile economy. Even so, Latvia may have to eventually abandon the currency peg because of serious problems with competitiveness. In Bulgaria, the strict fiscal discipline that has been imposed by the latest governments in order to sustain the currency board and facilitate a fast EMU accession, may have avoided the need for a bailout so far, however it has also hampered prospects for real convergence and has negatively impacted on unemployment, which has remained high throughout the years. Persistence with fiscal austerity during the current economic conditions is also largely connected with the significant contraction of the Bulgarian economy in 2009 (-5%).

Moreover, the maintenance of a fixed exchange rate, when accompanied by high inflation rates leads to currency appreciation in real terms, which makes exports less competitive and affects adversely the current account position. This was observed in most countries of Central and Eastern Europe (CEECs) after pegging their currencies to Western currencies (Wyzan, 1998). As long as the currency board remains in place, competitiveness cannot be recovered through a currency devaluation, which leaves the economy extremely vulnerable to international markets. Countries with high current account deficits such as Bulgaria are therefore in a higher risk of developing unsustainable external imbalances so far as they maintain the currency board. The less competitive an economy appears in international markets the greater the risk that speculators will attack and capital will flow out of the country.

The currency board regime is also largely connected with monetary growth, as the fixed exchange rate encourages the expansion of lending, particularly in foreign currency. In Bulgaria, money supply grew by more than 30% in only 2006-2007 and more than 80% in the period 2005-2008, a period which also saw a large increase in FDI inflows (own calculations from BNB, 2011). A consumer boom of this kind can accentuate the problems associated with the current account deficit as it tends to widen it and can become an increasing burden for an economy in recession, because of the increasing share of non-performing loans and a greater risk of speculative attacks. Rapid lending and consumer booms such as the ones observed across CEE in the last decade or so, can create asset price bubbles, rendering the system more vulnerable to speculative attacks and mass capital outflows. If the share of non-
performing loans continues to increase, many CEECs including Bulgaria may see their financial systems and currencies under serious threat.

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

The sustainability of the currency board arrangement in Bulgaria so far, has 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 15.5% of GDP in 2009 (BNB, 2010, 2011). Bulgaria has, until recently, maintained a strong 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 medium-term growth prospects. Among the factors supporting the sustainability of the currency board is also the current significant pool of international reserves, although as explained already, these can be dissolved quickly at times of crisis. Moreover the banking sector is relatively stable and well capitalised, although it may be put under risk if the share of non-performing loans continues to increase and the parent banks decide to increasingly cut off credit lines to their Bulgarian subsidiaries.

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, the choice of the currency regime, 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. An appreciating real exchange rate stemming from the currency board arrangement is largely behind the problems of competitiveness that Bulgaria has been facing for many years now and the soaring current account deficit which reached 29% of GDP in 2007 (BNB, 2011).

One positive factor is that the current account deficits have been largely financed by longer-term forms of capital such as FDI, which however, have been significantly declining as a result of the global slowdown of economic activity. Moreover the decline in domestic demand due to the recession has reduced the current account deficit from 29% of GDP in 2007 to 10% of GDP in 2009 and even further to 0.8% of GDP in 2010 (BNB, 2011). Nevertheless, it is expected to start inflating again from 2011 onwards and the Economist Intelligence Unit (EIU, 2009, 2010) does not rule out the possibility of a currency crisis or 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. More than 80% of the Bulgarian banking sector is owned by foreign banks which heavily depend on foreign funding, as reflected in the increasing loan to deposit ratio, which was more than 120% at the end of 2008, behind the Baltic countries and Hungary, but still well above 100 (IMF, 2010a). As a result of the immense participation of foreign banks in the Bulgarian banking system, 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. According to the Financial Stability Review of the European Central Bank, close to 60% of total loans to the non-financial private sector are denominated in foreign currency (ECB, 2010a, 2010b). Bulgaria’s high level of debt in foreign currency has also been largely encouraged by the fixed exchange rate, which made foreign currency lending appear as a less risky credit arrangement during the boom years. The high indebtedness of the private sector, both households and
enterprises, coupled with the current economic circumstances is therefore likely to threaten the macroeconomic stability Bulgaria has managed to sustain in recent years.

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 12.3% on average in 2008, while the fall in domestic demand due to the recession has affected it downwards to 2.4% year-on-year in 2010 (BNB, 2011). Since the nominal exchange rate cannot be devalued as a consequence of the currency board, high rates of inflation produce currency appreciations in real terms and the Bulgarian exports become more expensive and hence less competitive in international markets. The rise of the real exchange rate is therefore 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 excessive and 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 growth prospects. Moreover, the issues of recovery and growth acquire a special importance for the Bulgarian economy, which remains the poorest economy within the EU. According to information contained in the latest press release by the National Statistical Institute, the Bulgarian economy has only expanded marginally by 0.4% in 2010 (own calculations from NSI, 2011), as external demand from the EU remains subdued and austerity measures weigh down domestic demand. Medium-term growth prospects are expected to be moderate, as both external and domestic demand will remain weak for the next years, because of high unemployment, the increasing share of non-performing loans and limited access to credit throughout the whole EU.
IV. EMU integration under 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 (own calculations from IMF, 2010b). 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’s burden with large current account deficits makes the economy 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). Bulgaria is currently under significant 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.

The global integration of capital markets also creates diffusion channels through which the impact of the crisis on individual countries can quickly expand to other economies. As a result, the structural problems of the Greek economy that were accentuated and came to the surface because of 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 realise 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 and now Ireland, Portugal and Spain, are struggling under the effects of the economic crisis. As a consequence, the leaders of the Eurozone are now becoming increasingly cautious about future enlargements and willing to impose stricter discipline on both member and candidate countries, reflecting the need to more broadly assess a country’s economic performance and competitiveness.

This trend is epitomised in the recent plans of the Eurozone leaders (following a joint proposal by Germany and France) for a new Pact for Competitiveness, which would oblige both member and candidate countries to implement reforms to increase competitiveness, according to a benchmark, set by the economy demonstrating best performance. This would essentially compel countries to opt for ‘internal devaluation’ policies, that is, the deflation of domestic wages to make exports more competitive, with negative consequences on domestic income levels, domestic demand and consequently growth. Especially for countries such as Bulgaria with chronic problems of competitiveness and a currency regime which does not allow room for exchange rate adjustment, the pressure to enforce policies of internal devaluation would exert enormous strain on its already fragile domestic economy and would further delay its real convergence. Most importantly, it is not at all certain that the harsh option of internal devaluation will indeed help the weaker countries of the EU periphery to eventually compete with the advanced
Eurozone members, which dispose of a solid technological and industrial base and a track record of competitive exports.

A fast-track EMU accession and an excessive focus on nominal convergence may also motivate countries to resort to various techniques in order to demonstrate satisfactory compliance with the convergence 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 fulfilment of the inflation criterion” (Manchev, 2005, p.2).

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. Without a supra-national fiscal authority to implement a European common fiscal policy, this kind of development would allow weaker countries to become prey to speculative attacks and increasingly
rising debt servicing costs, as was amply demonstrated by the case of Greece, Ireland and other peripheral Eurozone countries.

Most importantly, over-emphasis on nominal convergence criteria may well 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.

It is therefore important for Bulgaria to wait, at least until the recent proposals and developments within the Eurozone are somehow crystallised. The next couple of years will apparently be years of significant developments regarding the reshaping of the current structure of the zone, all of which will have a decisive impact on member countries, the EU countries on the road to accession and the future of the Eurozone itself. A lot will depend on whether the Eurozone leaders move on towards the establishment of a supranational fiscal authority, or whether the recent proposals by Germany and France become materialised, as well as the exact details of how these developments will move forward. According to how exactly the future of the
Eurozone is shaped, Bulgaria should then decide whether and when it should become a member of the EMU.

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 has grown by only 0.4% 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


