

**THE EURO AREA MEMBERSHIP OF BULGARIA
IN THE CONTEXT OF THE DEBT CRISIS**

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ABSTRACT

This paper analyzes the perspectives of a Euro area membership for Bulgaria by systematizing the reasons for the debt crisis and by reviewing the macroeconomic specificity of Bulgaria. The focus of investigation is on institutional and structural causes of the crisis. Recommendations are made on possible crisis-exit strategies and on the macroeconomic policies Bulgaria should pursue on its way to the adoption of the Euro.

Key words: Euro area debt crisis, structural and institutional reasons, Bulgaria, macroeconomic policy

JEL: E44, F34

INTRODUCTION

The objective of the present article is to outline the chances and threats to Bulgaria arising from a future Euro area membership by analyzing the institutional and structural causes of the debt crisis and the macroeconomic peculiarities of Bulgaria.

The institutional and structural reasons for the crisis can be summarized as follows:

1. Optimum currency area (OCA) criteria not fulfilled by the Euro area (EA);
2. Flaws in the Stability and Growth Pact (SGP);
3. Weaknesses in the institutional arrangement and policy of the European system of central banks (ESCB);
4. Lack of an EA exit procedure;
5. Lack of EA financial stability architecture before the debt crisis and imperfections in the financial stability architecture created in response to the crisis;
6. Fundamental macroeconomic imbalances between the core and the periphery of the EA and behavior of public and private sector in EAMS.

The macroeconomic specificity of Bulgaria is related to the type of the exchange rate regime (currency board arrangement) and to structural imbalances similar to those in the Euro area periphery.

Sections from 1 to 6 systematize the causes of the EA debt crisis. Section 7 reveals the macroeconomic features of Bulgaria and analyzes the perspectives of Bulgarian membership in the EA in the context of the EA debt crisis. Section 8 draws conclusions.

1 Optimum currency area (OCA) criteria not fulfilled by the Euro area (EA)

The OCA theory adds a new area to the map of integration – the monetary policy. The contribution of the OCA theory to the development of international economic integration is vital because the concept of integration union as a single market with free-moving factors of production, coordinated national policies and supranational regulation is enriched with a new element – a single currency.

An OCA is a territory where for a number of reasons it is beneficial to use fixed exchange rates or equivalently, a single currency. The OCA theory provides the rationale for establishing the most advanced form of economic integration – the monetary union.

The OCA theory has been developed by Mundell, Mc Kinnon, Kenen and others.¹ Mundell defines the optimum currency area as a territory with mobile factors of production. Mc Kinnon adds to the OCA criteria the openness of the economies of participating countries. Kenen proposes as an OCA criterion the production diversification of the economies in a monetary union. Ingram sets as an OCA criterion the high integration of financial trade. If members of a currency union are highly integrated in terms of financial trade, then capital flows may smooth temporary asymmetric shocks.² In the course of time additional OCA criteria have been invented such as similar business cycles of member countries, coordination of their fiscal policy etc.

The OCA criteria may be divided into economic and political. Economic criteria are those proposed by Mundell, Mc Kinnon, Kenen and Ingram, as well as business cycle similarity of member states. Political criteria are fiscal transfers, homogeneity of preferences and solidarity.

The OCA criteria may be systematized as follows:

- **Criterion of Mundell: mobility of production factors.** An OCA is a territory with high internal and low external mobility of production factors. High internal mobility of production factors compensates for the loss of a flexible exchange rate as an absorber of external shock. Usually labor is highly mobile within a country and relatively immobile across national borders. Mobility of financial capital is high, but mobility of physical capital is low. Production specialization of national economies strongly affects production factor mobility.
- **Kenen criterion: high diversification and similar structure of production and exports.** Countries with highly diversified and similarly structured production and exports form an OCA. This criterion concerns the symmetry of economic shocks. In countries with highly diversified and similar structure of production and exports economic shocks tend to be symmetric (different industries respond to the shocks in similar ways). Highly diversified economies are better candidates for a monetary union membership than low-diversified ones since diversification provides insulation against external shocks.
- **Criterion of McKinnon: high openness of economy.** Countries, which are highly open to trade and trade intensively with each other, form an OCA. It is important to distinguish between tradables and non-tradables. The prices of tradables are set in the global market and small economies cannot affect them, therefore exchange rate does not influence competitiveness. The relative price of national to foreign goods is the same in all currencies. If all goods are tradable, the prices of national goods are flexible and exchange rate does not influence competitiveness. The more open the economy, the lower the

¹ Mundell, R., A Theory of Optimal Currency areas, *American Economic Review*, vol. 51, 1961, p.509-517; Mc Kinnon, R., Optimum Currency Area, *American Economic Review*, 1963, vol. 53, p.717-725; Kenen, P., The Theory of Optimum Currency Areas: An Eclectic View, In: Mundell, R., A. Swoboda, *Monetary problems in International Economy*, University of Chicago, 1969

² Kawai, M. (1987): Optimum Currency Area. In: *Eatwell, J. - Milgate, M. - Newman, P. (eds.): The New Palgrave A Dictionary of Economics*, The Macmillan Press, 1987.

significance of exchange rate for competitiveness. Highly integrated goods markets and similar production structures suggest that shocks are symmetric and the need for exchange rate adjustment decreases.

- **Criterion of Ingram: high integration of financial trade.** If countries are highly integrated in financial trade, capital movements can mitigate temporary asymmetric shocks. There is a long-term wealth effect caused by capital flows.
- **Fiscal transfer criterion.** Countries, which have agreed to compensate each other for adverse shocks, form an OCA. Fiscal transfers can mitigate the effects of asymmetric shocks.
- **Criterion of homogenous preferences.** Countries participating in a monetary union must have reached an agreement on how economic shocks should be responded to. Political consensus is needed on how to stabilize economy, how to use fiscal and monetary policy etc.
- **Solidarity criterion:** when occasionally common monetary policy contradicts the interest of some members of a monetary union, they have to accept this situation for the sake of the whole union. An important condition of monetary integration is the presence of political will to integrate. In cases of asymmetric shocks the interests of some nation and regions may be conflicting. Member states must contribute to the common well-being of the monetary union and not allow nationalism to jeopardize its existence.

The essence of the OCA theory is to internalize external economic shocks in a currency union in order to improve their management and minimize their detrimental effects on participant countries. The OCA theory has a neo-Keynesian origin. The Philips curve, which is down-sloping (reverse) and stable in the long term, is a serious problem for the Optimum currency area theory. Since the OCA theory attempts to find the optimal number of currencies in a region it is difficult to apply it in practice and results from empirical investigations based on OCA theory require careful and cautious interpretation. Other foibles of the OCA theory are the considerable number of criteria (since sometimes the different criteria may produce contradictory results) and the difficulty to quantify these criteria. Merits of the OCA theory are the possibilities to use graphic presentation and panel data.

The OCA theory may be used to assess whether a certain country or a group of countries would benefit from participation in a monetary union.

The OCA theory provides a number of indicators whose values for a group of economies affect the assessment whether these economies would benefit from a common currency. Since the number of indicators is considerable, attempts have been made to create an aggregate indicator called an OCA index.³ Two countries form an OCA if their bilateral real exchange rate is stable in the middle and in the long term. The bigger the middle-term and long-term pressure on bilateral real exchange rate, the more difficult is the adjustment without a flexible nominal exchange rate. The higher the OCA index value, the less appropriate is the formation of a currency union, because bilateral real exchange rate is volatile in the middle and in the long term.

³ Bayoumi, T., Eichengreen, B. (1997): Ever closer to heaven: An optimum-currency-area index for European countries. *European Economic Review*, 41, 761–770; Bayoumi, T., Eichengreen, B. (1997) Optimum currency areas and exchange rate volatility: Theory and evidence compared. In Cohen, B.J. (ed.): *International Trade and Finance New Frontiers for Research: Essays in Honor of Peter Kenen*. Cambridge University Press; Horváth, R. (2007): Ready for euro? Evidence on EU new member states. *Applied Economics Letters*, 14 (14), 1083-1086 etc.

OCA indices have certain disadvantages – they use simplified empirical methods and do not comprise all OCA indicators. Although they are well theoretically constructed, OCA indices cannot always explain decisions to form or enter a monetary union. These decisions may be influenced by many factors, including political considerations. The OCA theory is merely one of a number of factors that affect the choice of an exchange rate regime.

Whether the EA meets the OCA criteria is a matter of extreme importance for a number of reasons. On one hand, the monetary union has intensified trade and financial integration among Euro area member states (EAMS).⁴ On the other hand, it is open for discussion whether EAMS inflexible labor markets will allow smooth adjustment in case of a big asymmetric shock or a financial crisis. The European monetary union may prove to increase asymmetric shocks instead of decreasing them since the existence of a common nominal interest rate automatically leads to diverging real interest rates in EAMS due to different inflation rates.

Our review of theoretical and empirical literature shows that the EA is far from an OCA. The criteria of Kenen, McKinnon and Ingram are satisfied. However, the criteria of labor mobility and fiscal transfers are not covered, while the criteria of homogenous preferences and solidarity are still under question.

At present the European Union has a restricted fiscal competence. Public finance is governed mainly at national level, while the Union is in charge of regional funds, agricultural subsidies and administrative costs covered by member states' contributions. The launch of the monetary union in 1999 did not influence the distribution of fiscal power between the different levels of government, though a single currency suggests a supranational fiscal arrangement. In the lack of a single EU fiscal authority the Union-level fiscal policy is implemented by sluggish and ineffective public finance agreements involving different governance levels.

In spite of the inefficient arrangement of fiscal policy matters at the Union level, establishing a supranational fiscal structure has always been a bone of contention among politicians and researchers. Although the EMU institutional structure has been strongly criticized, a consensus about the creation and the parameters of a supranational fiscal authority has never been reached.⁵ While some researchers support fiscal integration,⁶ others oppose it.⁷ The main obstacle for fiscal integration is the reluctance of national states to transmit fiscal power to the EU level.

In our view, a supranational fiscal authority should establish and run a supranational fiscal transfer system. Members of the monetary union struck by an asymmetric shock ought to receive money from non-affected member countries. Such transfers would mitigate both a recession in a recipient country and an inflationary boom in donor country. Because shocks tend to be random, each country may find itself in the roles of both a provider and a receiver of funds. A Euro area fiscal transfer system would work like a common insurance against shocks for all EAMS.

In the absence of a supranational fiscal authority the fiscal policy coordination of member countries is crucial to the fate of a monetary union.

⁴ Lane P. (2006) "The real effects of EMU", American Economic Association AEA 2006 Conference paper, January.

⁵ Oates, W., 2001, Fiscal competition and European Union: contrasting perspectives, *Regional Science and Urban Economics* 31, 133-145.

⁶ Tabellini, G., 2003, Principles of policymaking in the European Union: An economic perspective, *CESifo Economic Studies*, 49, 1, 75-102.

⁷ Alesina, AL. and R. Wacziarg, 1999, Is Europe going too far? Carnegie-Rochester Conference volume, supplement *Journal of Monetary Economics*, December, 1-42.

2 Flaws in the Stability and Growth Pact (SGP)

The SPG is supposed to counteract the deficit bias and decrease the probability of a debt default in the EA. However, the Pact has several foibles:

- National governments often use the SPG to justify unpopular austerity measures. This may work in the short term, but in the long term it carries the risk of undermining the support for European integration, especially if fines are imposed.
- The SPG is often disregarded by different EAMS because the procedures for imposing penalties are sluggish and ineffective.
- The 3% limit for the deficit/GDP ratio is artificial and difficult to justify, especially in cases of economic difficulties.⁸
- The SPG restricts the counter-cyclical functions of fiscal policy (automatic stabilizers and discretion) if a national budget is not in the balance or surplus zone.
- The Pact does not require that during economic upturns governments build a safety buffer for bad times by accumulating surpluses.
- The SPG concentrates on setting low limits for budget deficit and sovereign debt but does not stimulate the reduction of a surplus or the acceptance of a deficit when it is necessary to do so.

The SPG flaws may be overcome by setting limits not for the actual budgets but for cyclically adjusted ones or by targeting public debt in the medium term instead of targeting annual budgets.

3 Weaknesses in the institutional arrangement and policy of the European system of central banks (ESCB)

The Maastricht Treaty vaguely and ambiguously states that the primary objective of the ESCB is to maintain price stability. Other important goals such as growth and employment are disregarded at the expense of low inflation. It is not surprising then that since the launch of EA debt crisis the ECB has not acted convincingly enough and with all resources at its disposal to calm the financial markets. The ECB has so far been persisting in its inflation targeting policy risking the breakup of the Eurozone and the creation of immense social and economic disparities.

The ECB should have taken the responsibility from the very beginning of the crisis to do what is required to stabilize the government bonds' secondary markets and prevent liquidity problems from becoming a solvency crisis. Precious time to intervene has been wasted in a sluggish process of negotiating bail-outs.

Too late, in 2011 the ECB bought substantial amounts of government bond, finally taking on the role of a lender of last resort. However, this isolated action will hardly be enough to restore market confidence. Extensive purchases of government bonds in the secondary markets are required to stabilize the market.

⁸ The 3% limit is based on the following assumptions: public debt/GDP ratio of 60%, nominal GDP growth of 5%, and inflation rate of 2% and real GDP growth of 3%.

4 Lack of an EA exit procedure

The decision to establish a monetary union without an exit procedure carries huge risks for both the whole union and the countries which decide to leave it. The exit of one or more states may generate contagion effects in the union and prove impossible for a number of reasons. First, there are no legal mechanisms to be used by the states, which want to abandon the EA. Second, the decision to depart from a monetary union will have a high economic price. Banks will be put under pressure and may need to be recapitalized because local depositors will try to transfer their money to other EA member states due to fears of devaluation of the new national currency. The debts of leaving countries will remain denominated in euros, while their budget revenues will be denominated in a new devaluating national currency, which will further complicate the service of these debts. High inflation, deep financial crisis and sharp deterioration of living conditions are the most probable outcome from a decision to abandon a monetary union.

If an EA exit procedure had been foreseen for countries which fail to observe the SPG requirements, this could have decreased the moral hazard and mitigated the current debt crisis. It is recommended that an exit procedure be created as soon as possible for troubled countries, which fail to meet the condition on which they have received financial support from the EU and IMF.

5 Lack of EA financial stability architecture before the debt crisis and imperfections in the financial stability architecture created in response to the crisis

A huge imperfection of the EMU design before the debt crisis was the absence of financial stability tools. Such tools were created to address the EA debt crisis.

Crucial to the crisis outcome will be the EU institutional response which has found expression in the creation of new tools to counteract financial crises: the European Financial Stabilization Mechanism (EFSM), the European Financial Stabilization Facility (EFSF) and the European Stability Mechanism (ESM).

The EFSM can render financial support to all EU member states, while the EFSF and the ESM are designed to provide funds for EA member states in distress.

The EFSF is a temporary special-purpose unit established to raise funds from financial markets and to deliver financial resources to troubled EA member states at interest rates lower than the market ones. The EFSF has been criticized for its similarities to other special-purpose vehicles such as the Collateralized Debt Obligations (CDOs) and the Structured Investment Vehicles (SIVs) that were in the center of the US mortgage crisis.

It should be emphasized that money funds can correct short-term money failures but not long-term structural problems. Money funds ought to be used with caution because the financial support they provide may have crowding-out effect on private lending and private lenders may become subordinate to the priority of money funds to act as lenders of last resort (LOLR).⁹

Money funds provide financial support on the condition that the states in distress implement certain programs for macroeconomic and financial stabilization. This should guarantee that troubled countries will really and truly do what is necessary to stabilize their economies and finance. The ESM will act as an international LOLR and will provide financial resources to EA member states when markets refuse to do so, at interest rates lower than the market ones. This will benefit not only the troubled countries but also its lenders. The ESM

⁹ The role of the LOLR is to provide financial assistance in emergency situations. LOLRs are central banks at national level and the IMF on a global scale. The ESM will start acting as a LOLR in the EA in the summer of 2013.

requires private sector involvement in the financing of problematic countries. The nature and the extent of this involvement depend on the implemented programs for financial and macroeconomic stability. The requirement of private sector participation in the financial support for troubled countries should guarantee the rational investment of granted funds and the elimination of possible crowding-out effects on private investment and lending.

6 Fundamental macroeconomic imbalances between the core and the periphery of the EA and behavior of public and private sector in EAMS

One of the main reasons for the debt crisis is the great disparity between the center and the outskirts of the EMU, which manifests in the different levels and trends of important macroeconomic indicators like per-capita income, consumption, saving and investment. Before the crisis peripheral states tried to catch up with the center in their development through cheap foreign loans. The asymmetries between the center and the outskirts of the EMU are most obvious in saving and consumption. After the introduction of the Euro the peripheral countries took advantage of low interest rates, took loans and increased their consumption expenditures. For ten years (1997-2007) real consumption expenditures have grown by 55 % in Ireland and by approximately 35 % in Greece and Spain¹⁰. On the other hand, the share of consumption in Germany has been steady since 2001 which, combined with the high rate of saving, gives the country lots of money to lend abroad. The picture of imbalances is completed by investment trends. The share of investment expenditure in GDP has slightly declined in Greece, remained constant in Portugal and has risen in Ireland and Spain¹¹. However, in the latter two countries the increase of investment share has been due to the boom in residential construction rather than due to a rise of productive capacity that can contribute to economic growth.

In brief, foreign loans have been used in Greece and Portugal to increase consumption and in Ireland and Spain to build residences. In all the four countries the increase of their foreign debt after the adoption of the Euro has been accompanied by a low rate of saving. The received foreign loans have not been used to increase productive capacity, to generate economic growth and decrease debt burden. The imprudent use of foreign loans has made their service by the peripheral countries problematic. In spite of this imprudent behavior of the troubled countries in borrowing and spending, the debt crisis is not only their problem but a systemic crisis of the whole EMU. If the crisis is not systemically solved it may affect all the EA.

The government debt crisis has political and institutional foundations because it is related to the political project of monetary integration and creation of the EMU. Finding a way out of the crisis requires new institutional framework of the EA and new decisions in the areas of monetary and fiscal policies.

The monetary union has intensified financial integration but has also deepened the imbalances and the asymmetries between the core and the outskirts of the EA. The main cause of the crisis is a structural defect of the EMU that lies in its very foundation: the implementation of a common monetary policy without fiscal integration (or at least fiscal harmonization).

In years before the global financial crisis, the EA as a whole was developing in accordance with global economic trends, and the EA average economic indicators were close to those of the world economy. However, these aggregate indicators covered profound differences among the EAMS. While in the outskirts of the EA demand grew faster than output, in the core countries the opposite trend developed. The wastefulness in the periphery was financed by

¹⁰ Higgins, M. and Klitgaard, T. (2011), "Saving Imbalances and the Euro Area Sovereign Debt Crisis", *Current Issues In Economics And Finance*, Volume 17, Number 5, Federal Reserve Bank of New York.

¹¹ Ibid.

frugality in the center. This situation matched the interest of both sides for a while. Whereas peripheral states experienced economic booms nourished by cheap foreign loans, the core countries kept growing due to increasing exports in spite of sluggish domestic demand.

It is seducing to attribute the EA debt crisis solely to frivolity and irresponsibility in the peripheral countries. Though, reality is much more complex and multi-dimensional. The rising indebtedness of the periphery took place with the tacit approval of the center and was stimulated by trade and wage policies of core states. These policies were aimed at restricting real wage growth and at promoting exports. However, the flow of funds from the core to the periphery was caused by decisions made in the private but not in the public sector.

The essence of the problem is not the very existence of macroeconomic imbalances, but their size. While in 2008 Germany had a current-account surplus of about 7 % of GDP, some peripheral EAMS registered current-account deficits exceeding 10 % of GDP. Peripheral countries covered their deficit current accounts by surplus financial account due to substantial capital inflows from the core. Much of this capital was spent on consumption and unproductive investment.

In Greece and Portugal the waste of foreign capital was a consequence of public sector behavior. In Ireland and Spain the misallocation of funds resulted from decisions of the private sector to invest in real estate bubbles for speculative purposes.

The EA periphery has a heavy debt burden and must relieve it. However, it will not be easy. The troubled states aggravated their competitiveness by letting wages grow faster than productivity and cannot restore it by currency devaluations vis-à-vis their major trading partners. The crisis can easily spread across the whole EA because banks in the core countries hold large amounts of peripheral sovereign bonds and are exposed to high risk in case of a peripheral country's default.

7 The case of Bulgaria

Bulgaria convincingly fulfilled the criteria of public debt and budget deficit from 2002 to the onset of the global financial crisis in 2008. From 2003 to 2008 the long-term interest criterion was also met. Although each currency board arrangement is assessed separately by European institutions, it can be accepted that Bulgaria satisfies the exchange rate stability criterion too. The only convergence criterion Bulgaria did not meet in March 2008, was the inflation one. Before 2008 Bulgaria succeeded in fulfilling the inflation criterion once – in 2003, but in all other years the inflation rate in Bulgaria was significantly above the reference value. Before the global financial crisis inflation was the main obstacle for Bulgaria on the way to the adoption of the Euro.

In March 2008 Bulgaria met all Maastricht criteria except for the price stability and the two-year participation in the ERM II. In March 2010 Bulgaria did not satisfy the criteria of inflation, long-term interest rates and two-year participation in the ERM II. The global financial crisis eased the fulfillment of price stability criterion by diminishing inflationary pressures but complicated satisfaction of the budget deficit and long-term interest rate requirements.

Over the reference period from April 2011 to March 2012, Bulgaria met the economic convergence criteria of price stability, budget deficit, public debt and long-term interest rates, but did not meet the criterion of a 2-year ERM II membership and the legal requirements for central bank independence, the monetary financing prohibition, and legal integration into the Eurosystem.

Countries with currency board arrangements experience difficulties in fulfilling the price stability criterion. The theoretical explanation of this fact is that the simultaneous fulfillment of the inflation and the exchange rate stability criteria is impeded by the real appreciation of the national currency resulting from structural changes in the transition to a market-oriented economy as well as by the real convergence of prices and income to the

European levels. In a currency board arrangement the nominal exchange rate is fixed which automatically guarantees the satisfaction of the exchange rate stability criterion. The entire real appreciation of the national currency results in higher inflation which hampers the fulfillment of the price stability criterion.

Meeting the inflation criterion is related to choosing between economic growth now and eventual growth after the adoption of the Euro. Covering the price stability criterion requires restrictive fiscal and monetary policies. Though, macroeconomic restrictions decrease not only inflation but also economic growth and real income. Bulgaria, which is in a process of real and nominal convergence to the EU advanced economies, must carefully select the moment of introducing the Euro.

It is unlikely that Bulgaria accomplishes a sustainable fulfillment of the price stability requirement in the years to come. It is realistic to expect an adoption of the Euro around 2020. The postponement of an EA membership has good sides – Bulgaria will have time to catch up with advanced EU economies in terms of price level, GDP per capita and other key real macroeconomic indicators.

It is not recommended that Bulgaria join the EA before the end of this decade for a number of reasons. First, the sustainable meeting of the inflation criterion over the medium term requires macroeconomic restrictions, which will slow the GDP and real income growth. Second, real appreciation of the Bulgarian lev can be ascribed to two factors: structural changes in production and a shift of private consumption to services. Both factors arise from the process of transition to a market-oriented economy. In the following years the rate of real appreciation of the Bulgarian lev is expected to decrease, which ought to ease the satisfaction of the price stability criterion. Third, entering the EA will not bring any substantial economic change for Bulgaria, because the Bulgarian lev is fixed to the Euro and Bulgaria is highly integrated with the EA in terms of trade and business cycle similarity. Fourth, entering a monetary union during a debt crisis bears certain risks. Bulgaria may be hit by contagion effects, which would spread across the whole EA in case of a peripheral sovereign default or, as an EA member, may find itself in a position of a net provider of funds for the newly established European financial stability tools. Sixth, though Bulgaria keeps strict fiscal discipline, the stability of its public finance can easily be undermined by imprudent private sector behavior like in Ireland and Spain.

Bulgaria could easily become the next EA indebted peripheral country because before the beginning of the global financial crisis Bulgarian economy was characterized by substantial macroeconomic imbalances similar to those in the EA outskirts: huge current account deficits, debt-fuelled economic growth and misallocation of cheap foreign funds. Foreign capital was wasted on a massive scale by the private sector via increasing domestic consumption, spending on luxury cars and offices and investing in over-inflated property bubbles for speculative purposes.

Adopting the Euro should not become an end in itself. The EA membership of Bulgaria makes sense only if it is accompanied with the building of quality institutions and regaining the trust of foreign investors. Kosovo and Montenegro, which unilaterally adopted the Euro, do not have the faith of international financial circles. Unlike these two states, Poland, Hungary and the Czech Republic cleverly use the advantages of autonomous exchange rate policies and are not in a hurry to enter the ERM II, but have the trust of foreign investors.

Bulgaria meets most of the OCA criteria and the benefits from a monetary union membership ought to outweigh the cost. The high level of business cycle similarity between Bulgaria and EA economies should guarantee that the common monetary policy would not cause additional inflation or unemployment in Bulgaria. The Bulgarian lev is pegged to the Euro in a currency board arrangement; therefore Bulgarian monetary policy is almost completely dependent on the monetary policy of the ECB. For Bulgaria the adoption of the

Euro would not mean a loss of monetary policy tools but an elimination of transaction costs with the EA.

In terms of real convergence Bulgaria lags behind and is the poorest state in the EU with the lowest per-capita income and labor productivity. Under the conditions of EA stagnant growth and debt crisis, Bulgarian government should concentrate on increasing the effective use of European funds and on attracting foreign investment. These require zero corruption tolerance policy, improving the functioning of state institutions and building quality infrastructure.

Budget should be balanced not through cutting expenditures (their percentage share in GDP is one the lowest across the EU), but by improving the quality of work of the revenue administration for the purpose of increasing fiscal revenue and by restructuring and optimizing expenses. A transparent, consecutive and long-term oriented macroeconomic policy is needed to return foreign investment to Bulgaria and to provide the funds necessary for economic growth.

In each quarter of 2010 and 2011, Bulgaria has marked positive economic growth when compared to the previous quarter. At first sight this fact is optimistic as it seems that Bulgarian economy is successfully recovering from the crisis. However, a careful survey of the dynamics of the GDP components leads to different conclusions (Table 1).

Table 1: GDP growth rate and its components in comparison with the previous quarter

	Final consumption	Gross Fixed Capital Formation	Exports of goods and services	Imports of goods and services	GDP
2010Q1	1,0	-4,7	-0,7	-1,4	1,2
2010Q2	0,5	-1,4	7,2	3,4	1,5
2010Q3	-0,2	-2,9	10,4	0,3	0,8
2010Q4	0,6	2,4	-4,1	6,0	0,4
2011Q1	-0,2	-3,7	7,0	3,3	0,5
2011Q2	0,2	-2,8	-0,1	-1,5	0,5
2011Q3	0,3	-3,5	2,8	1,1	0,2
2011Q4	0,2	-0,1	2,5	1,5	0,3

Source: National Statistical Institute of Bulgaria

In 2010 and 2011 final consumption remained almost unchanged. The faint growth of GDP was due to the positive development of net exports (the difference between the exports and the imports of goods and services). The gross fixed capital formation fell by an average of 2 % per quarter.

The economic growth Bulgaria enjoyed in 2010 and 2011 was illusionary and unlikely to last long because:

- The main driving force of the economic growth – the internal consumption, was not increasing;
- The permanent fall in investment has a negative impact on the growth potential of Bulgarian economy, which has limited production facilities;
- Over 60% of Bulgarian exports consist of raw materials and energy resources. Bulgaria is poor in raw materials and energy resources and cannot rely on their exports to achieve a sustainable economic growth;
- The ECB prognosticates a fall in economic activity of the EA in 2012 by 0.1 %, which may negatively influence Bulgarian exports.

Table 2. Current and financial accounts of the Balance of payments of Bulgaria in 2011

(mil. eur)	<i>2011Q1</i>	<i>2011Q2</i>	<i>2011Q3</i>
<i>Current account, net</i>	147	80	1 170
<i>Financial account, net</i>	-78	-295	-1 167

Source: Eurostat

The analysis of the balance of payments reveals other potential threats to Bulgarian economy. Before the crisis, negative current accounts were compensated by positive financial accounts. In 2011 the situation is completely reversed: a surplus current account and a deficit financial account (Table 2). The permanent outflow of local and foreign capital from Bulgaria in various forms shows the assessment of economic agents of the quality of Bulgarian macroeconomic policy. The main driver of Bulgarian economic growth – the foreign direct investment, fell from 6.7 billion Euros in 2008 to 1.3 billion Euro in 2011. What is more disturbing though is the fact that Bulgarian capital leaves the country in various forms and is invested abroad instead of locally.

CONCLUSIONS

The sovereign debt crisis in the Euro area went deeper and grew into a crisis of growth, which is proved by the forecasts of a negative growth in the Euro area for 2012. The development of the crisis has demonstrated that it is not merely a short-term crisis of liquidity but a result of deep structural and institutional problems at national and communitarian level. The crisis cannot be solved by simply pouring money into the economies of the states in distress, but rather by implementing institutional and structural reforms at the level of Euro area and in the Euro area member states. The competences of the Euro area institutions should be redefined, fiscal policies of Euro area member states should be strictly coordinated and new financial stability tools should be created to lend money only if the troubled countries implement national programs for macroeconomic and financial stabilization.

The global economic crisis, the subsequent recession and the EA government debt crisis have delayed the processes of real and nominal convergence for several years. Before the global crisis Bulgaria was expected to adopt the Euro around 2015. Considering the delay in the integration process it is more likely that Bulgaria will join the EA at the end of this decade. The most probable scenario for the Euro introduction for Bulgaria is to maintain the currency board arrangement (CBA) and to observe the new crisis-imposed EU requirements. The specificity of Bulgarian economy is determined by several factors:

- size of the economy - small;
- degree of openness of the economy - high;
- type of the exchange rate regime - currency board arrangement;
- resource base of the economy - limited;
- way of integration in the global economy - current membership in a regional integration unit (the European union) and a future membership in a currency union (the Euro area).

These specific factors demand a macroeconomic policy consistent with new global and EU realities. Bulgarian macroeconomic indicators should be kept around the EA average in order to guarantee a fluent continuation of the process of nominal and real convergence. Bulgarian governments implement more restrictive fiscal policies than the European standards require. These policies could damage the growth potential of Bulgarian economy. Although Bulgaria has marked a faint GDP growth each quarter since early 2010, this economic recovery

is deceptive because the main driving forces of economic growth – consumption and investment, have been on decline. Only net exports are positive due to the increase in exports of raw materials. With a deficit financial account, with falling consumption and investment expenditures the growth prospects of Bulgarian economy cannot be good.

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