

TRANSITION TO THE EURO AND THE EXPECTED IMPACT ON THE BULGARIAN ECONOMY

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ABSTRACT. The transition from BGN to the euro is likely to be a fact for Bulgaria in the next 5-10 years. This publication summarises and gives an overview of the expectations for the effect of this on the national economy. Prognoses for the development of the process are presented as well as the risks related to internal and external factors. Influence is expected on: interest rates, financial fees, inflation, foreign trade and the political climate. The experience of other countries where the transition to the euro is linked with a subsequent crisis occurrences is also commented on.

Key words: BGN, euro, inflation, interest, economy, politics, expectations

ЗАМЯНАТА НА ЛЕВА С ЕВРО И ОЧАКВАНТО ОТРАЖЕНИЕ ВЪРХУ ИКОНОМИКАТА НА БЪЛГАРИЯ

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РЕЗЮМЕ. Преминването от лева към еврото най вероятно ще стане факт за България в следващите 5-10 години. Настоящата публикация разглежда и обобщава очакванията за ефекта от това върху националната икономика. Представени са прогнози за развитието на процеса и рисковете, свързани с вътрешни и външни фактори. Очаква се влияние върху: лихвите, финансовите такси, инфлацията, външната търговия и политическия климат. Коментира се и опита на други държави, в които въвеждането на еврото се свързва с последващо развитие на кризисни явления.

Ключови думи: лев, евро, инфлация, лихви, икономика, политика, очаквания

Introduction

Formed officially in 1999, the euro had lasted for three years in a "virtual" form, with twelve European countries replacing its national currencies on January 1, 2002. That is when the first waves of dissatisfaction with the change in mass commerce began. The Germans gave it the name: teuro – from teuer, expensive. Many Italians will confirm to this day that the end of their welfare came in 2002 with the fist touch with the "new money". The opinions for and against the euro are controversial: Angela Merkel calls it "our common destiny". Politicians across the broad spectrum from Emmanuel Macron to Viktor Orban consider it the most important institution of united Europe. At the same time, former British Foreign Secretary William Haig describes the euro as "a burning building without any exits". "Although it was an experiment designed to unite them, nothing really divided Europe as much as the euro", says the Nobel Prize winner Joseph Stiglitz. Generally, the euro is the eternal source of controversy in Europe. And in the next few years it is highly probable that Bulgaria would be in the focus of these disputes (Tomov, 2019).

The influence of the euro on pricing interest rates

There seems to be a difference between the statistical data and how the consumers perceive the transition to the euro.

There are many speculations about the matter, for example, according to statistics – the change of currency does not increase inflation, while consumers claim the opposite in countries like Germany and Greece. This controversy, in fact, has a simple explanation: significant price increases only affect certain sectors and commodities without being able to significantly change the metrics of the large customer basket, considered by the statistics. But at the same time, there are daily goods and services, where the change in price is most noticeable. There is nothing mysterious in the mechanisms of price increase. The most important of these is the rounding of prices in the new currency so they look attractive (Tomov, 2019). According to most forecasts, we should not expect a huge overall inflation rate in Bulgaria. Some commodities can rise significantly, and this will create a sense of reduced purchasing power. Similarly to consumers in countries like Germany and Greece, price increase of some goods might be detected in Bulgaria which is elusive for the statistics.

Some opinions about Bulgaria's entry into the Euro zone are optimistic. For example: Levon Hampartzoumian commented that Bulgaria's accession to the euro zone would not affect the Bulgarian economy badly, as many goods and services are currently traded in euro. He also reminded that the BGN has been in a currency board to the euro for 20 years. The process of joining the euro zone is more important than the EU accession itself. In his words, Bulgaria has been a member of the zone for 20 years since the currency board policy was implemented. According to him, the dispute whether

the BGN is correctly converted to the euro is insignificant. He added that if there was a dramatic distortion of the BGN-EUR ratio, the Bulgarian currency would have been converted to another foreign currency. Hampartzoumian adds if there was a dramatic distortion of the BGN-EUR ratio, the Bulgarian currency would have been converted to another foreign currency. According to his prediction, nothing bad will happen when the euro is adopted. Its positive effects will be felt by the "most economically active people" – those with business (Hampartzoumian, 2018).

A negative opinion about Bulgaria's joining the euro zone is expressed by the financial expert Steve Hanke, a professor at the Johns Hopkins University in the US, known in our country as the father of the currency board. He makes an analogy with the fate of Greece, if Bulgaria takes up this path. Hanke said that currently, with the currency board system, Bulgaria is unofficially a member of the euro zone and the BGN is a clone of the euro. According to him, the idea of official entry into the euro zone is bad for several reasons. First of all, because of the moral hazard. "If you enter the euro zone, you will face the moral danger Greece is facing. Bulgaria will say. Look, we can be a bit more relaxed about our fiscal situation in Bulgaria because if we get into difficulty, the EU has no other option than to save us". That's what the Greeks thought. Greece was officially in the euro zone and was spending money like crazy. Greek politicians did not spend money, they stole money.

According to him, the Bulgarians will not win anything if they adopt the euro but will lose the power of the currency board and will face the moral hazard that Greece had. "If you enter the euro zone officially, you will be just like Greece," Hanke is convinced. Joining the euro will not be a magical solution to all the problems in Bulgaria. "These are nonsense because the BGN is unofficially in the euro zone, nothing will change, except that Bulgaria will lose a lot of sovereignty, it will be officially in the euro zone, something without exit." That's why I say it is like in the song of "Eagles", "Hotel California" – You can check any time you like, but you can never leave" (Yuseliiev, 2018).

Inflation has an indirect effect on exchange rates through its impact on interest rates. When interest rates in one country are higher, capital from low-interest countries is being channelled to it. That's why the currencies of Australia and New Zealand are now rising and the US one is getting cheaper. Bulgaria also has the advantage in terms of interest rates as compared to the Euro zone. The difference in recent years is about 1% for household deposits in BGN and EUR, with no currency risk involved. This has been a factor in supporting the price increase of the BGN over the last 10 years, including the strong growth of the economy. But there are also market forces that would act on the reduction of the BGN price. These are the trade balance of the country and the direct foreign investments. The foreign trade deficit "drains" the foreign exchange reserves of the country and requires capital flows. A permanent foreign trade deficiency would lower the exchange rate, which would make imports more expensive and make exports more competitive. This deficiency is not necessarily a negative factor because it may be due to imports of machinery and equipment to be financed by foreign direct investment and subsequently to contribute to the country's GDP growth, including through exports. This happened in Bulgaria when there was a large foreign trade deficit. The crisis in consumption and the

recovery of foreign markets have changed this. In the course of two years, the deficit has fallen from 1.5 billion BGN a month to several tens of millions. The deficit did not impact the stability of BGN, because it was financed by foreign investments. Even if the BGN had been depreciated before 2008, the change in the foreign trade balance since then would have strengthened the BGN.

There are statements from 2008 that the BGN is underestimated or it would have risen in recent years if the exchange rate was determined on a market principle. Most likely the crisis would have caused speculators to sell BGN very actively at the end of 2008. This would have improved the foreign trade more and now the currency of Bulgaria would grow due to a positive balance. Periods of depreciation of the BGN would have been short, however, the large currency movements would have increased the business insecurity and minimised all benefits without taking into account the loss of confidence in the banking system or the BGN due to the lack of a currency board (Tsachev).

The acceptance of the euro is obligatory for all EU members, with the exception of Denmark (and the UK as far as it is still in the Union). But our country is now in a truly unique position: countries like the Czech Republic and Sweden are knowingly trying not to meet the criteria in order not to enter the euro zone; Bulgaria covers them and wants to enter but cannot. Many technocrats in the European institutions and in some more influential national governments believe that the acceptance of the euro should not be rushed. At least until the incomes in Bulgaria are a bit closer to the average for the Union. Not many people in our country realise that "convergence" means growth not only of salaries but also of prices. So far, the introduction of the euro has not led to major inflationary processes - according to official statistics. However, that is not so according to the subjective perceptions of the people.

"There will be no inflationary impulses above the healthy levels - neither in ERM II nor in the acceptance of the euro," emphasises Dimitar Radev, the Governor of the Bulgarian National Bank, in an interview with Bulgarian National Television (BNT). "However that does not mean that prices will remain unchanged. We are in the process of a real convergence. This process, inter alia, means getting closer to the average income and price levels in Europe. "If in Slovakia, say, a loaf was 49.99 crowns before the change, then it should have become 1.66 euro - a not quite "convenient" price. To achieve the same "attractiveness", merchants raised it up to 1.99 euro. In theory, rounding should work in both ways - some things should rise, others should get cheaper. In practice, however, there is no case of rounding down. There are two other factors. First, the transition to the euro entails certain costs for traders, which in general (says a Deutsche Bundesbank study) they tend to transfer directly to their customers. Second, the change of currency leads to the so-called "phenomenon of rational inattention" – forced to constantly calculate prices, most people at a certain moment stop to pay attention to the changes, even when they are at their disadvantage.

"It can be expected that the change in the currency will lead to significant price increases in a number of sectors, especially notably in those related to entertainment" they warned at the time. The effect on overall measured inflation (according to the so-called Harmonised Index of Consumer

Prices, or HICP) is not big – Huffner and Koske rated it at no more than 0.32%, but it is very noticeable because it refers to everyday necessities: coffee, cigarettes, newspapers. Not accidentally the Swiss economist Hans Wolfgang Brahringer invented the so-called "index of perceived inflation" and showed that according to consumer perceptions in Germany, the inflationary effect of the euro was four times higher than the one measured by statistics. All the studies on the subject show that the most serious rise is in spheres of publishing, restaurants, hairdressing and tickets for cinema. The effect is the strongest for middle-income and higher-income people spending more on entertainment. This was the case even in Lithuania that accepted the euro at the end of a deflationary cycle with record low interest rates. Eurostat reported the most visible price adjustments in cafes, hairdressing salons, housing and home repairs. Entry into the euro area is expected to reduce interest rates on loans and to decrease part of the risk premium on bonds. The National Bank of Lithuania estimates that in the first year only, the benefits for citizens from lower interest rates exceeded 40 million euro. Plus another 18 million were saved because of the decrease in transfer and exchange fees. The latter is particularly important for Bulgaria, where remittances from the Diaspora abroad are a major economic factor. On the other hand, the first of these effects can be offset by the global rise in interest rates. As for the Diaspora, a significant part of the transfers to Bulgaria comes from non-European countries such as the United States, Canada and the UK. The access to cheaper money hides risks and can seriously loosen up the financial discipline of the Bulgarian government. The example of Greece and the other South European countries in this aspect is very eloquent. The situation can be illustrated with a quote by Alan Greenspan: "When the euro zone was created, everyone decided that the South would behave like the North and the Italians would start spending as Germans. That did not happen" (Tomov, 2019). The risk of abuses in particularly large sizes is expected to increase, following the removal of the currency board.

In view of the above, the following conclusions can be made:

No huge leaps in inflation are expected. However, some commodities will become more expensive due to optimal price rounding by the sellers. At first, the prices will rise, but the situation will gradually return to normal. The rising dynamics in

prices, inflation and business will bring the economy of Bulgaria closer to that of Europe.

Unfortunately, financial concussions, similar to those in Greece, can occur. It is important to note that the problem is not the change of currency but the loosened control, corruption and financial abuses in particularly large sizes which often accompany such currency change.

Conclusion

Entry into the euro zone may be advantageous for the Bulgarian economy. Expected positive effects are: reduction of bank fees and interests as well as an ease of the foreign trade with the euro zone economies. As a negative effect should be mentioned the increased opportunities for financial abuse by Bulgarian politicians. It is reasonable to expect some increase in inflation, but it is likely to be moderate and temporary. The worst course, which at this stage seems unlikely, is to reach a crisis requiring reverse introduction of the BGN. Failure, success, or both – the future will show.

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