ECONOMIC POLICY ANALYSES

The Eurozone and Bulgaria – interrelations and future perspectives

Nadya Yorgova

- The current analysis confirms strong interrelation between Bulgaria and the Eurozone member states.

- In mid- and long-term perspective the positive sides of joining the Euro area are definitely outweighing the possible negative ones.

- Stepping on the economic background and the topical analysis of the present situation, one can unmistakably conclude that Bulgaria needs to quickly move forward to the currency club.

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Abbreviations:

BNB	Bulgarian National Bank
CB	Currency Board
EA	Euro Area
EC	European Commission
ECB	European Central Bank
ECOFIN	Council of Economic and Financial Affairs Ministers
EMU	European Monetary Union
ERM II	Exchange Rate Mechanism II
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GVA	Gross Value Added
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
MPs	Members of Parliament
NPISH	Non-profit institutions serving households
NSI	National Statistical Institute
R&D	Research and Development
SGP	Stability and Growth Pact

1. Summary

After its accession to the European Union in 2007, Bulgaria faced numerous further challenges. Before the country there stood cohesion disparities, a catching-up process and improving the country's image as an equivalent partner of the other EU member states, rather than a slowly developing peripheral country. Recent years have made the country face both global and local obstacles to reaching these goals. Current economic developments of the crisis raging worldwide in the last 3 years have pulled Bulgaria back by reaching economic indicator values lower than their pre-crisis levels. Probably the most logical way towards resolving those issues seems to be the deepening of European integration by joining the deepest form of integration so far – the Euro area. If one compares the current situation and the indicators of the Eurozone as an inner EU circle with those of Bulgaria, on the surface it may seem like some EA countries perform rather worse, due to the crisis developments. However, looking into more detail, it appears that the Eurozone governing bodies are taking the measures necessary for providing the common currency with an impetus for development even at the cost of bailing out its member countries. Thus, potential stability, catching up and the suggestion of "better in than staying out" are on the table for joining the Euro area. The economic positives provoke the necessary political and economic measures to be taken for Bulgaria to move forward to the next level of integration and to joining the currency club.

2. Foundations of the EMU.

2.1. Background of European Union with a Focus on the Formation of the Inner Monetary Union.

Before going into the details of the structure and the functions of the European Economic Monetary Union as an inner European Union circle, it is worth following the developments in the EU itself from the monetary perspective of internal union formation. About 60 years ago, when the countries that had recently experienced world wars were gathering with the idea of transferring key economic policies on a supranational level, the six founders of the EU were still far from the idea of giving up their national currencies.

The first real steps towards monetary unification in the EU were taken in 1988. Then the European Council mandated a committee of experts under the chairmanship of Jacques Delors (the "Delors Committee") to make proposals for the realisation of an Economic and Monetary Union. A year later, in 1989, the thus formed Committee came up with the "Delors Report" for realisation of a monetary union in three stages. The same report was submitted to the European Council and in the same year it agreed on the proposal for setting up a common monetary union, then in the very next year of 1990 the **first stage** of the EMU project began. While in Central Europe the countries were already starting to deepen the integration among them, Bulgaria was still in a phase of shifting regimes. In late 1989 the Bulgarian Head of State and Communist party leader was removed from office and in early 1990 the party voluntarily gave up its power. At that time Bulgaria had already managed to accumulate a significant foreign debt and the IMF approved stand-by loans to the country. This made transition and the economic environment unfavourable, while the uncontrolled printing of money, liberalisation and political instability portended critical developments. Despite these obvious differences, 1990 set a number of upcoming challenges for both Bulgaria and the European Community (as a predecessor of the European Union).

Two years after 1992, when the European Union Treaty was signed, in 1994 the **second stage** of monetary integration began with the establishment of the European Monetary Institute (succeeded by the European Central Bank). Although the Institute did not actually carry out a common monetary policy, nor was it competent to intervene on the foreign exchange markets, it served as a foundation for the further institutional developments of a common policy. At the very end of the second stage of EMU establishment, in 1998, the European Central Bank was instituted and situated in so-called Mainhattan (the financial heart of Frankfurt am Main in Germany). Its functions and responsibilities will be clarified further in this paper. While the newly established European Union (already operating as such) was gaining power and projecting further integration in the field of monetary issues, a deep economic and political crisis was raging in Bulgaria. As a result of the shrinkage of external markets due to the fall of the Soviet Union and the transition of ownership from state to private, along with the banking sector difficulties, a boom in continuous budget deficits, resulting in growing governmental debt, challenged the economic stability of the country. The banking sector turned into a main accelerator of downturn. With it providing ill-judged lending, lacking strict regulations and supervision, and being recapitalised by the National Bank, the banking crisis led to extreme losses of national funding. It was followed by a deep financial and economic crisis constituting a severe fall in the exchange rate from 70 BGN/USD in January 1996 to 2936BGN/USD in February 1997, when the crisis reached its apogee, and when monthly inflation exceeded 242%. Adding to that inevitable social and political pressure, the state government found itself unable to deal with the situation. This crisis turned out to be among the most severe ones in the contemporary economic history of Bulgaria and to a great extent it determined the future economic development of the country. Apparently to counteract it, external help was necessary and for receiving it from the IMF, the government in power was required to implement a draconian reform programme and to maintain a currency board (CB) as a monetary regime. However, the CB implemented in Bulgaria was a second generation model, which required the coverage of all the money in circulation with reserve. At the same time, rules which were slacker than was traditionally the case were set, leaving the national bank with only limited monetary policy leverages to avoid systematic crises in extraordinary circumstances. This regime came into force in July 1997. It came as clear evidence of the course of the EU interrelation Bulgaria was on, aiming at further integration. Such was made evident by the fact that, although most of the savings were in US Dollars, Bulgaria pegged its national currency to a European currency– namely the German Mark. Two years later, when the Euro was introduced, the Bulgarian currency was automatically fixed to it at the rate at which the German mark was replaced by the Euro. By pegging its national currency to the European via the currency board arrangements, Bulgaria started to passively follow the economic policies of those countries that adopted the euro.

The **third phase** is probably the most interesting from the perspective of deepening integration. It started in 1999 when the euro was introduced as a single currency in the Euro area and this phase is still ongoing. The eleven countries comprising the Eurozone at that time had irrevocably fixed their former national currencies. At the end of the previous phase of preparation for the EMU, the main fiscal rules of functioning of that EU inner union were set in the Stability and Growth Pact. Its key purpose was and still is to facilitate and maintain sustainable stability in the Economic and Monetary Union after the countries are already involved in it. The main indicators of the pact adopted in 1997 regard fiscal stability, and namely an annual budget deficit of no more than 3% of GDP and national debt not exceeding 60% of GDP. However, in 2005 the pact underwent a reform and the European Union Council agreed on relaxing the rules. In this way, the business cycle and other external factors were allowed to be taken under consideration before declaring a country in excessive deficit. This reform is the main reason why no procedure for breaking the rules of the SGP has yet begun against any of the member states, although there are a few examples of countries exceeding the fiscal limitations set. This reform turned out to be a two-sided issue, since there were arguments for and against the flexibility of rules regarding fiscal discipline. Evidently, threatening accumulated debt by some of the Eurozone countries has troubled the waters of the EU in a crisis environment, which has proved the opponents of the SGP reform right to a great extent, rather than its supporters.

By the time of the SGP reform year of 2005 Bulgaria had already undergone a number of reforms towards market economy and had managed to sustain the currency board regime. Until then, the country had walked the road towards EU accession and had successfully closed all the negotiation chapters so that the President, the Prime Minister, the Minister of Foreign Affairs and the Chief Negotiator of the Republic of Bulgaria with the European Union had put their signatures under the treaty for full-fledged EU membership on behalf of Bulgaria.

2.2. Implementation and Developments of the Single Currency.

Bearing in mind that the Euro area itself is the highest and the most sustainable form of integration reached so far, in the following paragraph its widening so as to reach the current shape will be outlined. In the framework of the original idea for Euro area formation and in line with the membership rules, 11 out of all the 15 member states adopted the euro in 1999. Those countries were Belgium, Germany, Ireland, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. At that time the single currency was only used for non-cash operations and was not in circulation. Despite later doubts about the authenticity and methodology of the data provided, in 2001 Greece was accepted into the currency club after national statistics verified covering the convergence criteria. At the beginning of 2002 the single currency was introduced and came into being, replacing the old national currencies of 12 countries. At that time Great Britain and Denmark had already announced their position of remaining apart from the single currency (Sweden is also taking advantage of this so-called opt out clause of staying out of the Eurozone, but in an informal way). During the next few years, the currency area observed no further widening. Only in 2007 Slovenia managed to cover the convergence criteria and joined the Euro club. In the next year two island countries were added to the Eurozone – Cyprus and Malta. 2009 was also not an exception in the process of widening – then Slovakia joined the currency regime. Skipping a year, ECOFIN gave its confirmation to Estonia in 2011, despite the doubts about its readiness on behalf of the ECB. Thus, the Euro area currently includes 17 full-fledged member states. There are also a few exceptions, such as the Vatican City State, the Principality of Monaco and the Republic of San Marino, which are licensed by the ECB to issue their own coins (which, in the case of the Vatican, acquire more numismatic value than being a means of payment). Other countries using the euro as national currency on the principles of unilateral euroisation, and without a licence for printing their own money are Montenegro, the Principality of Andorra and Kosovo. Thus, the overall number of people daily using the euro as an official means of payment is close to 330 million. In this way, the euro has rapidly turned into the second most important international currency, following the US dollar.

2.3. Establishment and Functioning of the Euro area.

After revising the establishment stages of the EMU and its widening, it is relevant to look through its **governing institutions**, which will enable further analyses of its current status and policies. At the centre of Euro area governance is the European Central Bank (ECB), which is at the core of the decision making body. Basically it represents the whole of EU diversity at the most, since its employees come from all the member states. It remains at the centre of those bodies, acquiring functions of central banks both of the European Union and the Euro area, respectively the European System of Central Banks (ESCB) and the Eurosystem. Originally, the concept of a common monetary policy among all member states was set in the Treaty establishing the European Community. It implied a general authority consisting of the ECB and all of the national banks (currently 27) comprising the ESCB. However, even in the beginning of the EMU formation there were countries (like Great Britain and Denmark), which stated that they were unwilling to join the common currency. Thus, the decision making and policy implementing authority of the Euro area needed further restriction to the limits of those countries that are indeed members of the Euro area. In this case, the so called Eurosystem is responsible for monitoring, shaping and implementing policy. It consists of the ECB and the 17[1] national banks of those countries currently in the Eurozone.

In favour of further analyses, it is important to clarify the structure of the **Eurosystem** and its functions. The main objective of the Eurosystem is to preserve price stability and to guarantee its members sustainable and non-inflationary growth. For the achievement of those goals, the ESCB and the Eurosystem are governed by the decision-making bodies of the European Central Bank (ECB). These bodies are the Governing Council and the Executive Board of the ECB. The Governing Council includes the six members of the Executive Board and the governors of the national central banks of the 17 Euro area countries, and it decides on the shape of the Euro area monetary policy. The Executive Board consists of the President, Vice-President and four other members, appointed by the European Council. On the other hand, it is the body responsible for monetary policy implementation in accordance with the decisions and the guidelines set by the Governing Council. To ensure it achieves its main target of price stability, the ECB executive body could assign given operations regarding monetary policies to the national banks.

After reviewing the EMU and the main points of management, the **recent developments of Bulgaria** towards it will be outlined in the current paragraph. To begin with, an overview of where Bulgaria stands on its road towards it will be favourable. There are four stages for a country to enter the currency club of the EU. The first condition is being an EU member state. Secondly, it needs to enter the so-called anteroom of the Eurozone (ERM II). Thirdly, the country should remain in the ERM II for at least two years. Only then and after fulfilling the Maastricht criteria for adopting the euro at least a year prior accession, the country may become a full-fledged member of the Eurozone, with all the pros and cons as a result of it.

Since Bulgaria fulfilled the first condition and entered the European Union in 2007, the next step is ahead. Only a few years ago, when the current financial and economic crisis had not yet hit Europe, the second step towards entering the Eurozone was still easy and mainly formal. It is worth underlining that there exist basically no official requirements for entering the ERM II. However, for a country to step in, an absolute majority of ECOFIN Eurozone members and the ECB is necessary.

[1] As of the beginning of 2011the Bank of Estonia also joined it.

For this reason, a leader in the negotiating team should be the Minister of Finance of the given candidate country, of course with the support of the governor of the National Bank. They need to convince all the members of the Governing Council of the ECB that the country is ready to enter the anteroom of the Euro area. In fact the pre-voting negotiation process is indeed the real part of the ERM II accession, while the voting process itself is considered only formal. One reason for this is the fact that this is namely the phase when the ECB has a voting mandate, while in the next phase, when it comes to practical adoption of the euro, convergence criteria fulfillment become crucial and the ECB may only provide its statement on the matter of readiness of the candidate.

Countries which are currently a part of the Exchange Rate Mechanism II are Denmark, Latvia and Lithuania. While Denmark joined it at the very beginning of 1999 and declared reluctance to undertake further steps towards adopting the euro after a referendum in 2000, the Baltic countries joined the mechanism shortly after their EU accession in 2004 and clearly declared their interest in Eurozone accession. However, in 2006 Lithuania was rejected accession because the statistics showed a 0.01% outmatch of inflation criteria. This was a clear signal for the already restricted policy of accepting other members into the Euro club. In the same manner the Baltic countries were the last to enter the anteroom of the Eurozone.

Besides informal barriers towards entering ERM II, there are strict and formal criteria set on the next stage of joining the Eurozone and adopting the euro by a given country. They are known as the Maastricht criteria, for they were set in the Treaty on the European Union from 1992. This set of macroeconomic requirements is reviewable in addition to the requirement of staying in the anteroom for at least two years prior Eurozone accession and involves the following:

- Fiscal stability that examines sustainability of public finance and includes two components:
    - the budget deficit must not exceed 3% of the GDP;
    - public debt to GDP must not go beyond 60%.
- The inflation rate should not exceed with more than 1.5% the average inflation rate of the three best performing member states in terms of price stability, measured in HICP (Harmonised Index of Consumer Prices)
- Long term interest rates must not be more than 2% higher than those in the three best performing member states in terms of price stability;
- The exchange rate of the national currency must remain in the corridor of +/-15% fluctuation against the Euro (Exchange Rate Mechanism II) and should not be devalued.

Table 1. Maastricht Criteria and Bulgaria (2007 – 2010)

	2007		2008		2009		2010	
	Bulgaria	Value of Reference	Bulgaria	Value of Reference	Bulgaria	Value of Reference	Bulgaria	Value of Reference[1]
Budget Deficit/ Surplus to GDP (%)	0.1	3	1.8	3	-3.9	3	-3.6[3]	3
Public Debt to GDP (%)	19.8	60	16.2	60	14.8	60	13.7[2]	60
Inflation Rate (HICP, %)	7.6	2.8	12	4.1	2.5	0.6	1.7 [3[3]]	1
Interest Rate (%)	4.5	6.3	5.4	6.2	7.2	6.1	6.9[1] [6.0[3]]	5.8

[1] *According to the last published convergence report of ECB as of May, 2010*
[2] *Preliminary data at the end of 2010, National Statistical Institute of Bulgaria and Bulgarian National Bank.*
[3] *According to the Ministry of Finance of Bulgaria statistics.*

Although there are no formal requirements for a country to enter the Exchange Rate Mechanism II after its accession to the EU, nor is there any limitation for the period of staying in it, Bulgaria did not manage to enter the anteroom in 2010 either. Nevertheless it was among the top priorities of the new government that came into power in mid 2009 as the next step towards adopting the euro, it is still an on-hold process. Back then, at the very beginning of its mandate, the new government was very much focused on fulfilling the Maastricht criteria described above, which would provide it with the confidence to start negotiations for entering the ERM II. However, at the beginning of 2010 the government became a successor of an actual reverse in budget balance from 1.8% surplus in 2008 to a deficit reaching 3.9% of GDP in 2009. Thus, Bulgaria did not fulfill the public finance stability criteria, which provoked a decision for postponing negotiations for entering the ERM II. On the other hand, there were unofficially expressed concerns from the member states regarding mostly non-economic factors such as organised crime and levels of corruption, rather than economic convergence criteria fulfillment. This resulted in the current freezing of the current government's original plan for adopting the Euro aiming to achieve it in 2012-2013. It also shows that the Euro area members have become far more cautious and conservative in recent years, especially when it concerns further enlargement of the zone with peripheral countries.

3. Analysis of Current Developments and Policies Implemented.

3.1. Current Economic Developments – Bulgaria and the Euro area.

The economy of Bulgaria entered the global crisis almost a year after its breakout, which means that a revival is to be expected at least with the same time lag. So far the country has not experienced the financial crisis in the matter of banking sector bankruptcies and the necessity of bail-out packages. However, the economy has not been spared by the overall downturn. Most drastically, the crisis was transferred from Europe to the country through the channel of the real sector and export oriented industries. Evidently, the pre-crisis stable **GDP growth** of the country dropped by almost 12% in the period of just a year from 2008 to 2009 (*see Table 2*). Although the flash estimates of the national statistical institute for 2009 expected an overall decline in GDP amounting to -4.9% in 2009, they were even surpassed by the final annual data revealing a drastic -5.5% decline in GDP. Thus, the stable trends of development were replaced by insecurity and vulnerability. In addition, a political change of government in power from a socialist led coalition to a centre-right cabinet of minority occurred in the summer of 2009. The negative economic trends also remained at the beginning of 2010, even though they developed at a slower pace. Despite the extremely low basis for comparison in 2009, not until the second half of 2010 were there even slight signals of recovery (*See Table 2*). Minor recovery at end 2010 comes as a confirmation of the interrelation of the Bulgarian economy with the EU (and particularly the EMU), determined by a parallel revival of Euro area countries as important trade partners of Bulgaria *(see Table 2).* Anticipative recovery trends observable in the Euro area (*See Graph 1.*) result in a serious external demand for Bulgaria, which is among the main factors for enlivening the export-oriented companies. Such an interrelation proves the interrelation between Bulgaria and the Euro area being related through the currency board arrangements in the country.

Going into the details of the main economic indicators, statistical data make it clear that namely the industrial sector, responsible for about one third of the overall value added production in Bulgaria, is that which experienced the crisis developments most notably. The shrinkage in the sectors of services and agriculture were not affected that much relatively and they are less related to transferring the impulses of the crisis in the country, which is why industry will be reviewed in more detail. While in 2007 industry comprised 32.3% of the Bulgarian economy, in 2009 the sector observed most dramatic shrinkage of all sectors – it declined by 2%. Whereas, in the first two quarter of 2010 industry continued declining, in the 2nd part of the year it evidenced two quarters of growth, reaching 33.4% at the end of 2010, surpassing the values from 2007. In accordance with expectations for the sector, comprising the indicator of business climate in industry[2], a reflection of significant monthly increase by 4.1 percentage points was manifested in February, 2011. Since the indicator replicates sectoral managers' expectations for near future developments, their optimism was provoked by positive market signals and a favourable business climate expected in the coming months. However, by February, the concerns of major enterprises remained the insufficient demand and expected rise in prices, which were already doubled, reaching 1.2% monthly[3] and predicted to grow even more in subsequent months due to fuel price rises.

[2] Business Conjuncture - National Statistical Institute, February, 2011
[3] Consumers Price Index in January (measuring monthly inflation rate) was 0.6%, while in February the same index was 1.2%

Table 2. Macroeconomic Indicators

Indicator	2007	2008	2009	2010
GDP of Bulgaria, billion EUR	28.8	34.2	31.5	36.0*
GDP growth (%)	6.4	6.2	-5.5	0.2
GDP growth in Bulgaria, 2010 in comparison with the same period, previous year (%)	**Q1**	**Q2**	**Q3**	**Q4**
	-3.6	-1.4	0.5	2.8
GDP growth in the Euro area, 2010 in comparison with the same period, previous year (%)	**Q1**	**Q2**	**Q3**	**Q4**
	-4.1	-2.1	0.6	1.7
Gross Value Added by Industrial sector 2010 in comparison with the previous quarter (%)	**Q1**	**Q2**	**Q3**	**Q4**
	– 3.53	– 8.33	2.99	0.72

Source: National Statistical Institute, Sofia; Bulgarian National Bank
** Preliminary data*
***Not available*

3.2. Foreign Trade and Foreign Direct Investments.

As already stated, the recent growth of industry in Bulgaria was predominantly due to its export oriented component, which was facing revival. An overview of the trade balance of Bulgaria, mentioning the signals of revival in 2010 in comparison with the critical 2009 enables canalising the influence by countries. The overall numbers[4] reveal that there was a total improvement of exports in 2010 of 33.2% (*See Table 3*), which reflected the overall trade balance with a decrease of the deficit by BGN 3.14 billion. Such an improvement of the trade balance from a deficit of 23.5% of GDP in 2007 to only 6.7% in 2010[5] recovered the indicator to BGN 3.43 billion in 2010. It is obvious from *Table 3* that 2010 enjoyed strengthening the export flows to Bulgaria's main trade partners from the Euro area, such as Germany, Italy and France. There were also positive fluctuations towards the neighbouring countries with traditionally steady trade flows to and from Bulgaria, such as Greece, Romania, Turkey and Serbia.

These positive developments with regard to the trade balance indicator, however, hide not only export increase but also import decrease. In addition, the import decrease is defined mainly by the shrinkage in domestic demand, which is far from a positive outcome. Unlike the previous years of credit expansion and intense FDI inflows, in 2009 domestic consumption shrank dramatically by 7.3%, while in the previous years, it grew steadily at about 5% annually (*See Table 4*). Such a prior-2009 stable growth contributed to a current account deficit of EUR 7.7 billion and 8.1 billion respectively in 2007 and 2008. This provoked warnings from the ECB and other monitoring institutions claiming that in terms of FDI shortage the trade balance deficit would not decline and the country would soon be in need of external financial support. Conversely, such concerns have so far

[4] According to the National Statistical Institute data on exports, imports and trade balance in 2009 and 2010 (preliminary data).
[5] BNB and NSI preliminary data

been proven wrong by a current account deficit amounting to a modest EUR 356.2 million in 2010 as a result of a remarkable FDI decline, accompanied by restricted lending policies of the commercial banks and decreased consumption. As a direct reflection of the recession on financial markets and of these economies that were the main investors in the country, Bulgaria witnessed severe downturn in FDI inflows as early as in 2008. Being a main catalyst of growth, such a decline inevitably resulted in an overall downturn of the national economy. The main reason for the economic downturn is namely the decline of FDI volumes from over EUR 9 billion in 2007 to a modest EUR 1.6 billion in 2010. Most of the investments during the high period were attracted by the sectors of construction, finances and commerce, predominantly those in real estate and construction. Despite the significant downturn in these sectors, the biggest sources of investments in 2010 remained EMU countries like Netherlands, Belgium, Cyprus, Greece, and Germany[6].

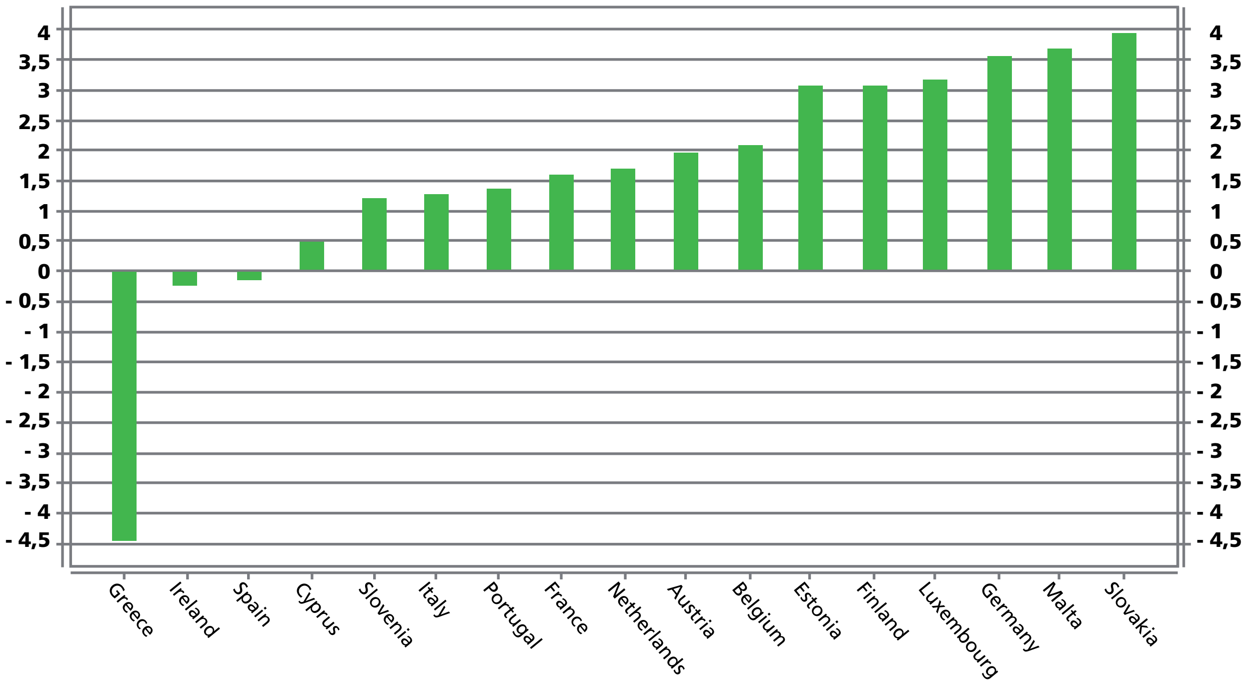
Table 3. Exports, imports and trade balance of Bulgaria by main trade partners in 2009 and 2010*

	Exports			Imports			Trade Balance	
Countries, groups of countries	2009	2010	Growth, %	2009	2010	Growth, %	2009	2010
	Mln. BGN			Mln. BGN			Mln. BGN	
Total	**22881.8**	**30488.1**	**33.2**	**33006.0**	**37476.5**	**13.5**	**-10124.2**	**-6988.4**
EU	**14854.8**	**18567.5**	**25.0**	**19789.7**	**21996.8**	**11.2**	**-4934.9**	**-3429.3**
EA countries:								
Greece	*2186.1*	*2418.8*	*10.6*	*2015.5*	*2233.4*	*10.8*	*170.6*	*185.4*
Ireland	15.6	16.9	8.3	95.6	105.3	10.1	-80.0	-88.4
Spain	734.3	813.5	10.8	534.0	707.6	32.5	200.3	105.9
Cyprus	106.2	89.7	-15.5	61.9	54.2	-12.4	44.3	35.5
Slovenia	97.3	230.7	137.1	280.3	296.3	5.7	-183.0	-65.6
Italy	*2136.9*	*2953.1*	*38.2*	*2544.2*	*2772.5*	*9.0*	*-407.3*	*180.6*
Portugal	81.7	88.6	8.4	57.3	109.5	91.1	24.4	-20.9
France	1025.1	1229.0	19.9	1160.4	1231.0	6.1	-135.3	-2.0
Netherlands	362.0	460.8	27.3	907.7	1050.9	15.8	-545.7	-590.1
Austria	448.9	574.7	28.0	1335.4	1304.3	-2.3	-886.5	-729.6
Belgium	1298.3	1148.7	-11.5	557.6	712.6	27.8	740.7	436.1
Estonia**	9.0	21.4	137.8	12.2	7.3	-40.2	-3.2	14.1
Finland	38.1	53.4	40.2	198.8	186.0	-6.4	-160.7	-132.6
Luxembourg	24.6	40.0	62.6	27.1	25.8	-4.8	-2.5	14.2
Germany	*2582.5*	*3244.5*	*25.6*	*4052.7*	*4372.0*	*7.9*	*-1470.2*	*-1127.5*
Malta	12.3	12.4	0.8	14.1	50.7	259.6	-1.8	-38.3
Slovakia	185.2	204.6	10.5	379.4	407.4	7.4	-194.2	-202.8

Source: National Statistical Institute, Sofia
** Data are preliminary as of 11.03.2011*
*** Estonia joins the EA in 2011*

[6] According to BNB statistics

Graphic 1. Real GDP growth rate volume change on previous year (%)



Source: Eurostat, 2011

3.3. Social Dimensions of the Crisis.

Even though Bulgaria has already turned the external rating agencies' perspectives from stable (in 2008 and 2009) back to positive in 2010[7], the crisis still puts steady pressure on household welfare, which to the greatest extent represents the social price of it. Through the financial markets the overall access to liquidity in the economy and respectively access to **credits** for households were dramatically restricted. The loans to households and NPISHs (Non-profit institutions serving households) increased from BGN 6.9 billion in 2005 to over BGN 18 billion in 2008[8], which amounts to an average growth of BGN 3 billion a year. This trend of credit expansion financing most of domestic consumption growth in this period has noticeably shifted in 2009. Then the indicator rose by only a little more than a billion BGN and in 2010 even witnessed a decrease of BGN 155 million. This shift to a conservative lending policy is one factor that will prevent households from enjoying the pre-crisis levels of domestic demand at least in the next 2-3 years, while at the same time their indebtedness has increased.

Besides the reflections from the financial markets, the **labour market** also mirrors quite relevantly the crisis effects. In Bulgaria, annual unemployment rose from an almost natural rate in 2006 to a threatening 9.2% in 2010, increasing to 9.78% in January 2011. Looking at the monthly labour force data[9], it becomes evident that the labour market in 2008 was also starting to reflect crisis trends. Although very weak, the first signs of unemployment rates growth (on

[7] Ministry of Finance, Sofia (Credit Ratings)
[8] According to the BNB statistics on Deposits and Loans, 2011
[9] National Employment Agency within the Ministry of Labour and Social Policy, Sofia

monthly basis) were detected in October 2008, reaching 5.85%. Almost a year and a half later in February 2010, already 10.26%, amounting to over 380 thousand people were unemployed (which is so far the peak of unemployment). To confirm the lag in the revival period necessary for the labour market with respect to the overall economic situation, it becomes clearer that in recent years it takes more time for young and inexperienced people to join the labour market as well as that unemployment lasts longer than it used to in the pre-crisis period[10]. Besides the young, among the most affected by the crisis are also the low-skilled groups and minority ethnic groups, who are namely those threatened with going below the poverty line. Vulnerability of payments is another rigorous effect of crisis that has recently hit the Bulgarian labour market. In 2009, when unemployment had already increased, more than 30% of workers who remained employed got reduced earnings either along with reduced working hours or working the same or even longer hours[10]. Thus lower incomes from wages and salaries are a second factor for decreasing domestic consumption, increased indebtedness and growing bad loans. In addition, since the labour market reacts to positive signals relatively slowly, this channel for stimulating domestic consumption is also obviously efficient.

Unfortunately, it is expected that government measures with regard to social services will give the opposite effect in future. It is evident from the fact that African countries are not among the destinations of top investors that business is not so much attracted by the low cost of manpower as by its qualification. Moreover, the most vulnerable groups of unskilled and uneducated seem to be seriously threatened with future labour market shocks, unemployment and poverty. Any given cabinet in this situation is challenged by an environment urgently demanding reforms to put a focus on education, technologies and innovations. By spending only 4% of GDP on education[11], the conclusion assumes that reforms demand financing, whilst the lack of financing means a lack of reforms, which is unfortunately evident in Bulgaria in the field of education in the last decade.

There were also positive influences of some governmental measures towards the labour market such as a slight decrease in social security and an introduced stimulus for flexible working hours. Such a decrease, along with programmes for training and retraining, reflected the business climate and labour market. However, as a side effect there were also those 30% who were paid less, which has resulted in overall **emasculation** and in even higher growth of poverty in recent years. In addition, if one looks at the structure of incomes in the country, the trend of very low recent improvement in wages and salaries as a percentage of the total, unlike pensions (*See Table 4*), reveals threatening conclusions. Those numbers suggest a growing disparity between the two groups. Looking at demographics and the projections on future developments, it appears that the ratio of population beyond working age to those working is constantly increasing. If the current demographic trend endures, in 2060 the population between 15 and 65 years will halve, unlike those above retirement age, who are expected to even increase their number[12]. Poverty, on the other hand, puts further pressure on demographic growth and will affect reproduction processes, and respectively will compress the pension system, provoking its future indebtedness.

To add to the effects mentioned, **inflation rates** put even more pressure on household welfare. In addition to the fact that they are growing higher than incomes, increased prices will have a reflection on loan interest rates since they reflect risk in the country. Moreover, if the in-

[10] Households and Government Responses to the Great Recession in Eastern Europe and Central Asia, World Bank, 2011
[11] In comparison with the average of 18% in the EU.
[12] According to the National Statistical Institute's estimations

flation rates also continue to rise in the Euro area (2.4% in February y-o-y), the ECB is expected to increase the base interest rate from the current 1% as a lever for restricting price growth in the following months. Using it in the opposite direction from the end of 2008, when the base interest rate in the EA was cut from 4.25% to the recent stable level of 1%, poured liquidity in the financial markets that lacked it. Now the opposite effect is needed in order for the Euro area to overcome the external effects on price stability. As for Bulgaria, in currency board regime, the National Bank does not have the wherewithal to determine base interest rates, respectively – to influence inflation rates. In this case there exists a threat that if inflation continues rising along with a decrease in GDP growth, the economy will face stagflation that will further prolong the effects of the crisis. Prices in the country rose by 1.2% in February[13]. Furthermore, prices are expected to increase even more and to become higher in the following months as a result of the increase in prices of fuel and food in March, 2011. Such developments came as a result of the ongoing political crisis in Lebanon and Egypt, along with the effects of the worldwide economic crisis on global economy, such as increased indebtedness and loosened monetary policy in the largest economies. These reflect the prices of raw materials, which affect not only the retail and services sector in Bulgaria, but also the export oriented industries. The combination of measures is expected to decrease fuel prices by 5-6% of their current value. However, such a decrease will most probably not remain stable and the prices will move up again eventually due to further rises in prices on international markets. To effectively counteract such developments, only an increase in disposable incomes would compensate the effects. Such developments will most probably result in slowing the already modest economic revival in 2011. Moreover, it might further prolong the complicatedness of the labour market and maintain the gap between frozen incomes and growing prices, which is leading to further impoverishment and disparity with the other EU members. The impact of the crisis on the labour market only deepened the country's situation of ranking amongst the poorest in the EU. Such countries are by default suffering from social polarisation to the highest degree. Similarly, in Bulgaria the income distribution is rather misbalanced – 20% of the richest people receive six times more income than those 20%, who are the poorest. Since the biggest share of poorest people is accounted for by those who are unemployed, the crisis reflections pose a serious challenge to overall social wellbeing.

3.4. Public Finances and the Bulgarian Governmental Response to the Crisis.

Bulgaria ended 2009 with a deficit of 3.9%[13], which was almost 2 percent less than the average for the Euro area (-6.3% of GDP in 2009). However, remaining apart from the currency area, Bulgaria will have to cope with the threshold of 3%[14] in order to join it. Besides, the trend of its decrease is threatening, for in 2008 there was a surplus of 1.8% of GDP (*See Table 1*) which turned into a deficit beyond the Stability and Growth Pact values of reference in only a year. What is positive in comparison with the Eurozone countries is the public debt generated by the countries. While Bulgaria has shown a stable trend of decreasing consolidated public debt since 2000, preserving levels of 14.7% in 2008 and 2009, followed only by Luxembourg and Estonia,

[13] In February, 2011, according to the National Statistical Institute; measured in accordance with the national methodology.
[14] Under EU accounting rules measuring budget deficit on accrual consolidated basis (incl. expenses and revenues at the time they occur, regardless of whether they are still payable/receivable or not), differing from the Bulgarian methodology recognising deficit on a cash basis at the moment of accounting.

the average debt of the Euro area increased by approximately 10% in 2008 and 2009, reaching nearly 80%[15] and exceeding the referent Maastricht values by almost 20%. Although Bulgaria does not report dramatic deviations from the referent values, unlike countries in the Euro area like Greece and Ireland, it went downwards with regard to its previous years of fiscal discipline when intentions of joining ERM II and the Euro area seemed realistic. Furthermore, preliminary data[15] for Bulgaria in 2010 reflect a better position of public finances, not reaching the deficit of 4.8% set in the budget update in 2010. Thus, even though public finances performed better than expected, a deficit of 3.6% still exceeds the referent values of Maastricht.

Although the government tried to follow a strict course of fiscal discipline, expenditures in 2009 exceeded revenues and consolidated budget shifted from a surplus in 2008 to a deficit of 3.9% in 2009. A negative economic trend continued at the beginning of 2010, resulting in low revenues and only 5 months later the necessity of a budget update became inevitable for the first time since 1997. These changes consisted of a 20% cut in resources for government departments and EUR 70.6 million less for municipal administrations. Such measures correspond to the governmental shortening of administrative positions by 12%, since the current government came into power (summer of 2009), targeting 16% by the end of 2011. While there is still room for optimising the number of civil servants in reaching the target of 20% less administration by 2020, set by the current government, there is a need for optimising administrative procedures and their effectiveness, which would undoubtedly improve the business and investment climate in the country. Such an update was necessary in order to preserve the low tax burden in the country, unlike what other peripheral countries like Greece and Spain did with VAT. In 2010 the Bulgarian Parliament passed a law implementing a minimum threshold of the fiscal reserve at EUR 2.4 billion. It amounted to EUR 3.3 billion as of December 31, 2010, decreasing by 17.9% year-on-year. Its further contraction below the minimum threshold could endanger the currency board arrangements in the country. Then at the end of 2010, the Bulgarian Parliament approved the 2011 state budget, which set an optimistic framework of 3.6% economic growth and a budget deficit of about 2.7% of the GDP[16], barely below the 3% threshold of the EU Stability and Growth Pact.

Regarding future developments, the government is working on a National Reform Programme 2011-2015 corresponding to the Europe 2020 Strategy and the Bulgarian Convergence Programme 2011-2015. Its main goal is for the small open economy of Bulgaria to overcome the crisis, reorienting its policy towards improving competitiveness, while taking maximum advantage of its main trade partners' economic revival. For doing so there are a number of areas needing reforms. In the field of fiscal discipline from the beginning of 2011 the government has been developing a "Financial Stability Pact" aiming at long-term macroeconomic stability in the country. The three main points in it are: 1. Public sector reaching a maximum of 37% of GDP; 2. Budget position to be determined in accordance with the GDP growth and the level of public debt; 3. Direct tax policy amendments to be implemented only in the case of wide public discussion and a quorum of 2/3 MPs. Reforms are also envisaged in the fields of healthcare and education. With regard to the labour market, the government aims at improving the employment rate from 59% in the fourth quarter of 2010 to 76% in 2020 and even more – a higher productivity of labour force, which is a crucial point for the growth of incomes. Among the other priorities

[15] Ministry of Finance of Bulgaria, 2011 based on Eurostat.
[16] In accordance with Bulgarian accounting.

of the government for improving the business climate are a decrease in administrative burden and improving efficiency of administration, e-governance, R&D and infrastructure. Regarding the latter, there was a significant development of EU fund assimilation in 2010. Despite last year's significant progress in assimilation of funds, which rose to 16% in February 2011, there are still many challenges before the country to catch up to the average of 22.60% in the EU. However, in the sense of national prioritisation of an export oriented economy and attraction of investments, physical infrastructure and qualified workforce will be of crucial importance and these should be the areas of primary attention for any government in power in the near future. If one refers to a two-speed EU, these long-term goals set as Bulgarian priorities need to be followed closely, for Bulgaria still has a long way to go before catching up with the high-speed members regarding the public sector, business and households.

Table 4. Macroeconomic Indicators (2007-2010)

	2007	2008	2009	2010
GDP per capita, EUR[1]	3773	4475	4466	4787
Total Income of households [average per household, BGN]	8429	9297	9550	8775[1]
- of which (%) from wages and salaries	47.7	51.9	52.2	52[2]
- of which (%) from pensions	22.1	23.2	27.6	30.6[2]
Inflation rates (HICP), average annual growth (%)	7.6	12.0	2.5	3.0
Unemployment rate (%)	6.9	6.3	9.1	9.2
Base Interest Rate in Bulgaria (%)	3.93	5.12	2.40	0.20
Domestic consumption, annual growth (%)	7.2	2.6	-7.3	-1.1

[1]*Preliminary data for 2009 and/or 2010*
[2]*Data from the fourth quarter of 2010*

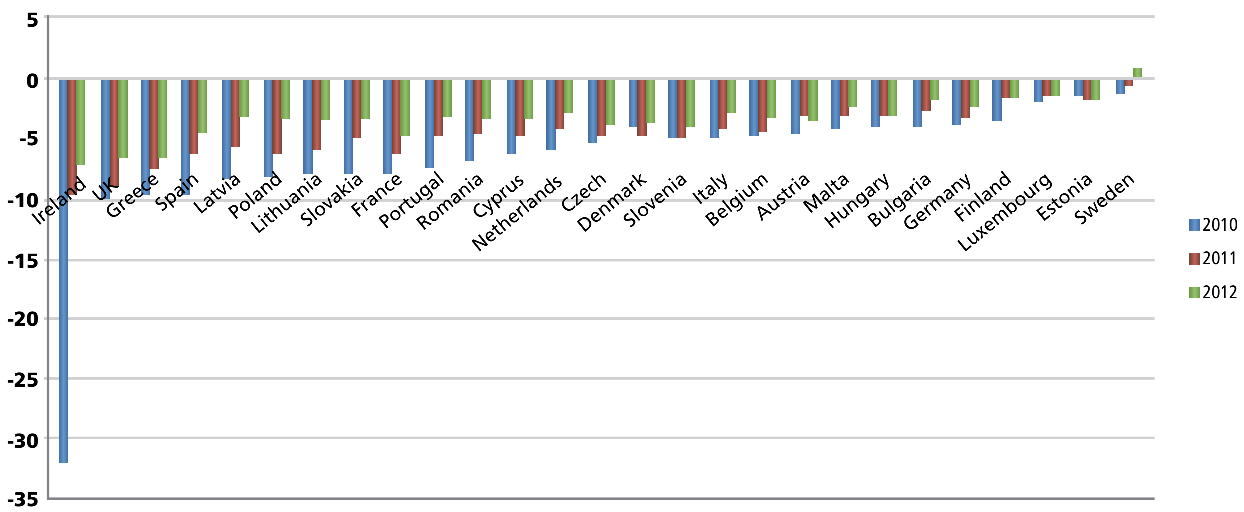
3.5. Public Finances and the Euro area's Response to the Crisis.

Among the biggest challenges for the European Union remains its two-speed development. Huge macroeconomic disparities between participant countries put additional pressure on the evident marks of crisis on the Union and its inner current area. The financial crisis transferred from beyond the Atlantic easily turned into a fiscal one. The lack of flexibility and competitiveness in some of the EU member states resulted in accumulating public debt and **budget deficits** far beyond the referent SGP thresholds. It is evident from *Graph 2* that the budget deficit record breaker from the Eurozone in 2010 is Ireland, with more than 30% of GDP, which pulls down the overall index of budget deficit in the currency zone from 6.3% in 2009 to 7.28% in 2010[17]. Governmental expectations regarding budget deficit decreased due to measures undertaken for fiscal consolidation that will take effect namely in the following 2 years (see *Graph 2*), reaching an average of

[17] Ministry of Finance of the Republic of Bulgaria – Fiscal and macroeconomic analyses, 2011

3.2% in 2012. In 2010 Ireland faces a number of difficulties, both economic and political. As a result of loosened public expenditures and accumulating a threatening debt, the government in power was punished with early elections where people voted for the opposition party to come into power. Unlike Ireland, only 3 countries remained in the limit of Stability and Growth Pact, e.g. Estonia, which left the currency board by joining the EA in 2011 preserving a deficit below 3% at the cost of painful restrictions and unpopular reforms. The extreme levels of unemployment of nearly 20% in the hardest months of severe crisis were met by a government response not in the face of turning to external financing for public expenditures, but in restrictive governmental policy and dramatic cuts, which led to the governing party winning another mandate, admission to the Eurozone and revival of the financial market trust in the country. Taking both these examples from the two opposite ends of *Graph 2* below makes the Bulgarian closer-to-Estonia position slightly optimistic. However, it is a tricky issue, since Bulgaria managed to increase public debt from surplus to below SGP threshold in only a year, at the same time postponing crucial reforms in healthcare and pension systems.

Graph 2. Budget deficit, European Union

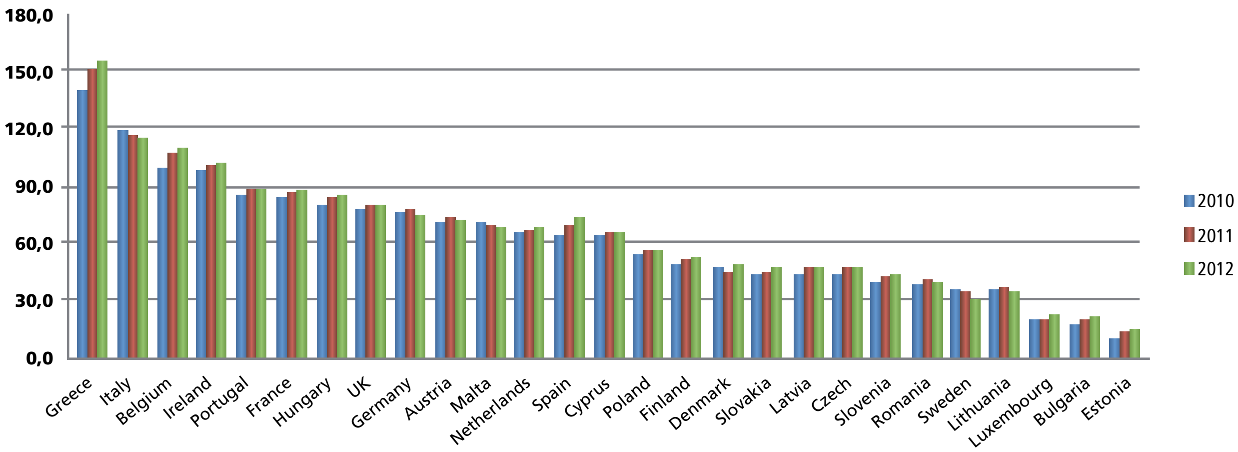


Source: Fiscal trends in the EU, Ministry of Finance of the Republic of Bulgaria report, 2011.

A long-term result of systematically accumulated budget deficits by some fiscally undisciplined Eurozone countries (*see Graph 3*) led to high average **public indebtedness** in the currency area. In 2010 the average value of that indicator reached over 73% of the GDP, while in the EU countries remaining out of it, public indebtedness was limited to the average of nearly 45%. For the above-mentioned consolidation undertaken in the Eurozone, the governmental expectations for the developments till 2012 are for an increase of nearly 9% in the countries out of the EA and preservation of close to 73% indebtedness of those in it. In a longer term a threat before restricting indebtedness in the EU will appear to be the aging population that poses hazards for pension systems in the whole of Europe. For recent years there has been an accumulated hidden debt in the pension system that will turn into an evident one when the aging process results in a rolling over population pyramid. The EC report alarms that if there is no shift in the trend and policies, by 2060 EU indebtedness will reach 500% of the GDP.

As a result of following prudent fiscal policy in recent years and despite the deficits in the last two years, Bulgaria is expected to preserve its top three positioning among countries with the lowest public debt, remaining under 20% of the GDP in the following two years.

Graph 3. Public Indebtedness, European Union



Source: Fiscal trends in the EU, Ministry of Finance of the Republic of Bulgaria report, 2011.

To counter the disproportions between Euro area members and the challenges posed by the above-described fiscal crisis for sustainable and fluent economic growth and cohesion among member states, a number of measures have been undertaken by the governing bodies of the union. These measures effectively presented bail out procedures for fiscally undisciplined countries like Greece, Ireland and Portugal, systematically breaching the Stability and Growth Pact.

After revealing a hidden deficit and debt in Greece, external market trust in the country was dramatically corrupted, throwing a shadow of mistrust on the euro currency stability. In order to prevent further developments, the European Commission at the beginning of 2010 firstly declared readiness to help Greece out of the crisis, then in April 2010 agreed on BGN 110 billion in a 3-year period. A little later a rescue package consisting of European and IMF funding was discussed. Nevertheless, the trust in peripheral countries was not revived, which provoked ECOFIN (27) to set up the Temporary Rescue Fund for the Euro area by 2013, amounting to EUR 750 billion, of which 250 billion comes from the IMF, another 60 billion from the European Commission budget and the remaining 440 billion is an installment from the Euro area countries plus Poland and Switzerland.

In the autumn of 2010, a few months after setting the European Financial Stability Fund (EFSF) in Luxembourg, despite its unwillingness, Ireland was addressed a rescue package of EUR 85 billion in return for a cut in public expenditures and an increase in taxes. Such a step was undertaken in order to prevent a further spread of fiscal crisis into other peripheral countries.

The next focus of concerns turned out to be Spain and Portugal. While Spain is so far struggling to avoid the need of external financing, Portugal fell into the trap of political crisis in March 2011. It came as a result of the fourth consecutive parliamentary rejection of a proposed plan for expenditure cuts. The country's inability to repay its debt is expected to result in a rescue package of EUR 75-80 billion.

While the crisis severely revealed weaknesses in management and consistence of the Eurozone, its leaders were discussing measures to overcome them. By replacing the temporary EFSF with European Stability Mechanism (ESM) after 2013, all 27 countries agreed upon the mechanism that will permanently exist in order to financially support Eurozone members in difficulties before repaying their public debts. Within the intergovernmental agreement providing its member countries with access to funding, they undertake certain responsibilities. Some of them regard a law to set a prohibition for accumulating debts of over 60% of the GDP, to coordinate tax bases, to tie wage and salary growth to labour productivity and the retirement age – to life expectancy. Besides the 17 Eurozone countries, Denmark, Poland, Romania, Lithuania, Latvia and Bulgaria will join the mechanism. By supporting the initiative the Bulgarian government declares its willingness to join the Eurozone.

4. Conclusion.

1. By joining the European Stability Mechanism Bulgaria undertook preliminary financial engagements of EUR 300 million, along with non-financial obligations that will further be clarified, since the mechanism will come into operation after 2013. Although Bulgarian participation will have a disciplinary effect, the financial responsibilities have already been undertaken and will become payable regardless of whether the country is a Euro area member or not. Of course, behind such a decision, motives for preserving the euro currency stability should also be seen, since Bulgaria along with Latvia and Lithuania have their national currencies bound to the euro to a different extent and any problems the common currency experiences are easily transferrable back to them.
2. New member states transfer national monetary policy on a supranational level – to the ECB. For that reason the responsibility of determining and preserving the basic interest rate (at which commercial banks receive lending from the central bank) is also transferred to the ECB. Operating in terms of a currency board regime, which recalled such functions from the Bulgarian National Bank, practically Bulgaria will not have to lose any more sovereignty by joining the EA. Thus, the effect on commercial banks will be expected in interest rates becoming more borrower-friendly. Accordingly,[18] the spread between interests on deposit and loans in Bulgaria in 2008 was 4.9% and decreased to 3.9% in 2010, while the banks in the Eurozone operate at a spread of only 1%. There are a number of reasons for such a disparity, but the main one is that the countries outside the Euro area remain risky to banks, which increases the price of monetary resource on interbank markets.
3. For Bulgaria, with a currency board regime and an exchange rate pegged to the euro, there are no instruments for obtaining a competitive advantages through the channel of exchange rates. Thus, on the one hand it is not possible to positively influence customers and domestic demand through encouraging imports at high rates of exchange. On the other hand, in a small and open economy, a possible impetus to export oriented domestic producers could be given through the underappreciated national currency. However, in terms of a currency board regime, Bulgaria gave up the tool for influencing exchange rate for encouraging export/import as early as in 1997.

[18] BNB statistics, 2011

4. There is a great deal of evidence of the success of the currency board in Bulgaria. Its original framework reveals the Bulgarian lev pegged to the euro and expropriated instruments for influencing the BGN exchange rate domestically by covering every single lev with the respective amount of euros. Thus, the Bulgarian National Bank is obligated to keep euro reserves exactly to the same amount of Bulgarian money in circulation. In that sense, the economy is daily operating with "hidden" euros, covered with an image of levs. While in the Eurozone the euros are used for settlements, in Bulgaria they remain in reserve. By really replacing BGN with euros the reserves, fluctuating around EUR 12 billion (in 2010), would become available for operating on market principles. What is more, wealth and value produced by the economy depend on its competitiveness and labour productivity and they are independent of the currency itself – it could just measure already created wealth and value. Thus, the given currency regime could place limitations on monetary and fiscal volatility, thus preventing crises like the one in 1996-1997. On the other hand, sustainable economic development is the best insurance for a stable currency regime, sound public finances and a stable currency, which are crucial for a small and open economy like that of Bulgaria.
5. There is a general understanding and belief that, in the process of replacing the Bulgarian lev, inflation will rise due to the so-called "rounding up" effect. However, previous experience shows that in countries like Slovakia, which joined the Euro area in 2008, there was a minimal inflation of 0.2% due to currency replacement. The rounding up effect was partially avoided through obliging merchandisers to publish prices both in the national currency and euro 6 months prior to 2008. Moreover, such a rounding up effect could possibly appear once, at the moment of replacement and could not affect the economy in the longer term. In the case of stable incomes growing in parallel or even anticipating a rise in prices and a well-informed society, a higher inflation trend may even not appear.
6. The arguments used by the Czech Republic, for example, for staying out of the "troubled waters" of the indebted Eurozone do not have stable grounds for Bulgaria, since passively following the currency area policies via a currency board makes the Bulgarian lev strongly dependent on the processes of the Euro area itself. Thus, in terms of internal or external shocks in the zone, Bulgaria is already involved in them regardless whether it is in it or not.
7. Bulgarian financial markets are paying a risk premium that appreciably increases the price of financial resources for funding both personal and business endeavours. This makes investors rather cautious about their decisions to invest in Bulgaria. Nevertheless the currency board regime sends positive signals of stability, thus attracting savings and foreign inflows that provide money liquidity, possible membership in the Euro area could only increase the external perception of stability in the country. By the time Bulgaria fits in the currency club, the trust of financial markets will increase like it did in Estonia, for example, where it resulted in future investment flows, lowering financial resource prices and overall revival.

Even in 1997 the Bulgarian government had no other option but to adopt the currency board regime in order to overcome hyperinflation and uncontrolled public indebtedness. Back then the country ceased active implementation of monetary policy and transferred the control instruments at a supranational level by pegging the BGN to the German mark/euro. By this act, aiming to import stability, the country exported monetary policy to automatic stabilisers implemented in the currency board rules, while closely following the monetary policy of the Eurozone after its formation. Already having the Bulgarian lev pegged to the euro via a currency board, most of the negatives have already been experienced. The good news is that, by transition from a currency board regime to the Euro area regime, Bulgaria will not experience as dramatic a shift as could be unavoidable for a country without a currency board. In fact, such a transition could only strengthen the present regime, releasing more space for economic development and leaving limited political options for internally provoked crises. The bad news is that Bulgaria will need to prepare for the transition and will have to prepare fast in order to be able to take advantage of the available benefits and to prevent future threats posed by hidden indebtedness of the pension system and prolonged reforms. The crisis proved the obvious fact that a GDP decrease leads to a decline in inflation. However, it will not be enough impetus to encourage Bulgaria to join the Eurozone. The challenges towards reasonable public spending and strong political will remain for the better long-term perspective of the country to make further steps in joining the Euro area.

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