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Regarding the Unilateral Euroization of Bulgaria

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The Euroization

The euroization was recommended to Bulgaria at the Bulgaria and Europe Conference in July. The ex presidential adviser Prof. Jeffrey Sachs called to start preparations to dismantle the Currency Board and introduce the euro. "Bulgaria must be ready to introduce the euro if the Currency Board fails. This should not be done unilaterally. Your country should reach an agreement with the IMF and the ECB on future actions in unforeseen circumstances ... If Argentina had dollarized its economy, the crisis would not have hit it."[1] Alfred Schipke, a lecturer at Harvard University, reiterated this idea in a stronger manner. "Bulgaria can become one of the countries that have introduced the euro before joining the European Union." Ilian Mihov from the European Institute of Business Administration went to extremes claiming that "The ECB does not have at least one economic argument against the unilateral euroization of our country."

Definition

The official euroization and dollarization is the withdrawal of the national monetary unit and the introduction of the euro or the US dollar as the only legal tender. The Central Bank ceases to issue money, to be a lender of last resort and to control inflation and the interest rate. Thus a country is stripped of its independent monetary policy and its Central Bank's monetary sovereignty is abolished.

There are two factors needed and sufficient for success from the perspective of pure macroeconomic logic: an official reserve, which is large enough to replace the national currency and a good level of integration with the country (region) whose monetary unit is introduced.

[1] It is a brave assumption that authorities on the matter have strong doubts about.

It is just a hypothesis of official replacement of the money that is being considered. The uncontrolled eviction of the national currency by a foreign currency is a different matter. After many financial crises and devaluation of assets that are denominated in a local currency, the economic agents in most East European countries in transition keep some of their savings in US dollars, euro or Swiss francs. Real estate is quoted in a foreign currency. There had been periods when the large-scale use of the US dollar was called uncontrollable dollarization and thought to be an attribute of an extremely grave crisis. Once displaced, the national currency is slow in regaining position. The repetition of a monetary crisis is never to be ruled out but it is not what this article is about.

What Is the Reason for Recommended Euroization?

The short answer is: to do away with the monetary risk. With a Currency Board Arrangement in place, the risk has been reduced to a very low level, in other words, it is economically irrelevant. Other arguments are the structural compatibility and the high extent of integration of the Bulgarian economy into the eurozone. As the lev is pegged to the dollar, people won't find the replacement difficult. And finally, there are the assumptions that should the Currency Board be removed, the official introduction of the euro would parry certain negative developments, that the turbulence experienced by the Bulgarian economy are symmetrical to the turbulence in the eurozone, that the ECB's monetary policy would be optimal for Bulgaria as well. These allegations, most of which are disputable, are all the arguments. Further we will prove that for a country with a project to join the EU and its Economic and Monetary Union (EMU) these arguable pluses cannot make up for the losses.

Let's return to the idea. As the authors realize, they are making an illegitimate call (that the EU law does not provide for) to introduce the single currency in Bulgaria, they recommend reaching an agreement first and then introducing it. The only additional "argument" they recommend to the country is the need to save the Currency Board Arrangement (?!).

Why Does the European Union Object the Unilateral Introduction of the Euro?

During the negotiation process the European Commission reminded the candidate countries of the three pre-accession stages in the way to the single monetary unit. The stages start with accession. In the first stage, the new member country is judged whether it meets the Maastrich criteria of similarity and all requirements of the Treaty on European Union. In the second stage, the new member country announces that subject to the assent of all other members it starts the procedures that precede the introduction of the euro; the new member country pegs its national currency to the euro and given the consent of the European System of Central Banks fixes a central exchange rate and a deviation margin and sticks to a special Exchange Rate Mechanism (ERM II)[2] in the course of two years. In the third stage, an evaluation is made of the ERM II performance, a final exchange rate is fixed for the national currency to the euro – a conversion rate, and the redenomination is done over a certain period of time.[3] If successful, these three stages are considered a "key factor for the success of the European monetary integration" and are called its "functional culmination" as "ERM II structures the right balance between the liabilities and flexibility"[4] of the EMU member countries.

It is evident the above-mentioned authors suggest that Bulgaria should not go through the compulsory stages and should not apply the ERM II. The warning of ECOFIN should be emphasized: "It should be clear that any unilateral introduction of the single currency by means of euroization will be contrary to economic rationale that underlies the EMU in the Treaty. Therefore, unilateral euroization could not be the way to bypass the stages that are provided for in the Treaty on the introduction of the euro."[5]

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[2] The probable deviation margin will be +/- 15 percent.

[3] Maastricht Treaty, Article 109 J (1); Article 1 of its Protocol No. 6. A two-year period was fixed for the full redenomination of the EMU member countries.

[4] Eugenio Domingo Solans, Member of the Governing Council and of the Executive Board of the European Central Bank. Exchange rate policies in the accession process. At the conference on "Alternative Exchange Rate Regimes in the Globalized World" marking the 10th anniversary of the Currency Board in Estonia, Tallinn, 11 June 2002.

[5] ECOFIN Council, Conclusions on exchange rate strategies for accession countries, COUNCIL OF THE EUROPEAN UNION, Brussels, 7 November 2000.

What is to be deduced from the Treaty? 1) The euro shall be introduced by the countries only after they join the European Union and after a successful exchange-rate procedure. The introduction of the single currency is a "common interest" of the EU and the country that introduces it; 2) It is not possible to breach the European Treaty for the sake of one country and introduce the euro by way of exception. Therefore from now on we will use just the term "unilateral euroization," i.e. the introduction of the euro without the consent and commitment of the ECB. This shall not make a country qualify for EMU membership. It is evident that the crisis is an "argument" that the EU won't take. The introduction of the euro is the crowning event in the European integration of a country and not a safety belt in the event of a crisis.

The Agreement Problem

It would be good to mention them who disobeyed the rules of euro introduction and explain why. These are Kosovo and Montenegro, i.e. *autonomous territories, not states.* They did not lose their monetary sovereignty as they did not have any, and introduced the euro to become less dependent on Serbia. In other words, they played on the political effect to disengage from the mother state. Moreover, they make no preparations for full EU membership and therefore do not feel bound to stick to the EU rules.[6]

The unilateral introduction of a foreign currency is different from the introduction subject to an agreement. Unilateral euroiziation is a unilateral decision. No negotiations are held. There is no possibility for a less strict regime. All the burden of the process and all the responsibility are borne by the government that decides to proceed with euroization. If it is agreed introduction, as a rule it is possible that the country whose monetary unit is introduced might opt to offer privileged treatment to the new monetary regime. A bill submitted to the US Congress intended to provide for official dollarization, including Argentina, tried to do that.[7] Unlike this bill

[6] The Republic of Ecuador, the Republic of Panama, the Republic of El Salvador, the British Virgin Islands, East Timor and other smaller countries have introduced the US dollar unilaterally.

that was not enacted, Montenegro and Kosovo never tried to negotiate nor have they negotiated any obligations on the part of the ECB.[8] Their monetary regime enjoys no privileges and the burden and responsibility is all theirs.

The EU officials use the term “unilateral euroization” consistently and unambiguously to emphasize there is no chance to negotiate an exception to the Maastricht Treaty. Their argument is that equal treatment of all members is the underlying principle of the Treaty and an exception shall not be made for anyone. Conversely, the replacement of a local currency by the US dollar is more likely to be negotiated as this won’t be a breach of multilateral treaties and the consent of the United States is all that is needed.

The Currency Board Has Taken Over Some of the Bulgarian National Bank's Key Functions

The Currency Board has taken over some of the Bulgarian National Bank’s key functions that the BNB should regain. In addition to being completely independent of the Government, the Central Bank should prove its competence to employ all monetary instruments to execute the monetary policy that is binding on the member countries. It is completely wrong to surmise that the Currency Board alone can be a proof of such competence. The Currency Board is a proof of independence and discipline but is incompatible with the ERM II. The BNB should produce proofs of capability to be a full-fledged member of the European System of Central Banks (ESCB) during the compulsory stages. It is only in this way that the BNB and the Bulgarian financial system can be integrated in the eurozone.

[7] A BILL to promote international monetary stability and to share seigniorage with officially dollarized countries. H.R. 2617, July 21, 2001 (referred to the Committee on Financial Services).

[8] Tommaso Padoa-Schioppa, Member of the Executive Board of the European Central Bank, The Euro Goes East, 8th Dubrovnik Economic Conference, 29 June 2002.

Why is it that a country aspiring to full European integration is denied the free option of unilateral euroization? To answer the question, we have to think of the EU in general and of the EMU in particular as clubs whose rules are binding on all who want to join them. The European model is based on the principle of equality, i.e. all members are equal, there are no first-rate and second-rate members, and all members have produced evidence of being capable of enjoying the same rights and of bearing the same responsibilities. The EMU members have replaced their national currencies with the euro (some made a "sacrifice"[9]) after producing firm evidence to persuade each other that they have highly developed and disciplined national monetary systems and fully independent and sovereign institutions that can meet the agreed criteria of exchange rate, inflation control, interest rate control, external debt management and budget deficit management.

If Bulgaria renounces the lev and refuses to pursue an independent monetary policy in future, these will be signs of non-eligibility for the club. In addition to exposing the Bulgarian political inadequacy, the unilateral euroization will create an institutional problem, about the manner in which Bulgaria will be represented in the ESCB and the ECB. Let us remember that the BNB has not even one function typical of a central bank and if it exists at all, it won't be admitted as a member. The question is who is to act on behalf of Bulgaria once it unilaterally replaces the lev with the euro? Even if, hypothetically, the strategic need of EU enlargement may accept a unilaterally euroized Bulgaria, then the Greek or the Romanian central bank would have to agree to represent the Bulgarian interest.

[9] "Let me pay tribute to the German Government for the courage to sacrifice the Deutsche mark, the emblem of German identity, and to give its support to the euro which was an unknown at the time, in the interest of the peace and prosperity of Europe." Reply by Dr. Willem F. Duisenberg, President of the European Central Bank, on the occasion of receiving the Grand Cross 1st class of the Order of Merit of the Federal Republic of Germany, Frankfurt am Main, 24 July 2002.

Cons at Home

In a country with a Currency Board Arrangement it is difficult to understand all pros of a monetary policy as a key instrument for financial stability and sound economic growth, as the board is a **temporary renunciation** of free monetary policy. It is easy to understand that the unilateral introduction of the euro is tantamount to **final renunciation** of whatever monetary policy. It is a big sacrifice in a country with non-competitive economy and low-income levels, as it leaves it with very few instruments to strengthen competitiveness to withstand the pressure of the free European market and to attract capital. It takes time, perseverance and phased integration to meet the Maastrich criteria of similarity and the ERM II. This is time of development and adjustment. Let us remember that none of the eurozone member countries met these conditions at once.

Loss of Seigniorage

The strongest cons at home are of monetary nature. When the euro is normally introduced, i.e. when all requirements are met, the BNB joins the ESCB and acquires a quota in the ECB capital. This allows the BNB to replace the lev notes and coins in circulation with the euro and transform the lev demand deposits and all other forms of lev debt outstanding into a euro debt using the conversion rate. This exchange rate that Bulgaria will successfully maintain two years after the application of the ERM II will be announced as inalterably fixed and valid for the redenomination of the whole outstanding debt.[10]

The unilateral euroization leads to the loss of the seigniorage (the net income from money issuing) for the past period. Bulgaria will have to provide the euro for circulation unassisted. With a Currency Board Arrangement, the levs withdrawn will have to be replaced by some of the euro reserves maintained to balance the levs in circulation and the demand deposits. This simple operation seems to have misled many people who fail to see that if the single Euro-

[10] Council regulation (EC) No. 974/98 of 3 May 1998 on the introduction of the euro.

pean currency is normally introduced, the 2.2 billion euro backing is not needed for the circulation and is released for other purposes.

In the event of an official unilateral substitution of the lev with the euro, the Government will have to substitute some 30 percent of all time and special deposits, the lev deposits. The sum amounts to over 2.1 billion levs or 1.1 billion euro. This is the indicative worth of the fiscal reserve. If the euro is normally introduced, then the redenomination is the operation proper.

This is not the whole loss from unilateral euroization. The normal introduction of the single European currency will give Bulgaria the right to share in the distribution of the ECB cash income and net profit.[11] In 2001 the seigniorage in the eurozone was some 150 billion euro. Further, if, hypothetically, Bulgaria was free of a Currency Board Arrangement and had met the Maastrich criteria, the national seigniorage would have been approximately 2 percent of the GDP, or 300 million euro. A unilateral euroization will forever strip Bulgaria of the right to claim such future earnings.

Arguments so far show why the monetary policy of the candidate countries is a matter of mutual interest with the EU member countries and why the ERM II procedure is so stringent and binding. The rate of the euro redenomination in Bulgaria and the BNB's share in the ECB is highly in the interest of the ESCB. Therefore, serious arguments are needed for the lev conversion rate.

In conclusion, as of today that will cost the country: 1) onetime sum of approximately 3.3 billion euro; 2) annual loss of seigniorage – at least 2 percent of the GDP; 3) renunciation of monetary sovereignty; 4) elimination of the BNB; and 5) loss of reputation. The last three losses are not measured in terms of money but the political implications are exorbitant.

[11] Protocol (No. 18) (ex. No. 3) on the Statute of the European System of Central Banks and of the European Central Bank, Article 32 and Article 33.

[12] Political economy generalizes the macroeconomic, institutional and political aspects of the national and multinational economic projects.

Unilateral Political Decision

In terms of political economy[12] apart from the macroeconomic conditions, there are many other relevant parameters of which the national interest is paramount. In that case the national interest is very clearly defined: Bulgaria aspires to be a full member of the eurozone, which is the world's largest market. The replacement of the national currency with a foreign currency requires an extremely hazardous political decision from the Government, which must take all the responsibility for the abolition of the national monetary unit and for the renunciation of the country's monetary sovereignty. Bulgaria's EU membership cannot justify such a decision as it will be a unilateral decision that breaches the Maastricht Treaty. The Bulgarian monetary and fiscal institutions won't have passed the harsh test nor will they have met the criteria of institutional compatibility, that is, the advantages of membership won't be absorbed. The unreformed and uncompetitive Bulgarian economy and the immature Bulgarian society will be hit by the difficulties of integration to which they are not adjusted.

The unilateral political decision to introduce the euro will foster to agents unrealistically high expectations on the part of the Bulgarian economic agents. Life will show all the time that the expectations had been unfounded and this will cause disappointment. Companies will get a misleading strategic idea of local conditions and of the potential of local monetary and financial institutions.

The loss of monetary sovereignty that in European tradition is part of the national sovereignty for a long period of time will strip Bulgaria of the right to become a full-fledged member of the zone of the single European currency and the single market. Full integration in the newly emerged economic giant that the eurozone has become will be impossible and the prosperity of the region will continue to be unattainable.

Let us ask one final question: Is there a political party to venture unilateral euroization under such circumstances? And when we are answering the question, let us consider whether a public debate on it is still on the Bulgarian agenda.

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The unilateral introduction of the euro is not free admission to the euro system. On the contrary, it is very expensive, as it has been explained above. Bulgaria successfully defended its position when Chapter 11 "Economic and Monetary Union" was closed and should not retreat. That position is the platform for the discussion on how to make the transition from the Currency Board to the introduction of the euro. A dispute of pros and cons related to unilateral euroization won't help.

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