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Should Bulgaria join the euro now?

Why being a Maastricht model student isn't enough

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The answer is: no – not yet. While the Bulgarian case for joining the euro seems compelling on first sight, neither Sofia nor Brussels should jump the gun now. Not only does Bulgaria still lack the institutional capacity to be a reliable member of the club; it would also lose important degrees of freedom to foster growth and deal with crises at home. This Blog Post argues that the Maastricht criteria may be a necessary, but by no means a sufficient condition for stable euro membership. Bulgaria's accession should be based on prudence, rather than precipitation.

1 Introduction

When it comes to the prospect of his country joining the euro, Bulgarian Prime Minister Boyko Borissov has a clear position: “We have done our homework for the Eurozone. [...] Any moment they invite us, **we can enter in**”, [Mr. Borissov stated](#) in January. Commission President Jean-Claude Juncker backs Mr. Borissov’s cause. In his 2017 State of the Union address, Mr. Juncker argued that “all member states that want to join the euro must be able to do so.” Looking at Bulgaria in particular, he added in January this year: “I have to say bluntly that [Bulgaria is ready](#).”

The question when Bulgaria can and should join the euro is about more than one country. It is about whether the criteria we apply today to measure a country’s readiness to join the single currency are still the right ones given the lessons of the crisis. And more fundamentally, it is about finding the right balance between deepening and enlarging the currency union. The euro crisis has taught us two important lessons: first, that **meeting the Maastricht criteria is a necessary, but by no means a sufficient condition** for a country to be a reliable member of the common currency; second, that adopting the euro as fast as possible might not always be in a country’s own best interest.

On first sight, the Bulgarian case seems compelling. The country formally meets the convergence criteria set out in the Treaties, its public finances outperform those of most euro-area member states, and its currency, the Lev, has been pegged to the euro since 1999 (and before that, to the German Mark) by way of a currency board.

However, neither Sofia nor Brussels should jump the gun now – it would be too early for Bulgaria to join. This is because the country lacks the institutional capacity to be a reliable member of the club, in particular at a moment when the process of EMU deepening is still incomplete and banking union is still in its infancy. Also, it might even be in Bulgaria’s own interest to continue to develop its economy without having to take into account all the constraints of euro membership too early. The crisis lesson should not be forgotten: Being a euro member in good times is easy. But being a member in crisis times simply means there are fewer degrees of freedom to deal with a crisis.

Hence, **grounding Bulgaria’s accession process on prudence rather than precipitation** would mean both sides can seize the opportunity to show that they have learned from the challenges of the past and at the same time optimize economic benefits.

2 A model student?

The case of Bulgaria's recent push to join the euro rests largely on its strong performance with regard to the **Maastricht criteria**. Agreed upon by member states in Maastricht in 1991, the so-called convergence criteria provide a set of economic benchmarks designed to ensure sufficient economic convergence before entering the Eurozone.

In spite of recent crisis experiences, these rules have remained **essentially unchanged** ever since the inception of the euro in 1999. They still consist of five economic indicators: price stability, soundness and sustainability of public finances, durability of convergence and exchange rate stability (see Table 1 for details). In addition, candidate countries must additionally bring their national legislation in line with the EU legal *acquis* on central bank rules.

Table 1: Euro convergence (Maastricht) criteria

What is measured	Price Stability	Soundness of public finances	Durability of convergence	Sustainability of public finances	Exchange rate sustainability																		
How it is measured	Consumer Price Inflation rate	Government deficit as % of GDP	Long-term interest rates	Government debt as % of GDP	Deviation from Exchange Rate Mechanism rate																		
Reference value	Not higher than 1.5 pp above three best-performing (i.e. lowest-ranking) Member States	Not more than 3%	Not higher than 2 pp above average of 3 best-performing Member States	Not more than 60%	Taking part in ERM II for two years without deviating more than 15 %																		
Bulgarian performance on euro area convergence criteria	<table border="1"> <caption>Bulgarian performance on euro area convergence criteria</caption> <thead> <tr> <th>Indicator</th> <th>Bulgaria</th> <th>Reference value</th> </tr> </thead> <tbody> <tr> <td>Inflation in %</td> <td>1.32</td> <td>1.5</td> </tr> <tr> <td>Govt. deficit (% GDP)</td> <td>0</td> <td>3</td> </tr> <tr> <td>10y government bond yield</td> <td>1.47</td> <td>2</td> </tr> </tbody> </table>			Indicator	Bulgaria	Reference value	Inflation in %	1.32	1.5	Govt. deficit (% GDP)	0	3	10y government bond yield	1.47	2	<table border="1"> <caption>Bulgarian government debt as % of GDP</caption> <thead> <tr> <th>Indicator</th> <th>Bulgaria</th> <th>Reference value</th> </tr> </thead> <tbody> <tr> <td>Govt. debt (% GDP)</td> <td>25.6</td> <td>60</td> </tr> </tbody> </table>		Indicator	Bulgaria	Reference value	Govt. debt (% GDP)	25.6	60
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Note: Source: Eurostat, ECB and own calculations. Data for debt as of Q3 2017, for deficit for 2016. Data for inflation and interest rates reflect one-year average 3/2017-2/2018.

Measured solely against this check list, Bulgaria indeed appears to be a **model student** for joining the euro (see Table 1). With a consumer inflation rate of 1.32% over the last twelve months, it

remained far below the current assumed reference value of about 2%. Government finances are in good shape as well: at about 25.6%, public debt was below half the required 60% of GDP in Q3 2017; and in 2016, the government remained well above the deficit limit of 3% and even ran a balanced budget. Regarding long-term convergence as measured in government bond interest rates, Bulgaria also stayed below the assumed threshold for its ten-year government bond yield over the last twelve months.

At the same time, even if its imbalances are no longer labelled as excessive, Bulgaria remains very much in the scope of the Commission as part of the Macroeconomic Imbalance Procedure (MIP). It continues to experience imbalances and major vulnerabilities, in particular in the financial sector. Alas, **compliance with the reformed governance framework, and that include the MIP, is not a criterion** for joining the euro as the criteria predate the post-crisis reforms.

3 The Maastricht criteria: Necessary but not sufficient

The sovereign debt crisis has clearly revealed one thing: the existing convergence criteria may be **necessary, but not sufficient conditions** to assess a country's readiness to become part of the euro. While the Maastricht criteria remain key measures of macroeconomic readiness, the last decade has clearly highlighted their limitations in other respects. With Portugal, Spain and Ireland, the Eurozone already witnessed three former Maastricht model students falter for reasons not covered by the current convergence criteria. In fact, **there are many factors for which a country might face severe difficulties inside the euro area in spite of meeting the Maastricht criteria.** They range from low factor mobility to a strong domestic bias in the financial sector and an overall buildup of imbalances in the Eurozone.

In the case of Bulgaria, the main issue remains **institutional readiness.** A concept that goes far beyond the current formal requirements on central bank independence, it is best explained by looking at one of the euro area's most important post-crisis remedies: the **banking union.** Being part of banking union means being part of a common system of supervision and ultimately resolution of banks. For this to work, European supervision and resolution authorities need to be able to rely on national judicial systems to do their job in issuing rulings, e.g. to draw on collateral or to settle disputes over non-performing loans. In a situation where the judicial system does not work, a bank could risk going into resolution because it cannot work out non-performing loans at a fast-enough speed, then relying on the Single Resolution Fund for support.

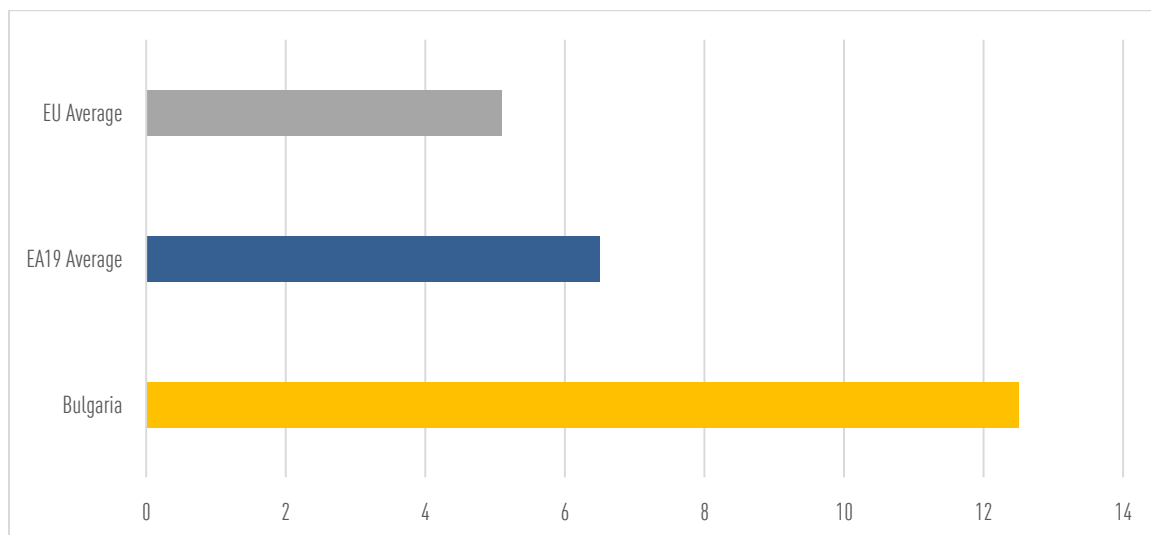
This is not a tenable situation, in particular because the banking union is still only at an infant stage and deepening EMU is nowhere near completion. In this situation more than ever, **institutional quality is not only a question of mere efficiency and effectiveness but one of the fundamental functioning and credibility** of the system. When domestic institutions

fail to deliver their part of the bargain, the reputation and operation of the system as a whole is at stake. The recent turmoil surrounding the Latvian bank ABLV is an acute reminder of this danger.

For the time being, there is ample reason to reconsider Bulgaria's readiness in this respect. Not only does the country still feature the highest level of corruption in Europe according to [Transparency International](#). More than that, ever since joining the EU in 2007, Bulgaria has been and still is covered by the [Cooperation and Verification Mechanism](#) (CVM), a surveillance procedure in which the Commission evaluates the state of legal institutions and the rule of law in Bulgaria and Romania. Ten years into the procedure, Bulgaria has so far not been able to meet any of the six benchmarks set by the mechanism. In its [conclusions on the latest CVM report](#) in December 2017, the EU Council lamented that “[w]orkload imbalances between courts remain a major challenge” and urged Bulgaria to build a “track record of impartial and professional decision-making”.

Such findings are worrying, especially in light of the fact that, at a level of 12.5 %, the level of non-performing loans in Bulgaria still remained well above the EU average of 5.1 % in December 2016. In 2017, the [IMF](#) confirmed that NPL levels in Bulgaria remain elevated, and recommended the country a strengthened supervisory review process.

Figure 1: NPLs as a percentage of total loans (Dec. 2016).



Source: European Commission.

Hence, in sum it does not seem to be a good idea from the perspective of the European partners to let Bulgaria join the euro for now as long as questions of institutional quality are not addressed.

4 Prudence, not precipitation

Then again, the same can be said from the perspective of Bulgaria. It is still the poorest country in the European Union; its GDP per capita is half of that of the poorest Eurozone member, Latvia. In light of this, and while its prudent fiscal policy is commendable, it seems pretty clear that keeping debt and deficit levels low should not be Bulgaria's primary concern. **Instead, it would arguably be best to invest in catching up with the rest of the European Union.** This is particularly true when considering that a number of Member States suffered from unsustainable booms induced by a sudden drop in interest rates after their euro adoption rather than featuring a steady and sustainable catch-up growth before finally joining the euro.

Today, Bulgaria is already well-positioned to achieve this type of prudent convergence. It already enjoys the monetary stability provided by the currency board – but is not yet subject to the much stricter governance framework applicable to euro-area members. This is all the more true when it comes to the Stability and Growth Pact, where potential sanctions have a different bite within than outside the Eurozone. Bulgaria should use this opportunity rather than constrain itself too early.

Even more importantly, one should not underestimate **the politics of a potential crisis** in Bulgaria. As pointed out above, the Commission still classifies the country as experiencing imbalances with vulnerabilities in particular in the financial sector. As a non-euro area member, **Bulgaria still has access to the EU's so-called [Balance of Payments facility](#).** This program – which is firmly established in EU law, has a relatively lean decision-making structure, and is administered by the Commission – could provide Sofia with swift and well-proven assistance in case it risks losing market access for whatever reason.

Access to this facility would be politically easy for Bulgaria in case of a crisis. By contrast, **accessing an ESM program in case of need is a huge political challenge** and comes with heavy policy constraints and with considerable public scrutiny from other Member States. Case in point: Almost no one outside the immediate Brussels bubble will recall the discussions around the three most recent cases the facility was used, namely Latvia (2008), Romania (2009), and Hungary (2010).

5 Conclusion

All this suggests that **it would neither be in Bulgaria's own interest to already pass the point-of-no-return of joining the euro, nor would it be a good idea from the perspective of its European partners.**

But there is a scenario in which Europe can give Bulgaria a piece of what the country would get out of joining the euro, namely turning the currency board into a permanent arrangement. For example, the EU could reaffirm its commitment to use the BoP facility to its fullest extent in times of crisis – and could at the same time make clear that any change to the existing monetary arrangements would only be an option of last resort for BoP programs.

As a first step towards euro adoption, Bulgaria could then enter a close-cooperation arrangement with the ECB to join the banking union once its institutional quality has improved sufficiently and it has left the CVM. This could be a trial phase in parallel to entering the ERM to see whether the country is really fit to join the euro for good.

At the same time, we should think about **adapting the convergence criteria to the new post-crisis reality**. Institutional readiness should be as important as economic convergence because joining the euro means joining banking union. Another obvious criterion would be compliance with the reformed governance framework, in particular a clean record under the MIP. Such an update will take time. In the meantime, we should not repeat the mistakes of the past.

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