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Bulgaria plans to join the euro – is the Southeast European EU country ready?

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Transformation process is taking longer than elsewhere

After the political upheaval of 1989, Bulgaria initially experienced a phase of strong social polarisation with frequent changes of government. The economic transformation was initiated with hesitation and very inadequately. After the severe economic and currency crisis of 1996/1997, new elections led to fundamental policy changes. The long-awaited strategy was now pursued as a coherent package under Prime Minister Iwan Kostow (1997–2001). It essentially consisted of structural reforms and the forced privatisation of state-owned companies. This was also the basis of the cooperation with the IMF, which supported the process with loans and insisted on pegging the Bulgarian lev to the Deutsche Mark (from July 1997). This brought about a long-term stabilisation of the inflation and exchange rate. The lev is still pegged but now to the euro as the anchor currency (Currency Board). The belated but stringent market-economy reforms brought Bulgaria to the threshold of the EU, which it joined in 2007.

Bulgarian economy is on a good path

Bulgaria's economic situation, which still has the lowest level of prosperity of the EU, has recently stabilised. Real annual GDP growth has exceeded 3% since 2015. Bulgaria has become an attractive location for customer service centres, with low wage costs and taxes combined with generally good foreign language skills being crucial criteria for investors. The country has moved up to become one of the world's most important manufacturers of auto parts. Solid growth has pushed unemployment down to a historic low (2018: 5.2%).

2018: Bulgaria requests to join Exchange Rate Mechanism II

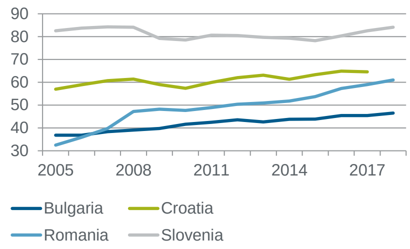
The positive growth trend also favoured the continuation of a restrictive spending policy, with Bulgaria meeting the Maastricht criteria for some years now. In 2018, public debt was one of the lowest in the EU, dropping to 20.5%, the budget balance was a marginally positive 0.1% and inflation was a moderate 2.6%. Long-term interest rates were on a very low level of 0.89%. So it was definitely plausible for Sofia to request entry to the Exchange Rate Mechanism II in June 2018, a step that precedes accession to the euro area. Entry to ERM-II is now coupled for the first time with accession to the banking union, which was created in 2014.

Not just formal convergence criteria are relevant

In light of previous experience, the ECB and the EU Commission consider not just formal criteria in their assessment of progress towards convergence but also the status and sustainability of real economic convergence. This is also because accession to the euro area irrevocably eliminates the possibility of currency devaluation, which allows price competitiveness to be restored quickly. Thus, in the event of competitiveness problems the only option – and one that is not easy to implement – is 'internal devaluation': lower wages and prices. In the past decade, however, Bulgaria has seen wage and unit labour cost increases above the EU average. Its extremely low and sluggish productivity growth is significantly below that of Greece and Portugal before the euro cash introduction in 2002 (Bulgaria has the slowest rates in the EU, see figure). Persistent corruption and oligarchic structures that massively obstruct competition and investment also nurture existing doubts. Weak institutions (such as the justice system!) add to the mix.

Figure: Nominal labour productivity per hour worked

In per cent, EU 28=100



Source: Eurostat

A lot of work remains to be done

Bulgaria's fulfilment of the convergence criteria and the existing stable exchange rate arrangement are important steps on the path to the euro. The country cleared a further very important hurdle by passing the ECB's bank stress test in August 2019. However, even after joining the euro area (not before 2022), greater efforts will remain necessary for some time to come in areas that have deficits and Sofia will have to persevere in its work to put in place more effective economic structures that speed up convergence. Significantly higher growth is necessary for it to overcome the prosperity gap to the remaining EU more quickly and, in light of the moderate total public debt level, investment in infrastructure and the still rather inefficient education system (both vocational and tertiary) would be particularly beneficial. Higher educational and training standards could also gradually reduce the present skills shortage. ■