ECONOMIC AND FINANCIAL INTEGRATION OF BULGARIA TO THE EU: MAIN TRENDS AND CHALLENGES

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Abstract: The åconomic and financial integration of Bulgaria to the European Union (EU) since the start of its official membership in 2007 coincided with the worst Global financial and economic crisis for the last seven decades and with the European sovereign crisis in the European Moneraty Union (EMU) as the "core' of the EU integration. The paper discusses the adjustment of the Bulgarian economy to the integration process in the EU which has been challenged by the deep institutional reform process as crucial for overcoming the crisis by making the normative power of the EU stronger. The macroeconomic performance of Bulgaria is revealed with regard to the compliance with the macroeconomic convergence criteria for the EMU. The financial sector reform is discussed to outline its ongoing reform with the EU law and regulation. Conclusions are summarized for the EMU's entry as a challenge and opportunity for further integration of Bulgaria the EU.
Keywords: European integration, EMU, Maastricht criteria, financial stability, EU reforms in the financial sector, financial integration.

INTRODUCTION

In the ten-year period from the conclusion of the Treaty of Accession of Bulgaria to the EU on April 25, 2005 until present the most important place in the adaptation of the economy to the European integration is the implementation of anational integration policy in favour of economic development and preparation for inclusion in the Economic and Monetary Union. Macroeconomic nominal convergence with the EU framework for admittance to the EMU is held both in terms of the strategy of "catching up" and efforts for overcoming the gap in socio-economic development to the old member states of the EU. Another main trend is the Bulgarian economy's marketization as becoming a part of the European single market through the free movement of goods, services, capital and work force on the basis of introduction the EU law and regulation, i.e. *the acquis communitaire*.

The proposed analysis in this study is based on the concept that EU integration can be distinguished from other factors of economic development under certain assumptions as regards the channels of transmission the Union's policies to the economic governance. The main strengths and weaknesses of the current membership of Bulgaria in the EU confirm that the EU as a normative power has played the role of an "anchor" of the transformation process in Bulgaria as well as in the other former centrally planned countries that have joined the EU. The concept of the Europeanisation for these countries has become equivalent to their EU-ization – a term introduced by Helen Wallace, an extinguished British professor in European studies at the start of the pre-accession stage (Wallace, 2001). The "EU-ization," as defined by the *acquis communautaire*, has become the chosen instrument for hastening the process of transformation from centrally planned to market economy.[1]

[1] The Europeanization described as a behavioural and institutional change transfer from Europe to other jurisdictions either of policy, institutional arrangements, rules, beliefs or norms, and secondly as capacity building in Europe, which also involves a transfer of policy, institutional arrangements, rules, beliefs or norms. (See: Flockhart,T. (2010) *Europeanization or EU-ization? The Transfer of European Norms across Time and Space*. JCMS 2010 Volume 48. Number 4. pp. 787–810.)

Due to the fact that the EU itself has been undergoing deep changes of its regulative power during the last decade the impact of the EU-ization has brought challenges that lie ahead before the integration process of deepening and widening of the EU. (Wallace, 2014). By drawing attention to the ongoing changes in the Bulgarian economy, our goal is to present the main results and changes that emerge to some extent under the impact of EU integration not as regulatory change but as a reflection of its impact on economic interdependence between the Bulgarian economy and the status of the EU at present.

For Bulgaria the preparation for the EMU has been inseparable part of the engagements of joining the EU in 2007. This issue presents in a concise form the embedded problems of the new EU member states as regards their efforts in the "the catching up" process of development in order to integrate.There seems always to be a "gap" that is a challenge to overcome as the rapid changes in the EU as a political actor and as normative power re-regulating the institutional order create new problems to be encountered especially by new member states like Bulgaria.

Such an example may be considered the process of preparation for the adoption of the euro which is ongoing. In the pre-accession period until 2007 the common view has prevailed among scholars and politicians in Bulgaria that the time of the adoption of the euro should be as soon as possible after the date of the country's accession to the European Union, namely in the second half of 2009 or on 1 January 2010 at the latest. This view has been completely consistent with the common position of the Bulgarian Council of Ministers and the Bulgarian National Bank (BNB) as stated officially on November 25 of 2004. It has been laid down as a goal in the 2004 Strategy of Bulgaria to prepare to join the European System of the Central banks and the ERM-II immediately after accession as intermediate stage of the EMU (BNB, 2004). The BNB declared the commitment to act within the current Currency board framework until its full euro area and Eurosystem membership. During the pre-accession period of Bulgaria until 2007 two main prerequisites have been looked upon as providing good grounds to expect to join the EMU sooner upon accession: the Currency board providing monetary stability and the fiscal consolidation providing stability of the public finance.

Since the accession to the EU in 2007 the Currency Board arrangement (CBA) has been considered to be an opportunity for achieving Bulgaria's compliance with one of the Maastricht criteria concerning the two years adherence to the fixed official rate of the Bulgarian currency (the BGL) to the Euro before joining the EMU. Bulgaria has been under CBA since 1997 and it's maintainance of the fixed rate to the Euro has been preserved automatically so far.[2] The compatibility of the CBA with the requirements for an ERM-II membership has been considered a logical consequence for raising the expectations for its entry. The expectations for Bulgaria's entry in the ERM-II have been based on the good record of public finances and the sustainability of the CBA.The EU-ization of Bulgaria's public finances has started during the pre-accession period and continued further when the country received an EU membership since the 1st Of January 2007. The EU requirements to converge to the Maastricht criteria have become crucial for preparation of the EMU entry.

At the time of the EU entry this has been considered in Bulgaria an achievable medium term goal on the basis of successful macroeconomic performance since 2001 involving: higher economic growth rates, creating fiscal reserves and reducing the debt-GDP ratio in the preaccession period. However Bulgaria has not been admitted to the ERM-II as expected. In the Convergence report for 2008 the stress is laid on Bulgaria's non-fulfillment of the price stability criterion and the build-up of some external imbalances highlights the fact that the temporary fulfilment of the numerical convergence criteria is, by itself, not enough for admission to the euro area.

As the Global crisis, followed by the European sovereign crisis since 2010, evolved in the EU deep change in the EMU and in the overall process of EU economic governance have occurred. The initiial design of the EMU and its overall functioning from its first decade of existence have been put under the pressure of the crisis management. This has had an important impact on the overall approach to the institutional characteristics of the EMU with inevitable consequences both for the "ins"countries of EMU as well as for the "outs",i.e.the EU member states like Bulgaria preparing for EMU entry.

Since 2015 Bulgaria's preparation for the EMU entry has been given again due attention by the Bulgarian Government. But now this priority has to be considered with regard to the EU strategy of deepening of the EMU as a Monetary, Banking and Capital Union (Completing the Union, 2015). There is a need to conceive

[2] The Currency Board in general provides an even stronger peg of the BGL to the Euro. Thus for Bulgaria until 2009 the entry into the ERM-II has not been considered to be problematic after the accession to the EU.

that the EMU has acquired new institutional and regulatory features that raise the requirements for the preparation to enter and adjust to it as a regular member country of the EU. The hypothesis is discussed that the delay of Bulgaria's joining the EMU may present a challenge of higher costs of compliance to the more advanced form of "differentiated integration" of EMU in the EU and its institutional architecture[3].

The analysis comprises three main parts of discussion of the present issues of Bulgaria's economic and financial integration. The first part presents the outstanding characteristics of the main stages of the integration of Bulgaria to the EU. The second part discusses the macroeconomic performance of Bulgaria with focus on the public finances's compliance with the Maastricht criteria as required framework for EU convergence. The third part presents the reforms in the financial sector of Bulgaria as an ongoing further adjustment to the requirements for the EMU entry.

1. MAIN STAGES OF ECONOMIC INTEGRATION OF BULGARIA TO THE EU

From the start of the transition from centrally planned to market economy in 1990 Bulgaria has set the strategic goal to deepen its integration in the European economy. The EU accession effort has received the Bulgarian broad public support and the Bulgarian Government's political will to successfully complete preparation for EU membership. In February 1995 Bulgaria concluded an Association agreement with the EU for a free trade zone with industrial goods to be achieved in 10-year period. In December 1995 Bulgaria submitted an application for European Union membership. In 2007 the Thesaloniki European Council confirmed the aim for the membership of Bulgaria in the EU and supported the goal of Bulgaria to finalize the negotiations for entry in 2004, giving to our country the opportunity to achieve the aim for membership in the EU as from January 2007.

The overall assessment for the Bulgarian economy reflected in the 2002 Regular Report of the European Commission was that Bulgaria *is a functioning market economy*. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that it continues implementing its reform programme. Bulgaria has achieved a high degree of macroeconomic stability and market mechanisms have been set at work to allow for a better allocation of resources.(Annual Report of the ERI at BAS, 2012, 2013, 2014). Good progress has been made in structural reforms, especially as regards procedures for market entry, the restructuring of the financial sector and privatization, thus setting the microeconomic basis for a process of sustained growth.

The economic integration of Bulgaria into the EU allows to distinguish five stages as follows:

- *First stage (1995–1999*) – Since 1995 Bulgaria's association with the EU has encouraged greatly the trade creation with the EU member states on the basis of the application of the principle of trade liberalization of the exchange of industrial goods by more rapid reduction and abolishment of trade tariffs of the Common trade policy of the EU. The assocaition to the EU encouraged the harmonization of Bulgaria with the EU and the creation of a free trade zone with the EU (at that time including 15 member states). During the association to the EU Bulgaria has made substantial improvements in its legislation in the economic area by amending the existing laws and regulations or drafting new ones and thus has successfully completed the process of the alignment with the EU in this field. Being a regular membet of the World Trade organization since 1994 Bulgaria has undertaken adjustment of its trade policy and practices in order to become harmonized to a considerable extent with Common trade policy of the EU. Any steps related to the adoption and implementation of the Common Commercial Policy at the time of Bulgaria's accession to the EU have been conducted in full compliance with the WTO principles and rules. Thus the association agreement has helped the adjustment of the Bulgarian economy to the Single market for goods, services, labour and capital during the period of transition to market economy and the rebirth of private ownership and entrepreneurship that followed since the beginning of the 90s.
- *Second stage (1999–2007)* – Based on the progress with the implementation of the Association agreement with EU Bulgaria has been invited to open accession negotiation for regular member ship of the EU by the Helsinki European Council of the EU in December 1999. In 2000 the negotiations were

[3] As stated in the Article1(3)Treaty of European union(TEU) and the Treaty on the Functioning of the European Union within or outside the Treaties of the EU in the field of European economic and monetary policy the differentiated integration is the cooperation of some but not all EU member states.

officially launched under explicitly defined 30 Chapters for achieving agreement for Bulgaria's EU entry.

After the Copenhagen European Council of the EU(15) in December 2002 defined the political framework for the achievement of the aim for membership of Bulgaria in the EU in 2007, the Bulgarian Government has concentrated its efforts to provide all necessary resources in order to finalize the negotiations on the accession in 2004.

In May 2005 the Treaty of Bulgaria's Accession to the EU has been signed giving to our country the opportunity to achieve the aim for full membership in the EU as from January 2007.

• *The third stage (2007–2008)* starts with the full EU membership of Bulgaria when two main economic goals have been undertaken:

The first goal is to strengthen the discipline of compliance with the EU single market of free movement of goods, services and capital. The freedom of movement of labor is a derogation, due to the agreed 6-years' period of transition to full application of the freedom of labour movement. But this practice does not restrict significant labor migration to the old member states, although there is no equality of the labor force in search of work in the old member states.

The second goal is to achieve full compliance with the Maastricht criteria for macroeconomic convergence as conditionality for admission to the EMU.

Until the end of 2008 Bulgaria has persistently applied the Strategy of its Central bank – the Bulgarian National Bank for adopting the Euro by 2010. In spite of the fact that substantial progress has been achieved as regards the stability of public finances of Bulgaria, due to the non-compliance with some of other elements of the conditionality for the EMU, Bulgaria has not been admitted to the procedures of the EU for joining the EMU. As the barriers to convergence with the Maastricht criteria for the EMU have been pointed out by the EU the higher rate of inflation as well as the inflexibility of labor markets and other economic problems in construction of market mechanisms.

• *The Fourth stage (2009–2012*) is stage of a gradual slowdown in the overall EU integration process due to impact of the Global and European financial crises. Albeit with a certain lag the effect of the EU crisis on the Bulgarian economy is reflected in the decline in economic growth and rising unemployment. Due to this as well as to the Sovereign debt crisis of some of the Euro area countries the preparation for the EMU entry has been postponed for a later stage of integration

The initial strategy of Bulgaria for entry into the Eurozone has been reconsidered.

After 2010 Bulgaria has undertaken further adjustment to the EU to introduce and implement new approaches to economic governance in the EU by introducing the "European semester" as an instrument for fiscal policy reforms dictated by the anti-crisis orientation of integration of EU policies. Overcoming the crisis in the EMU, the EU has started building the new institutional and legal framework for an accelerated and deeper budgetary and fiscal coordination and surveillance in the Euro area. While preserving the unity of the policies pursued at EU-27, not only about the Single Market but also in connection with the EMU the EU institutions have started the so called "differentiated" by introducing new and morestrict prudential regulation for fiscal discipline and for the financial sector.

For Bulgaria and other EU Member States outside the EMU the accession to the newly introduced institutional and financial regulation for the deepening of the EMU is considered feasible when appropriate. This main trend of re-regulation of the EMU presents a novelty in the integration process for the EU member states like Bulgaria that deepens the trend towards the differentiated integration in the EU.

At the same time Bulgaria has joined the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which was signed on March 2, 2012 from twenty-five Member States and includes the Fiscal Pact. The aim is to undertake commitments for a deeper budgetary and fiscal coordination and Community budgetary surveillance as a part of the upgraded EU law within five years of its entry into force and to deepen and strengthen the EMU including the launch of a European banking union and deeper Community budgetary coordination and supervision.

• *The Fifth Stage (2012-until present time)* is characterized by the further increasing of the challenges of rapprochement with the EU. The multiannual budget programming in the EU for 2014–2020 has introduced new instruments and initiatives for a further shift towards stimulating growth at European level in an unfavorable external environment due to the ongoing in Europe and worldwide economic stagnation. Challenges to Bulgaria increased due to the delayed exit from the economic crisis across the EU. Prospects for inclusion in the Exchange Rate Mechanism II of EMU to adopt the euro are complicated. The problem of occurrence of the risk of macroeconomic imbalances and slower transition to structural reforms are critical area of monitoring and recommendations from the European institutions.The unfavourable impact of the crisis in the Eurozone makes the integration process highly dependent on the choice of more adequate policies at national level alongside and in parallel with the effective implementation of European policies – valid both for those that are Common policies (the Trade and the Agricultural policies) and Community policies (Industrial policy, Energy policy and etc.).

The *general characteristics of the main stages* of Bulgaria's economic integration to the EU include the following:

Firstly, there is a comprehensive reorientation of economic policy of Bulgaria to achieve compliance with established strategic directions and objectives of the economic development of the EU on the basis of:

- implementation of **the National Plans for socio-economic development for 2007–2013 and its update for 2014–2020 as well as the periodically updated National Reform Programme and Convergence programmes** with the EU;
- continuous updating the priorities of development of Bulgaria takes place in accordance with the Lisbon Strategy of 2001 and since 2010 according to the **"Europe 2020" Strategy of the EU**. Bulgaria participates in the development and implementation of new approaches to economic governance in the EU, including the implementation of policies and EU recommendations on innovative directions for economic growth, employment and increasing the EU international competitiveness.
- Absorption of funds and programmess of the EU as a candidate country for EU membership, according to financial framework of the EUfor the period (2000–2007), and as a member of the EU, according to financial framework of the EU for 2007–2013 and the Multiannual financial Framework of EU for 2014–2020. According to the agreed EU priorities and areas of public funding Bulgaria undertakes the responsibility of co-financing of the EU funded projects at the expense of funds from the national budget of Bulgaria.
- In assessing the macroeconomic development of Bulgaria in the European integration process the implementation of the National Reform Programme and Convergence Programme are reported simultaneously to take into account the relationships between them.

Secondly, Bulgaria's integration into the Common EU policies and in the implementation of Community policies makes progress due to the administrative and institutional reforms which provide for a certain freedom of choice of the national-specific policy, but in terms of harmonization with requirements of EU law. Moreover, the impact of regulatory changes regarding the implementation of EU policies can be evaluated on the merits in terms of general economic developments in Bulgaria and on the basis of specific systems of criteria and indicators to be applied as a "threshold»values within the EU public accountability requirements in specific areas at EU level.

Thirdly, since the 2007 accession of Bulgaria as a regular member of the EU there has been applied a procedure for the the European Commission to implement a **Mechanism for cooperation and verification** in order to help our country to overcome the shortcomings and problems in the area of judicial reform, the fight against corruption and organized crime, which undoubtedly hinder the integration process. Monitoring and evaluation of progress in these areas on a regular basis under 6 criteria are interrelated and are long-term oriented towards judicial reform, fight against corruption and organized crime. In practice, institutional and legal and regulatory changes in the areas under consideration are essential to economic development in mind their role in the integration process.

Implementation of the Mechanism for Cooperation and Verification is expected to proceed further for some time onwards and to be suspended in the framework of this mandate to the European Commission for the period 2015–2020.

From August 7, 2014 Bulgaria has a **new Partnership Agreement with the European Commission** concerning the investments of European structural and investment funds for the 2014–2020 period On 22 December 2013 entered into force new rules for EU investment in 2014–2020 For the first time, the five European structural and investment funds will have to work according to common rules. This is done not only to simplify the use of funds and to allow them to combine and to invest in strategic projects that lead to economic growth and more jobs. Under the new rules Bulgaria is to develop and implement Strategic plans with investment priorities relating to these five funds for smart, sustainable and inclusive growth.

The start of Bulgaria's EU membership has been unfavourably influenced by the slowdown of economic development of the EU after 2007 under the impact of the Global financial and economic crisis. The critical structural macroeconomic imbalances of some Euro area states have caused the European sovereign debt crisis and raised the sustained losses of the EU in its international competitiveness. Since mid-2006, the European economy has entered in a period of downturn which has been deepened under the negative impact of the Global financial crisis since 2008 and the European debt crisis February 2010. The depth of the decline in economic growth in the EU and in the Euro zone has become one of the barriers for the post-crisis recovery. Slowing economic growth in the EU as a whole has emerged as a long-term problem that exacerbates the risk of financial instability and loss of competitiveness. This is a challenge for further reforming economic policy and management in the EU.

Financial instability has great disintegration potential in the EU (as the example of the debt crisis of Greece has shown)and the outcome of it make necessary the ongoing reforms in the Eurozone and the EU to prevent deepening crisis and to secure new mechanisms and institutions for risk management and risk sharing.

In summarizing the main trends influencing Bulgaria's integration,we have to consider that the EU integration process could not generate higher centripetal force for improving the chances of development of EMU as a "core" of the EU and thus making the enlargement of the EMU to be driven by support to the "catching-up" development of the new member states from Central and Eastern Europe like Bulgaria. At the present stage the EU faces challenges to implement a comprehensive programme to consolidate the Economic and Monetary Union by overcoming the impact of the Global and European crises. By choosing priorities for further deepening of integration in the EMU through completion of the Banking and Capital Union and completing the further development of the Single Internal Market European Union's leadership has laid the focus on policies to boost growth and implementation of the new "Road Map to build true economic and Monetary Union ".

In the context of the ongoing difficulties in the Eurozone and the EU as a whole out of the economic depression and overcoming the financial crisis, the medium-term prospects for restoring economic growth remain too controversial at this stage. Delayed recovery of economic growth in the EU inevitably has an adverse effect on the Bulgarian economy for which the external environment and European integration dependencies do not provide positive incentives for post-crisis development, but much rather determine the necessity of rethinking the alternatives to stimulate the national economy by domestic demand and economic co-operation and trade with all partner countries.

As major problems facing the prospects for economic growth in the EU and implications for Bulgaria can be viewed the following structural aspects:

- the challenges facing Bulgaria in relation to structural reforms in the EU post-crisis are determined by the development of the integration concept for Europe of "two speeds". Economic growth in the EU has sustained lower rates. Unemployment reached high levels that determine profound changes in social policy of nation states towards the erosion of the European social model.
- In managing the debt crisis in the Eurozone the EU as a whole has run into a round of complex but relatively slow changes in the interaction of monetary and fiscal policies.In this sense, the transition to long-term investment and growth as a priority for economic governance in the EU is crucial for Bulgaria. The question remains topical whether and how the eurozone as the core of the integration process will be able to avoid the risk to enter the second lost "decade due to low economic growth.

2. THE MACROECONOMIC PERFORMANCE OF BULGARIA IN 200–2015 AND ITS COMPLIANCE WITH THE MAASTRICHT CRITERIA

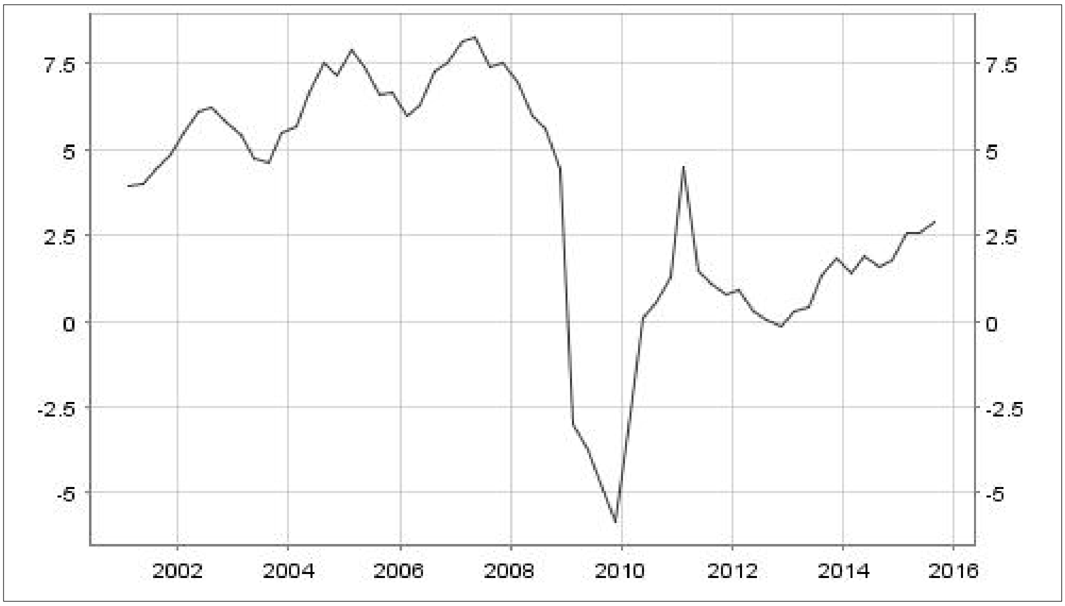
The issues of the entry criteria for the EMU as a set of Maastricht criteria from its initial period raise a number of questions about the proper "fitness" of a country to comply. As regards the set of Maastricht criteria of convergence for example, Kozluk (2005, p. 439–474) finds that some of the EU accession countries are better prepared for the single currency membership than some of the more established members had been at the introduction of the EMU.The differentiation between the strictness of Maastricht criteria for EMU entry, on one hand and the reconsidered since 2005 framework of the Stability and Growth pact applied to member states of the EMU allowing flexibility to adapt has been considered with regard to some recommendations for unification of fiscal deficits requirements for both EU members and the EMU entry (Nuti, 2006).

But the compliance with the fiscal sustainability criteria has gained new aspects of importance as the present European sovereign debt crisis has evolved since 2010. As previewed by Mongelli (2002, p. 34) the costs from negative external effects have become "very high for the EMU because not one, but more, member countries"were to run sizeable and protracted budget deficits, accumulating an unsustainable public debt, eventually some pecuniary externalities might ripple through the currency area." The compliance with *the nominal and real convergence indicators of* a EU member state in the preparation for the EMU entry remains crucial. As the recent Global crisis and European sovereign crisis have hit hard the Central and East European countries and the recovery so far has not been good enough (in spite of significant differences among countries) the questions about the growth model through deepening integration have been raised again. The EU membership could not facilitate much the catch-up model of growth due to the crisis implications though there are many differences among the growth performance of the countries of Central and Eastern Europe. The integration to the EU is important as it supports sound fiscal and financial policies in the new member states by the strengthening of the EU's current macro-finance assistance arrangements and economic governance improvements. However the role of proper fiscal policy becomes more important not only as instrumental for the EMU entry but because it has to take account of the need to stimulate economic growth. (Becker et al., 2010).

The fiscal vulnerability often arises from implicit liabilities towards the financial sector and for this reason sustainability assessments should also consider private-sector fragility. EU countries' budgets have been involved with providing great amounts of state aid to rescue banks and non-financial intermediaries. The post crisis institutions newly created to tackle the financial instabiliy provide new capacities for of the EMU. Thus for the EU member states like Bulgaria that are 'outs' to the EMU it is important to join the EMU as it may help growth by joining new cooperation agreements that are targeted to increase financial stability. The implementation of the Banking and Capital Union could contribute to the break of the vicious circle between the public debt and banking sector's debt and improve the fiscal consolidation in favour of the EMU (Zimmermann, 2015).

During the last decade, Bulgaria has achieved macroeconomic stability and positive GDP growth. The economic growth for the period (2000–2008) has been kept on stable upward track record due to the increased aggregate supply and consumption, fiscal consolidation, the foreign capital inflows as a substantially increased external source of finance and the maintenance of the monetary discipline through the sustainability of the Currency Board since 1997. GDP growth rate for the period (2005–2008) has averaged annually 6.4%. Compared to other EU member states Bulgaria has experienced since the start of the new millennium high rates of economic growth which have raised the expectations as well as doubts for the continuity of the "catch up" type of growth after joining the EU (Angelov, 2006). The growth of domestic and foreign capital investments has been concentrated predominantly in construction, real estate, tourism and services which contributed to overheating the economy. During the period 2005–2008, Bulgaria's GDP grew by a relatively rapid pace but in 2009, due to the impact of the Global economic crisis the GDP contracted by 5% and a slowdown of economic growth followed (Figure 1).

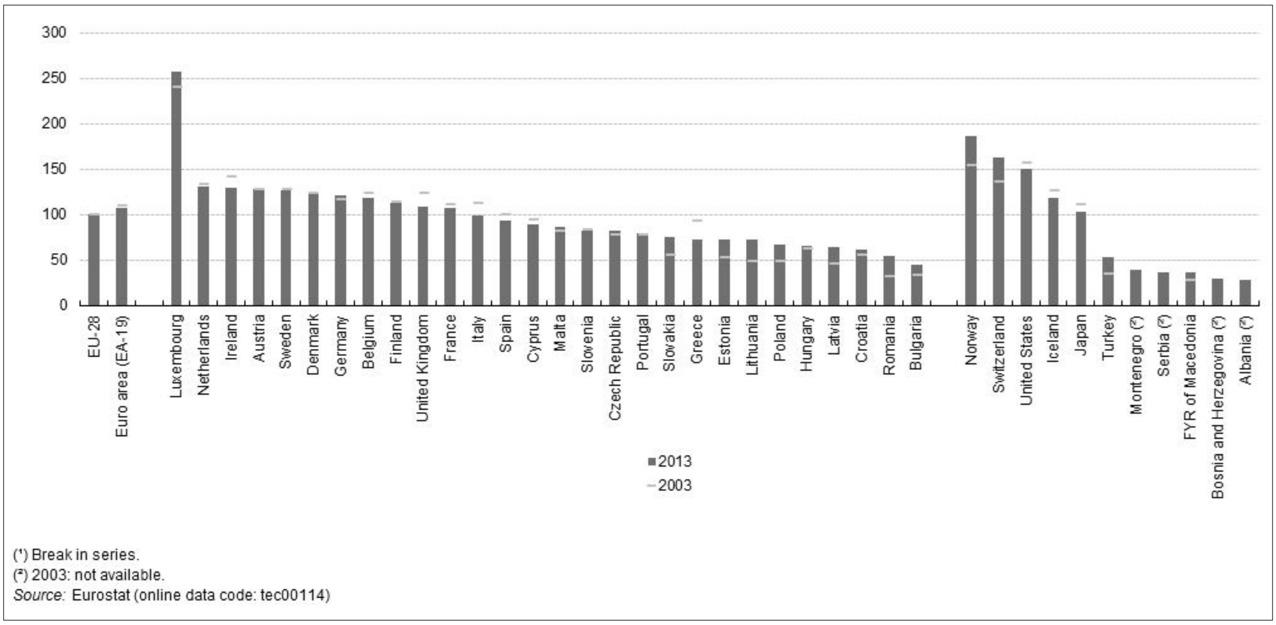
Since 2010 began a gradual recovery of the Bulgarian economy, but at a very slow pace. In 2010, growth was only 0.7%, in 2011 rose to 2% and in 2012 was only 0.2%. In 2013 and 2014 the economic growth remained rather modest at the rate respectively of 1.1 and 1.7%. For achieving the pre-crisis level of growth it has taken five years. In 2015 the rate of growth has increased to 2.9% and higher rate of about 3% has been forecasted for 2016.



Source: European Commission (Eurostat) National accounts of Bulgaria

Fig. 1. The Annual Rate of Growth of the GDP of Bulgaria (for 2002 -2014) (market prices, %)

Macroeconomic performance has allowed to maintain stability but the rate of growth has remained low in recent years. The unsatisfactory growth record has been accornpanied by relatively modest fiscal deficits, low inflation and a stable currency. Growth has been deprived of new capital inflows from abroad as direct and portfolio investments have fallen considerably as result of the Global and the European sovereign crisis. The economic growth has become largely dependent on domestic factors and only to some extent driven mainly by growth in services and manufacturing, the latter aided by an expansion in exports of labor-intensive goods.



Graph 1. EU Member States: GDP per capita at current market prices, 2003 and 2013([1])
(EU-28 = 100; based on PPS per inhabitant)

The need of raising growth is considered a necessary prerequisite to diminish the gap between the GDP per capita of Bulgaria and the average GDP per capita of EU-28. Bulgaria records the lowest level of this indicator among the EU Member States as its GDP per capita amounts to 53% below the EU average, Besides Bulgaria has achieved a very small increase of the GDP per capita from 2003 to 2013 compared to other EU countries. This indicator reflects the need of structural policies to raise the incomes' level and national wealthfare by economic growth that has to allow for better real convergence with the EMU (Graph.1).

The European commitments of Bulgaria for macroeconomic convergence with EMU are an integral part of the Accession Treaty to the EU. With the efforts for the implementation of Maastricht criteria for EMU Bulgaria has achieve progress towards macroeconomic nominal convergence (criterion on price stability, sound public finances, exchange rate, short-term and long-term interest rates).

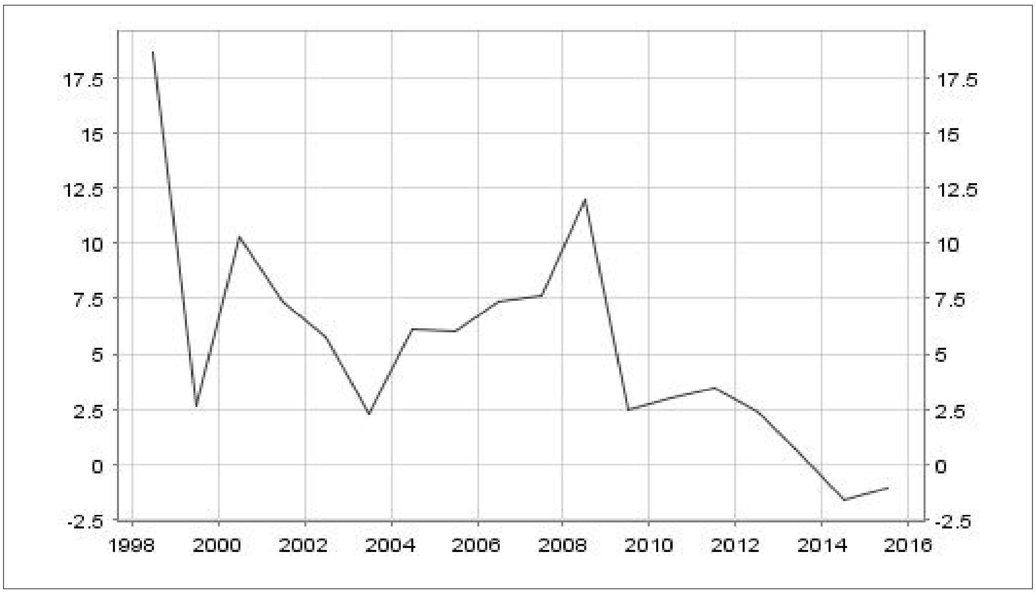
The price stability has been a target of the Bulgarian Government and central bank's policies since the pre-accession period.

For the period (2004–2008) the price criterion was not accomplished as the inflation was higher than the referent value threshold. The structural readjustment and credit expansion related to the higher rates of growth caused higher rates of inflation in the period (2004–08). The economic decline has caused a reversal of this trend since 2009 onwards by the recorded relatively stable process of deflation (Fig.2).

The domestic factors contributed to higher average inflation until mid2009 included: adjustments in administratively regulated prices, the harmonisation of excise duties with EU levels by increasing them in several stages upon and after joining the EU, oligopolistic type of the markets for a number of goods and services etc. The group of goods and services with administratively controlled prices had a positive contribution to overall annual inflation in contrary to the deflationary trends.

The external factors play a role in the domestic price formation due to the high openness of the Bulgarian economy and the high degree of import dependencies that exercise relatively big influence of the import prices. These prices rose steeply in 2004–2008 but recorded a steep annual decrease of 14% in 2009. Energy and food prices have been a major component of imported inflation especially if it is taken in consideration that these commodities have large share of the Bulgarian basket of the Harmonised index of Consumer Prices (HICP).

Their influence on the price level in Bulgaria is big as after the fall of the international prices of oil, energy resources and foods has been reflected in the deflationary trends in Bulgaria. After the average monthly inflation became negative in August 2013, the decline in consumer prices on an annual basis accelerated in 2014, and the decrease in HICP at the year-end amounted to 2%. The average annual inflation rate for 2013 was also negative at -1.6. The sharp fall in inflation in 2009 was partly a result of lower commodity prices and the contraction in economic activity. In 2010 and 2011 the inflation gradually picked up again, to 3 and 3.4% respectively, largely reflecting a increase of the commodity prices and increases in the excise duty on tobacco, foods, etc. and the deflation trends from abroad further decline in the rate of inflation. The deflation continued in 2015 creating risks of deepening of the deflationary trends (Fig. 2).



Source: Eurostat, 2015 (Bulgaria – HICP – Overall index, Annual rate of change, Eurostat, Neither seasonally nor working day adjusted, Unit Percentage).

Fig. 2. Inflation in Bulgaria: Overall Index HICP

The historically low level of *inflation* (within the range of -0.8 to 0.9%) in 2013 has been considered in the Convergence Report of 2014 as building risks of increasing inflation in Bulgaria (ECB, 2014). Such a forecast has not come true in 2015 least but not last because of the ongoing fall of the international prices of food, oil and energy resources. During 2014 a stable process of *deflation* was observed as half of the dynamics of consumer prices went in decline. After inflation became negative in August 2013, the decline in consumer prices on an annual basis accelerated in 2014, and the decrease in HICP at the year-end amounted to 2%. The average annual inflation rate for 2014 was also negative at -1.6%. The annual average inflation, measured by CPI, in the last 12 months (January – December 2015) compared to the previous 12 months (January – December 2014) was -0.1%. The deflation continued in 2015 and at annual basis in December 2015 compared to December 2014 was -0.9 %. The official forecast in the Convergence Pogramme of Bulgaria for the period 2015–2018 (MoF,2015) previews negative inflation trends to be replaced by a rather moderate rate of inflation for 2016 (HICP being 1,6% to 2% on annual basis)(MoF, 2015). The main risks of further deflationary trends remain due to the uncertainty of the medium term trends of international prices of crude oil, gas, services and foods. At the same time, a delayed recovery of domestic demand may alsol limit increases in prices of goods and services.

But as regards the adoption of the euro the problem of the pro-inflationary factors and their evaluation is an important issue of the forecast of medium and long term inflation trends and the ongoing readjustment of the Bulgarian economy to the global trends. Many new EMU countries have experienced a rise of inflation after joining the EMU.In a monetary union, there are a number of factors that exercise upward pressures on inflation and due to this inflation may become self-sustained and give rise to an abrupt adjustment. Since the nominal interest rate is fixed at the union level, any shock bringing inflation above the union average will reduce the real interest rate and fuel further inflationary pressures, in a self-reinforcing mechanism for instance by stimulating credit expansion.

However, also being out of the EMU has its risk of adverse impact of the pro-inflationary trends through the channels of imported inflation. These risks may be even higher for a country that is ou of the EMU if one takes into consideration the exchange rate risks related to impact of the import prices in euros and import prices in US dollars. A rising euro in the first halfof 2014 added to the growing world deflationary impact. The depreciation of the euro in the second half of 2014 was a prerequisite for limiting deflation in some groups of goods, such as manufactured goods and food.

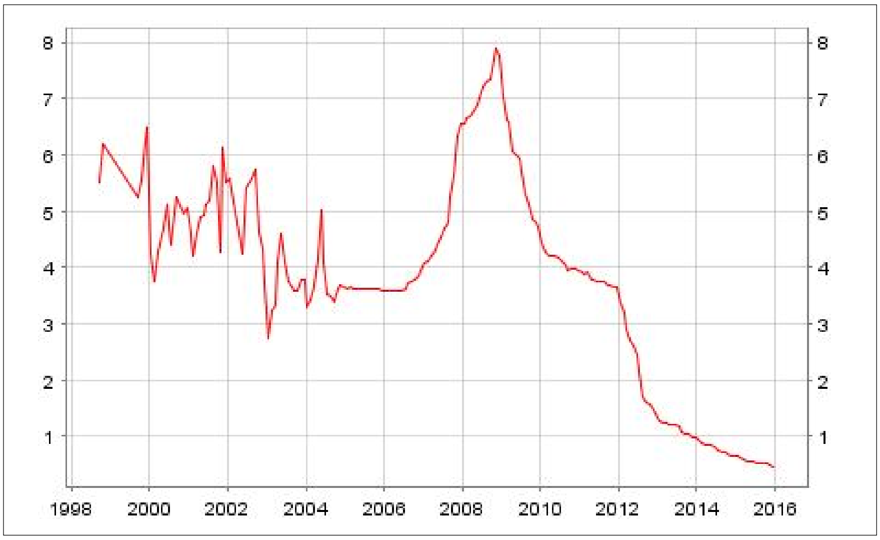
The expected slow- down of the deflation rate and the reversal of the trend in 2016 r may be due to the higher international prices in EUR terms, as a result of the depreciation of the Euro against the US dollar. This will compensate for the expected price decrease of the main groups of commodities in dollars.

These interdependences underline the role of structural and price realignment that Bulgaria has still to undergo in order to join the EMU.The main approach to circumvent higher inflationary trends by domestic policies is further diminishing the administratively regulated prices, increase market competition and stimulate aggregate supply and investments by carrying out structural reforms.

As a factor that has an impact on the level of inflation may be regarded *the money market interest rates and the long term interest rates*. As seen on Fig.3 the money market interest rates in Bulgaria have followed the trend of the macroeconomic adjustment since 2006 by passing through higher level of rising the price of credit during the deepening of the Global crisis and European sovereign crisis which placed pressure on the market liquidity.

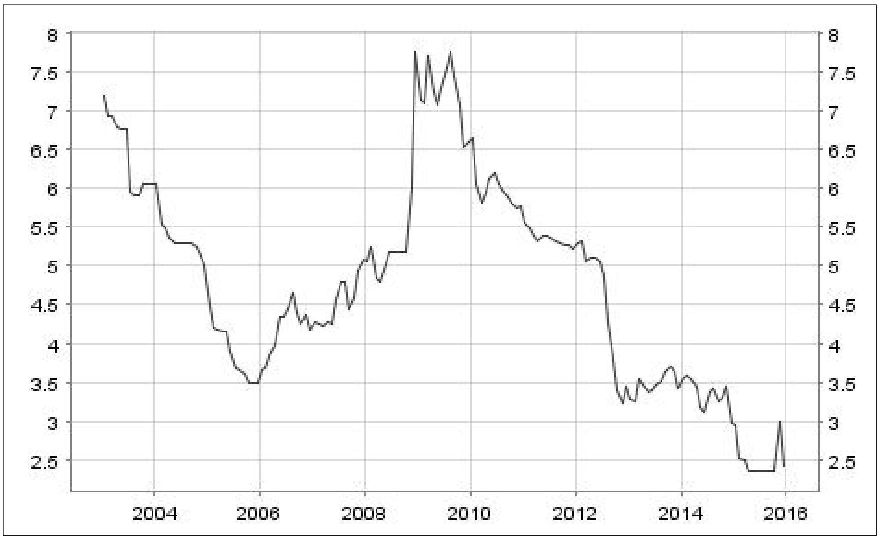
In the post crisis period the slowdown of the Bulgarian economy was combined with the availability of savings attracted as deposits and thus the own banking resources have increased in supply. This trend combined with the fall of the demand for new credits has caused accelerated slowdown of interest rates. This is also an inseparable part of the overall deflationary trends since 2009 onwards.

Another indicator influencing the inflation and inflation expectations is the criterion of convergence of the long term interest rates on the Bulgarian Government debt. The level of these interest rates is indicative for the convergence with the EMU as Bulgaria has had average long-term interest rates that were – to different degrees in separate year – much below the reference value for the interest rate convergence criterion since 2010. As seen on Fig.4, the long term interest rates on the Bulgarian Government securities have fallen considerably which may also be a factor to lessen the pro-inflationary impact of both servicing the debt as well as resorting to issuance of new debt.



Source: Eurostat, NSI of Bulgaria: Money market interest rates

Fig. 3. Money market interest rates in Bulgaria in (2000–2015)
(3 months (80-100 days) maturity, denominated in Bulgarian lev)

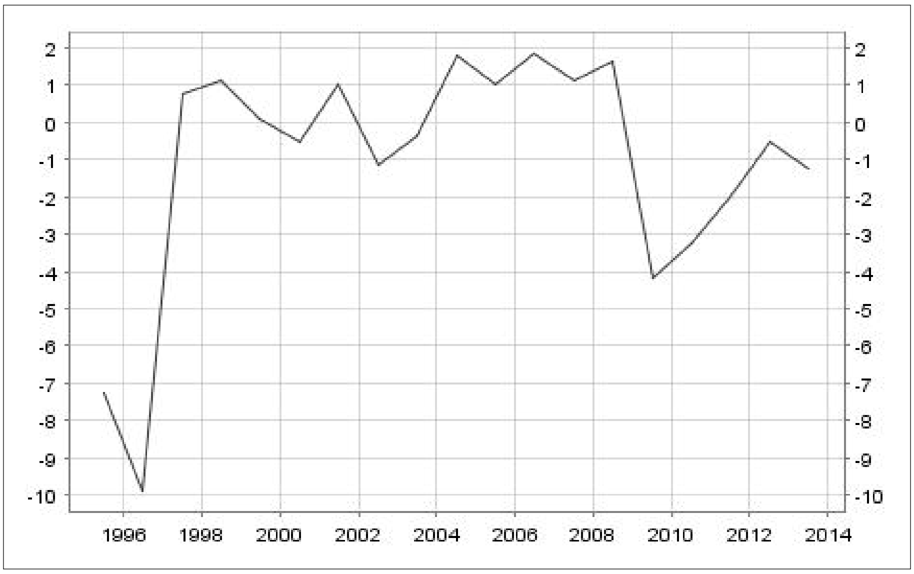


Source: Eurostat, National accounts statistics.

Fig. 4. Bulgaria, Long-term interest rate for convergence purposes

The low inflation rate in Bulgaria will be challenging in the medium term, given the limited scope for active monetary policy under the existing currency board arrangement Due to the fact that the GDP per capita in Bulgaria is significantly lower than in the euro area, it is difficult to foresee the exact size of the inflation effect resulting from the structural adjustment that is underway. On the Government agenda is to introduce an increase of the minimal wage from 2016 onwards as well as the liberalisation of the market for electric supplies which may cause higher inflation.In medium term the economy is expected to grow at a higher rate and as the income convergence proceeds, price level convergence is to continue. The outcome will depend also on the choice of the model of growth of the Bulgarian economy (Minasijan, 2011). This, in turn, would manifest itself in terms of higher domestic inflation, given the fixed nominal exchange rate..

As a new EU member state Bulgaria has no opt-out choice as regards the EMU and thus has the status of a Member State with a derogation. The convergence with the EMU requirements has been most pertinent by the gradual process of alignment of Bulgaria's *fiscal polic*y with EU requirements.Objectively the economic growth in terms of positive rates since 2004 has made possible to maintain the public finances adequately and to achieve a budget surplus since 2004 up to 2009. At the same time complex political and economic reasons justify the postponement of Bulgaria's participation in ERM II as the Convergence report points out to the need of decreasing the external imbalances and improve the laboour market. In practice, the deterioration of the indicator for government deficit for 2009 up to 4.3% of the GDP led to the imposition by the European Commission to Bulgaria a procedure for excessive deficit (see Fig. 5). In the subsequent years, and currently by adhering to the new rules and requirements to the government finances, Bulgaria has again restored the compliance with Maastricht criterion by adhering to consolidation of fiscal policy and improving the discipline of execution of the state budget.



Source: Eurostat, 2015. Data for 2015–2016 are estimates.

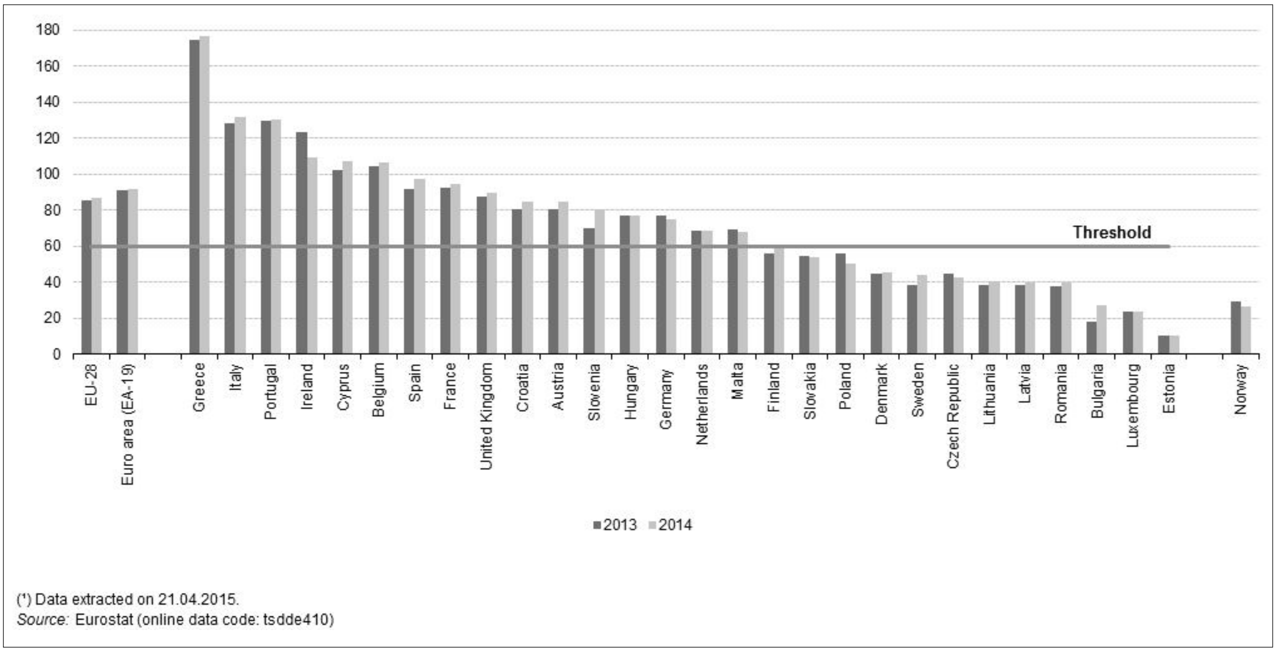
Fig. 5. Government Budget deficit (-) or sufitsit (+) of Bulgaria (% of GDP)

In fact after a temporary deterioration in the budget deficit in 2009 there was a relatively rapid return to a trend of improving macroeconomic behavior in accordance with the Maastricht criteria. This has been set as a target in the Government fiscal policy also for 2015–2016. The Convergence Programme of Republic of Bulgaria for 2014–2018.

As regards the *indicator for an average annual rate of growth of the public debt-to-GDP* Bulgaria has had consistently consolidated its fiscal policy throughout the period (1998–2015) and fiscal discipline has been much strict if compared with other EU countries (figure 6). The need to provide state aid to meet the needs of the deposit guarantees repayments after the closure of Corporate commercial bank and the liquidity support for other 2 domestic banks in crisis has caused rapid increase of the Government debt-to-GDP ratio in 2014.The steep rise of this ratio in 2014 caused the assessment of Bulgaria as a country with imbalances by the European Commission's Alert mechanism for greater macroeconomic imbalances. By end of December 2015 the government debt-to-GDP ratio is 26.4%, with the share of domestic government debt being 8.5% and of external government debt – respectively equal to 17.9% of GDP. In the government debt structure, domestic debt at the end of 2015 amounts to 32.1%, and external debt – to 67.9% of the total debt. Any further rise of this indicator for the Government debt may present a challenge to fiscal policy sustainability.

The debt-to-GDP ratio is subject to the threshold of the Maastricht criteria on public debt. In spite of inceasing the government debt-to-GDP-ratio Bulgaria is still much below the reference value of the 60% of GDP which is the threshold of this criterion of Maastricht.The comparison with other EU member states, including EMU member states shows that Bulgaria's debt is below the reference value .(Graph.2).

Another feature is the structure of this Government debt as being issued and sold abroad and in the country. The currency composition in which the Government debt has been issued is indicative for the high degree of Bulgaria's euroization. The debt currency structure as of end-December 2015 is as follows: 75.9% in EUR, 23.0% in BGN, 0.6% in USD and 0.4% in other currencies. As regards the currency composition of payments, since the beginning of 2015 the greatest is the euro-denominated share – 65.5%, followed by those in USD – 24.2%, in BGN – 10.1% .



Graph 2. Comparison of EU countries in Maastricht criterion indicator for share of public debt in GDP (%)

The achieved good discipline in government finances of Bulgaria deserves to be acknowledged. As seen in Graph 2, Bulgaria's indicator for share of public debt in GDP is below the threshold of 60% of GDP – less than 30% of the GDP. Nevertheless, due to the fact that the unfavourable conditions of the European sovereign crisis in the Euro area countries have lasted longer than expected, there is an objective necessity to take account of the need to implement the reforms in the EU that are targeted to deepen the integration capacity of the EMU.

The EMU has undergone important institutional and functional changes **while the euro area tackles the crisis and reforms its policies and in**stitution. It is acknowledged that the **"in-or-out" of the EMU is a** question that has become more complex (Rehn, 2013). The design of the EMU reforms is still shaping due to the different approaches of the member states to the issues and the political process (Ville et al., 2015). Surely the present state of the EMU (as considered to be "EMU 2.0.") raises the requirements and the mechanisms and instruments for a higher degree of common system of sharing the burden of making the EMU a more effective and robust functioning Union.

The costs of entering the EMU have grown as a result of the post crisis reforms in the financial integration not only due to enhanced needs of compliance with new legal provisions. The differentiated integration within the EMU gives solid grounds for better access of the EMU member states to the new institutions for sharing the risks and costs of financial integration and its new modalities. The challenge is that the EMU is at a stage to be completed by common policies to ensure a well-functioning monetary union. The problem is to access the implications of the "shift from rules to institutions" in the EMU in order to accomplish completely the Monetary Union. For the future enlargement of the EMU the differentiated integration will play a very important role. Bulgaria's preparation for the EMU has to take into consideration the fiscal capacity's needs to join the EMU in its present state of EMU 0.2.

CONCLUSION

The main macroeconomic challenges to Bulgaria are: (i) how to sustain high GDP growth, and (ii) how to ensure that this growth translates into new employment opportunities. Success in both dimensions will depend on the country's ability to implement the necessary structural reforms. The implementation of the requirements for the EMU entry at the present stage of its new design as EMU 2.0 may be demanding higher costs before being admitted to the full membership. But it is much more rational to get on track of preparation for the EMU entry at a time when the reforms in the EMU are to be introduced

The adoption of the euro may take place in Bulgaria after several measures are fulfilled:

1) under the auspices of the BNB there is a need to carry out the Asset Quality Review and the stress test of the Bulgarian banking system;

2) an in-depth evaluation of the financial sector of Bulgaria by the IMF Financial Stability Assessment Program (FSAP) and the World Bank is to be carried out by the end of 2016;

3) an analysis of the necessary steps for the realization of the strategic goals is to be reported to all responsible institutions in order that decision be taken for Bulgaria's EMU entry;

The accession to the euro area has been a strategic goal for Bulgaria for more than a decade but since mid2015 it has entered the stage of undertaking operationally planned activities to make the right choice and engage resourceful means to achieve full integration to the European supervisory and financial architecture. Bulgaria has become involved in the institutional reform process in favour of further deepening the integration in the EU but the reforms tend to raise the transitional costs of joining the new instititutional architecture of the EU integration.

The EMU has gone through a difficult but useful period of analysing the flaws in its original design, and has taken major steps to repair them. The new regulation contains tougher rules for fiscal policies, stronger oversight of macroeconomic imbalances, and a lender of last resort for sovereigns in the form of the European Stability Mechanism.The crisis has pushed the changes for the better to design prospective reforms by focusing on ensuring financial stability and in pursuing financial integration. The newly designed institutions and rules raise higher the requirements to comply with the EMU governance principles and institutions. The Single Market of the EU will be changing as the differentiated integration within the EMU proceeds further. Beyond this, it is equally crucial that the reforms will contribute to a more effective and robust functioning of EMU.

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ECONOMY AND CONTEMPORARY REALITIES IN THE GLOBAL WORLD SESSION