



## Bulgaria's Aspirations for eurozone Membership

Jakub Pieńkowski

*Bulgaria has declared its intent to join the eurozone. On 22 August, the Bulgarian government approved a plan of preparations for ERM II and banking union membership. However, eurozone countries and institutions are cautious about Bulgaria's ability to adopt the euro in the near term. Although in July they accepted Bulgaria's application to ERM II, they did so on the condition the country also join the banking union simultaneously. The accession of Bulgaria to the eurozone should not be expected soon but its participation in both mechanisms will strengthen its position in the discussion of post-Brexit EU reform.*

**Decision to Join the Eurozone.** Bulgaria's European policy is to participate in closer EU integration. The Boyko Borisov government has begun efforts to enter the eurozone, in part because it may develop into the integration core and countries without the euro may be marginalised. This effect would be more severe if a separate, large budget for the eurozone is created because it would probably reduce the structural funds allocated to non-zone states. That in turn would slow down the Bulgarian economy, which relies on these funds for about 3% of its GDP. Adoption of the euro also would save around €450 million in transaction costs, boosting GDP by an additional 1%. That is why in June, Minister of Finance Vladislav Goranov and the president of the Bulgarian National Bank, Dimitar Radev, applied on behalf of Bulgaria for ERM II membership, a mechanism confirming an economy's ability to maintain national currency stability. Borisov declared that with a year of technical preparations and two years of obligatory ERM II membership, Bulgaria could adopt the euro as early as in 2022.

Joining the eurozone has not been politically contentious in Bulgaria. President Rumen Radev has recognised it as a strategic choice, although he also states worries about prices rising faster than salaries, which initially would lower Bulgarians' standard of living. Adoption of the euro is promoted by the Borisov's party, Citizens for the European Development of Bulgaria (GERB). On the other hand, the co-ruling United Patriots—an alliance of three nationalist and Eurosceptic parties—declared its members are reluctant to accept the euro, but they have remained passive in this matter because in the coalition agreement they accepted closer integration of the EU as the government's priority. The adoption of the common currency is supported by the opposition Movement for Rights and Freedoms, home to many Bulgarian Turks, and the Eurosceptic Volya, a party under prominent businessman-politician Veselin Mereshki. The largest opposition group, the Bulgarian Socialist Party, supports the adoption of the euro, but in July, its president, Korneliya Ninova, called for rethinking this position. The non-parliamentary Revival party has tried to mobilise Bulgarians against taking on the common currency by collecting 220,000 signatures calling for a referendum on euro adoption.

The Bulgarian public lacks information or is confused about the euro, as visible in the survey conducted in June by the Open Society Institute. Of all respondents, 42% support joining the eurozone and 25% are against. Paradoxically, 56% do not want the Bulgarian lev to be replaced by the euro while 22% hold other opinion. The survey also shows that 45% of those who want Bulgaria to enter the eurozone are against euro adoption.

**Can Bulgaria Meet the Criteria?** According to The Convergence Report published earlier this year by the European Central Bank (ECB), Bulgaria now meets four of the five criteria to adopt the euro. The state budget recorded a 0.9% surplus against an acceptable 3% deficit. Its public debt was among the lowest in the EU,

amounting to 25.4%, so well within the 60% reference. Long-term interest rates were 1.4%, inside the 3.2% threshold. Annual inflation was 1.4%, below the reference level of 1.9%. However, the ECB assesses the country's expected growth as a "serious problem". In 2016, Bulgaria had 1% deflation. Inflation is boosted by economic growth, which the European Commission (EC) expected to reach 3.8% in 2018. The only criterion Bulgaria has not met is participation in ERM II, a mechanism of a minimum of two years' limiting fluctuations in the national currency against the euro to  $\pm 15\%$ . In fact, Bulgaria has operated within more stringent parameters; in 1997, the lev exchange rate was fixed to the German mark and then the euro. Entering ERM II would make Bulgaria's situation more comfortable because in the case of rapid pressure on the lev exchange rate, not only the Bulgarian National Bank but also the ECB would intervene.

Bulgaria declared its intention to join ERM II in 2017. However, the Borisov government suggested that it would ask formally for membership only if it would obtain certainty that the application will be supported by the ECB, the eurozone countries, Denmark (as an ERM II member), and their central banks. Although Bulgaria was supported by German Chancellor Angela Merkel, the president of the German Federal Bank was sceptical. President Emmanuel Macron announced support for Bulgaria but also signalled prolongation of the accession conditions.

**Difficulties on the Way to the Euro.** After the Greek financial crisis, doubts appeared in the eurozone about the "sustainable convergence" of Bulgaria. This was confirmed by EU Commissioner for Economic and Financial Affairs Pierre Moscovici, who pointed out that besides the formal criteria, "economic convergence" is also necessary. Bulgaria is the poorest state in the EU: in 2017, its nominal GDP per capita was only about 25% of the EU average, and in purchasing power parity (PPP), around 55%. Commissioner for the Euro and Social Dialogue Valdis Dombrovskis noted that a country's prosperity cannot be a criterion for euro adoption, but some eurozone countries—among them, Austria and the Netherlands—have pushed for a criterion of 70% of the EU average (PPP).

The stability of the Bulgaria's financial sector and the quality of supervision of it have led to doubts in eurozone states and institutions. This could be confirmed by the ineffectiveness of the state authorities in the face of the bankruptcy of the fourth-largest bank, Corporate Commercial Bank, in 2014 and major insurer Olympic Insurance in 2018. According to the International Monetary Fund, in 2016, about 12.5% of loans in Bulgaria were at risk when the EU average was 5 1%.

This past spring, the ECB and the eurozone states agreed to accept Bulgaria's application to ERM II on the condition of simultaneous accession to the banking union. Before then, a state's entry to the banking union became a requirement only at the moment of euro adoption. In July, Bulgaria accepted the condition and declared its intent to join both by July 2019. Under the banking union, the ECB will be able to directly control the liquidity of the three largest banks in Bulgaria, and, if necessary, all banks. However, the effectiveness of the Single Supervisory Mechanism, used to monitor the banks, depends on national supervisory systems while the Single Resolution Mechanism, used to manage problems with banks, relies on state courts. Bulgarian institutions, however, are inefficient and the country's financial laws have important gaps. This is confirmed by the Cooperation and Verification Mechanism (CVM) established by the EC in 2007 at the moment of Bulgaria's EU accession to support the independence of its judiciary and fight against corruption and organised crime. The EC planned CVM to last three years but it is still in place because the Bulgarian authorities have not introduced the necessary reforms. Although termination of CVM is not a formal condition for joining the banking union or ERM II, the EC clearly recognized Bulgaria's progress (or lack thereof) as an important criterion in assessing its ability to maintain "sustainable convergence". In August this year, Bulgaria asked the ECB to establish Closer Cooperation, a mechanism to control preparations for ERM II, and presented a package of legislative changes, including strengthening financial supervision and the independence of the Bulgarian National Bank.

**Conclusions.** because of Bulgaria's low level of economic development and the weakness of its state institutions, its announcement of euro introduction as early as 2022 may be too optimistic. At the same time, entering ERM II by July 2019 is a real prospect, thanks to the lev's fixed exchange rate. As an ERM II member, Bulgaria's economic stability should increase because, in case of a crisis, it would be supported by the ECB. This will also strengthen its credibility with financial markets, which would facilitate additional capital and foreign direct investment. As a country preparing to adopt the euro, Bulgaria also could better secure its interests during the negotiations on the new 2021-2027 EU budget. If Bulgaria adopts the euro, that would further reduce the number of EU members without the single currency and, in turn, limit the opportunities for Poland, which has postponed euro adoption indefinitely for now, to build a coalition to defend the interests of countries outside the eurozone.

The condition of ERM II membership with entry to the banking union is a new condition that goes beyond formal macroeconomic criteria. This may be a sign of a gradual, ad-hoc tightening of requirements by eurozone countries on candidate countries. This probably will strengthen the economic stability of the eurozone itself but could also set a precedent for changing the rules of accession to other integration mechanisms, which is unfavourable for Poland as it seeks to limit the EU's division into various speeds of integration.