DISCUSSION PAPERS

DP/50/2005

Economic and Monetary Union on the Horizon

Dr Tsvetan Manchev
Mincho Karavastev

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Contents

Abbreviations

EC	–	the European Commission
ECB	–	the European Central Bank
ECU	–	the European Currency Unit
EMI	–	the European Monetary Institute
EMS	–	the European Monetary System
EMU	–	the Economic and Monetary Union
ERM II	–	the Exchange Rate Mechanism II
ESCB	–	the European System of Central Banks
EU	–	the European Union
MF	–	Ministry of Finance
NSI	–	National Statistical Institute
PEP	–	Pre-accession Economic Program
SGP	–	the Stability and Growth Pact
TEC	–	the Treaty Establishing the Uuropean Union

SUMMARY. The paper discusses one of the major problems for Bulgaria, related to the EU membership – the time of the adoption of the euro. Authors hold the opinion that it 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 statement is completely consistent with the common position of the Bulgarian Council of Ministers and the Bulgarian National Bank concerning the introduction of the euro in Bulgaria, stated officially in the agreement between the two institutions signed on 25 November 2004.

The paper summarizes the essence and the importance of the European Economic and Monetary Union. It presents the criteria for membership in it, and the stages in its realization. The analysis of the institutional framework for the implementation of the macroeconomic policy in the country and the trends in the development of Bulgarian economy from the point of view of EMU membership criteria support the view that the most suitable resolution of the strategic problem for the accession of Bulgaria to the euro area is to do this without delay.

The paper tries to reveal the possible consequences for the country's economy of the change in the economic policy goals, and the degree to which this change could influence the process of euro adoption in Bulgaria.

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Introduction

Adopting the euro as Bulgaria's national currency for both cash and noncash payments is a logical step, marking as it does Bulgarian membership of the European Economic and Monetary Union (EMU) after the Treaty of Accession of the Republic of Bulgaria to the European Union comes into force on 1 January 2007. It is also inevitable, since the Treaty Establishing the European Community (TEC) contains the fixed requirement for each accession state to introduce the euro. Thus the issue comes down to timing; and the right timing, as shown by the analysis that follows, is the earliest available: the second half of 2009, or 1 January 2010.

We seek and find the arguments in favour of this rather categorical opinion in several venues. *First*, we look at what EMU means and examine its evolution and the extent to which it currently fulfils its objectives. *Second*, we look at the requirements for full EMU membership without derogation[1]. *Third*, we analyse the degree to which Bulgaria was in line with these requirements in late 2004. *Fourth*, we set out the undoubted benefits of full EMU membership based on member state experience; they provide the natural impetus for membership without derogation. Finally, we describe the institutional framework of Bulgaria's macroeconomic policy, which determines the challenges ahead and the rapidity with which the public can enjoy the benefits of full EMU membership.

I. The Emergence of European EMU

1. Quintessence and Genesis of the EMU Concept

Economic and monetary union is the highest stage of economic integration attained to date among countries within an integration community as a way of coordinating and unifying their economic policies. This form of union combines the other two forms of economic integration: economic union and monetary union[2]. In brief, the former of these entails not just a common market, but also a high degree of coordination and even unification of key economic policies between member states. The latter typically features fixed exchange rate between the integration community's currencies, or else the launch of a single currency within the community. Complete liberalization of

[1] Derogation, or the right to an exception, is available to EU member states which do not fulfill EMU criteria and are within Stage Three without losing their rights to conduct independent monetary policies.

[2] See **Molle, Willem**, *The Economics of European Integration: Theory, Practice and Policy*, 2001, p. 17.

the movement of capital is obligatory within a monetary union. Thus, EMU is an integration community of two or more states featuring:

- a common currency issued by an independent issuer (a union central bank) or irrevocably fixed exchange rates of the states within the union;
- a common monetary policy conducted by the union's central bank;
- a common market featuring the free movement of people, goods, services, and capital;
- an obligation on member states to pursue common economic policies subject to rules approved by them within the framework of an agreement such as the Stability and Growth Pact (SGP).

The idea of European EMU first emerged in late 1969 in the Hague at a summit conference of the then-six members of the European Communities[3]. In 1970 a report prepared under the leadership of Pierre Werner, then Luxembourg's prime minister and finance minister, set out the milestones to EMU. On 22 March 1971 the European Communities' Council of Ministers adopted a resolution defining the principles of such a union, and a plan for its implementation. The plan listed three stages for implementation within ten years. The collapse of the Bretton Woods monetary system and the world economic crisis caused by the 1973 oil price hikes put paid to the project. Nevertheless, some elements of the Werner Plan saw light of day in the early Seventies[4]: 1. exchange rate management within the European Economic Community ('the snake'), 2. the European Monetary Cooperation Fund, and 3. coordination and convergence procedures for member states' economic policies.

The European Monetary System (EMS)[5] was launched in March 1979. While not EMU, it pursued some similar objectives and partly made up for the failure of the Werner Plan. Most generally, the EMS aimed to constrain the exchange rates of participating currencies within narrow bands through central bank interventions on the forex markets subject to preliminary set rules.

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[3] The so-called founder members: Belgium, France, Germany, Italy, Luxembourg, and the Netherlands. The European Communities comprise the European Coal and Steel Community, the European Economic Community, and the Euratom European Atomic Energy Community. A separate Treaty created each Community. Until the Treaty on European Union ('the Maastricht Treaty') came into force in 1993, within the context of European integration "European Community" implied the European Economic Community as the most economically and politically significant of the three Communities. The Maastricht Treaty changed the name of the Treaty Establishing the European Economic Community to Treaty Establishing the European Community, thus the word "Community" today usually implies the European Community.

[4] For more details on implementing these elements of the Werner Plan, see **Gross, Daniel, Niels Thygesen**, *European Monetary Integration*, 1998, p. 15.

[5] The European monetary system was created on the basis of a European Council decision at Bremen in July 1978. The European Council held at Brussels in December 1978 adopted a Resolution creating a European Monetary System.

Members at the System's launch were Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, and the Netherlands. Britain, Greece, Spain, and Portugal joined later.

The European Currency Unit or ECU played a central role in the EMS currency exchange mechanism[6]. The rate of each currency to the ECU determined bilateral central exchange rates for all currencies in the system ('the parity grid'). The currency mechanism set maximum limits to market-driven exchange rate fluctuation *vis-a-vis* the official rates. Until late July 1993 maximum deviations were ±2.25 per cent. An EMS crisis in 1992 and 1993, caused by the discrepancy between the monetary policies of the Bundesbank and other central banks in the system, led to an August 1993 joint session of the Ecofin Council and EMS central banks' governors broadening permissible exchange rate deviations to ±15 per cent.

The Resolution creating EMS foresaw the European Monetary Cooperation Fund issuing ECU against the deposit of 20 per cent of the US dollar and gold reserves of community central banks into the Fund. This created a new international reserve unit as an alternative to the dollar. It did not have all features of money: it was not usable for exchange except in dealings between EMS central banks ('the official ECU'). Subsequently, however, entities (mainly corporates), the European Investment Bank, and even governments, began opening bank accounts, contracting payments, and issuing debt instruments in ECU, thus inaugurating 'the private ECU'[7].

The Single European Act[8] which came into force in 1987 added steam to the impetus of dusting down European EMU. In June 1988 at Hanover, the European Council convened a committee chaired by Commission President Jacques Delors and comprising member state central bank governors and monetary theoreticians. The Delors Committee had to propose specific measures for EMU establishment. It published the results of its deliberations, including the need to amend the Treaty of Rome[9], on 17 April 1989. The Com-

[6] The European Currency Unit emerged as an official accounting unit within the European Development Fund in 1975, before the European Monetary System came about. Initially called the European Unit of Account, it was a basket of the currencies of the nine member states at the time. Subsequently, the European Investment Bank and the entire Community adopted it as unit of account.

[7] See **Gross, Daniel, Niels Thygesen**, *European Monetary Integration*, 1998, p. 238.

[8] The Single European Act was adopted in 1986 and entered into force on 1 July 1987. The changes it introduced into the Treaty Establishing the European Community aimed at the emergence of a single European market with no barriers to the free movement of goods, services, and production factors.

[9] The Treaty Establishing the European Community, also known as the Treaty of Rome, was signed in Rome on 25 March 1957. Coming into force alongside the Treaty Establishing the European Atomic Energy Community on 1 January 1958, it was called the Treaty Establishing the European Economic Community. The Treaty on European Union, also known as the Maastricht Treaty, signed on 7 February 1992 and coming into force on 1 November 1993, gave the Treaty of Rome its current name, amended it, and set up the European Union. The Treaty of Amsterdam, signed on 2 October 1997

mission recommended a common Community monetary policy, conducted by a body entirely independent from member state governments and Community bodies: the European System of Central Banks (ESCB). This was to exist alongside member states' central banks. The Delors Committee recommended the adoption of the ECU, with all characteristics of money, as the Community's single currency.

The major conclusion from this short overview of the history and milestones of European EMU is that it is the logical consequence of accumulated political lessons.

In the long run, theoretical and practical limitations have acted as natural fixes and guides along the way towards EMU in Europe. The necessity to coordinate monetary and exchange policies on the one hand, and fiscal and structural policies on the other, is clearly apparent. Other key challenges include ensuring continuity in coordination and conducting coordination to clear rules, guaranteeing predictability, and hence public confidence.

2. Stages in EMU Implementation

The Delors Committee proposed that EMU should have three stages, with economic union proceeding concurrently. Below, we view the features of the three stages EMU underwent during the 1990s. They contain the requirements Bulgaria must fulfil on its way to the euro. The coming into force of the Accession Treaty with each state automatically implies that this state meets EMU Stage Two requirements.

Stage One: 1 July 1990 to 31 December 1993

This stage began a considerable time before TEC. Under it, European Community member states implemented the measures listed below as conditions for Stage Two. Later, these measures became integral parts of TEC as signed at Maastricht (TEC Article 116[10][2], Item A):

- removing all restrictions before the free movement of capital and payments between member states, and between member states and third countries in certain cases set out in the TEC;
- a prohibition on direct financing of budget deficits through central bank loans, and on any form of indirect financing or the direct purchase of government debt instruments by central banks;

and coming into force on 1 May 1999, amended both the Treaty Establishing the European Community and the Treaty on European Union. In the same way, the Treaty of Nice, signed on 26 February 2001 and coming into force on 1 February 2003, amended the Treaty Establishing the European Community and the Treaty on European Union.

[10] All TEC Articles are cited according to the new consolidated renumbering of European Communities Founding Treaties introduced by the Treaty of Amsterdam in 1997.

The Roles of Major European Union Institutions in Economic and Monetary Union Implementation and Functioning

The European Union Council, also known as the EU Council of Ministers or the European Communities Council of Ministers until the Treaty on European Union (the Maastricht Treaty) came into force, represents the interests of EU member states. The Council comprises a single ministerial level representative from each member state. Its composition depends on the scope of each agenda. Where agendas include items relating to EMU, its members would be finance and economy ministers (the Ecofin Council). The Council mentions in legal and economic literature in connection with EMU imply its Ecofin composition unless otherwise stated. As regards the TEC, a Council comprising heads of state or government leaders adopts resolutions on the presence of a majority of states which fulfill EMU Stage Three criteria, and resolutions on the launch of EMU Stage Three. Ecofin coordinates member state economic policies and adherence to the Stability and Growth Pact (SGP). Alongside the European Central Bank, Ecofin is responsible for common euro area monetary policy (that of the states which have adopted the euro) and for coordinating the monetary policies of EU member states which are not full members of EMU Stage Three. Ecofin adopts its resolutions by qualified majority. In individual cases, such as EMU matters in negotiations with third parties and international bodies, Council decisions require unanimity.

The Council adopts statutory instruments required for EMU functioning on the basis of European Commission recommendations, after consulting the ECB and taking into account European Parliament opinion. The ECB adopts statutory instruments linked with common monetary policy after EMU Stage Three.

Under TEC provisions, Council has the right to grant derogation to certain states subsequent to Commission recommendation. While derogation rights obtain, the state making use of them does not fulfill EMU Stage Three nominal convergence criteria (Maastricht Criteria). Derogated states are not equal members of EMU Stage Three: they do not adopt the euro as their currency; their central banks are not part of the eurosystem; their representatives have no Council voting rights on specific EMU issues; they are not subject to certain TEC provisions. The Council also plays a leading role in repealing derogation. At least once every two years, or else at the request of a derogated state, the Commission and the ECB may prepare reports to the Council on this state's adherence to Maastricht Criteria. The Council may then repeal derogation upon Commission recommendation, after consultations with the European Parliament, and after deliberation within the Council at head of state or head of government level.

The Council formulates and coordinates the national economic policies of EMU member states. On a recommendation from the European Commission, the Council may prepare projects on the main thrusts of member states' economic policies and submit them for deliberation by the European Council. The European Council then debates such projects and draws conclusions on them. These conclusions form the basis of Council recommendations on overall economic policy directions. At European Commission recommendation, the Council may make recommendations to states whose economic policies diverge from the aforementioned overall direction.

The Council also plays a central role in procedures to maintain budget discipline at member states. On the basis of Commission recommendations, the Council decides whether an unduly large budget deficit is present within a member state. It may make recommendations to this state, imposing penalties where they are not followed.

The European Council comprises the heads of state or heads of government of member states as well as the President of the European Commission. The latter's main function is to set the basic political thrust of the integration process. The role of the European Council as regards EMU is to provide political impetus and support its development. In practice, the European Council provides summit-level political leadership to EMU by directing it without adopting specific legislative measures.

- a prohibition on privileged state access to financial institutions at any level, including local government and public bodies or bodies created under special legislation;
- preparation of long-term programs for the stable convergence required for EMU, aimed specifically to ensure stable prices and public finances.

Before the start of Stage Two on the basis of a report from the Commission, the Council (also see the Box) assesses the progress made with regard to economic and monetary convergence, in particular with regard to price stability and sound public finances, and the progress made with the implementation of Community law concerning the internet market. The report plus a positive assessment of progress are fixed requirements for any state wishing to accede to the Union (TEC Article 116 [2], Item B).

EMU Stage One measures are advisory rather than mandatory. They aim to achieve mostly monetary convergence between individual states, while also paving the way for Stage Two. Countries wishing to accede to the EU after the start of EMU Stage Three must adopt Stage One measures in the pre-accession period, prior to their Accession Treaties coming into force; for Bulgaria, this means the expected EU accession date of 1 January 2007.

Stage Two: 1 January 1994 to 31 December 1998

The basic aim of this 'transition stage' was to mark "significant progress towards a convergence between the economies of member states," as well as to create conditions for subjecting community states to a common monetary policy. Measures which were advisory for member states during the Stage One now became mandatory. Prohibitions now addressed:

- privileged public sector access to financial institutions;
- limitations before the free movement of capital and payments;
- direct budget deficit financing by central banks.

Moreover, a rule made each member state solely liable for the obligations assumed by its public sector, while having no liabilities for other member states' public sector obligations. The Community was also free of such liabilities (TEC Article 103 [1]).

In the second stage, member states were mandated to avoid excessive budget deficits (TEC Article 116 [4]). To this end, the European Commission was to perform a special public finance monitoring procedure (TEC Article 104 without Paragraphs [1], [9], [11], and [14]). The Commission monitors developments in member states' budgets and government debt with a view to spotting major departures from two set ratios:

- whether the ratio of the planned or actual budget deficit to Gross Domestic Product exceeds a reference value (a part of Maastricht Criteria explained below); and
- whether the ratio of government debt to Gross Domestic Product exceeds a reference value.

The procedure provides for exemptions where departures from these values are transient, or where lasting convergence trends are evident.

If a member state does not fulfil the requirements under one or both of these criteria, the Commission prepares a report. The report of the Commission also take into account whether the budget deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the member state. The Commission may also prepare a report if it is of the opinion that there is a risk of an excessive budget deficit in a member state.

If the Commission considers that an excessive budget deficit in a member state exists or may occur, the Commission shall address an opinion to the Council.

The Council, acting by a qualified majority on a recommendation from the Commission, and having considered any observations which the member state concerned may wish to make, decide after an overall assessment whether an excessive budget deficit exists. Where the existence of an excessive budget deficit is decided, the Council makes recommendations to the member state concerned with a view to bringing that situation to an end within a given period. These recommendations shall not be made public, except where the Council establishes that there has been no effective action in response to its recommendations within the period laid down.

Stage Two also involved monetary policy measures. The new European Monetary Institute (EMI) had two groups of major functions (*TEC Article 117*): coordinating member states' monetary policies, and preparing transition to EMU Stage Three.

EMI duties are similar to those of the ECB, the main difference being that the Institute may offer non-mandatory opinions and recommendations to member states. With the launch of EMU Stage Three, the ESCB (EU member states' central banks plus the ECB) took over EU monetary policy and its members' monetary decisions became mandatory to member states.

TEC Article 124 (1) requires member states to regard exchange rate policy as a matter of joint interest during EMU Stage Three. In this Stage, exchange rate policy ceases to be the sovereign prerogative of member states and moves under Ecofin and ESCB management.

During Stage Two, each member state had to embark upon the process of granting independence to its central bank. This meant that by Stage Three at the latest, national legislations on issuing authorities had to be compatible with the independence criteria of TEC Articles 108 and 109. The criteria require that neither a national central bank, nor any member of its decision-making bodies may seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body.

Stage Three, from 1 January 1999

The most important features of EMU took shape during this Stage:

- transition to a common monetary policy conducted by the ESCB[11];
- ultimate fixing of exchange rates of the currencies of nonderogated member states to the euro;
- launching the single European currency into circulation;
- introducing mandatory safeguards against excessive budget deficits.

Public finance monitoring broadened in line with Stage Three obligations for member states to avoid excessive budget deficits (TEC Article 104 [1]). Where the Council finds that a member state is failing to put in practice its recommendations to cut a budget deficit, it may decide to give notice to the member state to take, within a specified time limits, deficit reduction measures (TEC Article 104 [9]). If the member state fails to comply with the decision of the Council, it may decide to apply or, as the case may be, intensify one or more of the following measures (TEC Article 104 [11]):

- to require the member state concerned to publish additional information, to be specified by the Council, before issuing bonds and securities;
- to invite the European Investment Bank to reconsider its lending policy towards the member state concerned;
- to require the member state to make a noninterest-bearing deposit of an appropriate size with the Community until the excessive budget deficit has, in the view of the Council, been corrected;
- to impose fines of an appropriate size.

[11] In practice, not all EU member states are equal participants in stage three of EMU. The term 'eurosystem' emerged because ESCB members include the central banks of states which have taken up derogation rights. The eurosystem comprises the central banks of states without derogation; they participate in formulating common monetary policy in the so-called 'euro area.' The euro area includes the states without derogation: those who have adopted the euro as their single currency. At the start of EMU Stage Three, the euro area included Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain, with Greece joining in early 2001.

The SGP[12] amplifies the above TEC provisions with a procedure for monitoring member state public finances and clarifying when the datum of -3 per cent of the annual budget deficit (a Maastricht Criterion) may be exceeded. The Pact also clarifies the duration and scope of penalties against states with excessive budget deficits. The SGP mandates EMU member states to maintain close to balanced or surplus budgets in the medium term. This would allow them to cope with normal business cycle fluctuations without exceeding the -3 per cent reference value. Euro area states have to prepare and update annual Stability Programs. Presented to the Council and the Commission, they show measures for attaining the medium-term budget objective. The Council decides whether to accept Stability Programs or propose amendments to them. The table below shows the public finance monitoring procedure time-scale.

Table 1

TIME-SCALE FOR THE APPLICATION OF THE EXCESSIVE DEFICIT PROCEDURE

Time (ultimate dates)	Action
1 March (year ***t***) or 1 September (year ***t***)	Member states submit data on their public finances to the Commission
1 June (year ***t***) or 1 December (year ***t***)	The Council decides on the existence of an excessive deficit on the basis of a report by the Commission and issues recommendations to the member states concerned
1 October (year ***t***) or 1 April (year ***t+1***)	The Council considers whether effective action has been taken and whether recommendations should be made public
1 November (year ***t***) or 1 May (year ***t+1***)	The Council decides on measures to be taken by the member states concerned to correct excessive deficit
1 January (year ***t+1***) or 1 July (year ***t+1***)	The Council imposes sanctions on the member states concerned
1 May (year ***t+1***) or 1 November (year ***t+1***)	The Council decides on an intensification of the sanctions or abrogation of the excessive deficit

Source: **Eijffinger, Sylvester C.W., Jakob De Haan**, European Monetary and Fiscal Policy (2000).

[12] This comprises a European Council Resolution on the Stability and Growth Pact adopted in Amsterdam on 17 June 1997 and two EU Council regulations: Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Regulation (EC) No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

The above procedure for imposing penalties in case of an excessive budget deficit does not apply to member states entering EMU Stage Three with derogation. Under the SGP, these states prepare Convergence Programs and present them to the Council and the Commission, updating them annually. These Programs address a broader scope of issues than Stability Programs. Apart from budgetary policy measures aimed at arriving at a balanced or surplus budget in the medium term, they include details of how derogation states view the process of meeting the criterion of a 60 per cent *government debt to GDP* ratio. They also show details of medium term monetary policy objectives, the link between these objectives and price stability, and exchange rates. Convergence Programs are redolent of EMU Stage Two, when Maastricht Criteria are attained.

At the outset of EMU Stage Three, the new consultative body of an Economic and Financial Committee (EFC) replaced the Monetary Committee convened at the previous Stage. The major difference between the two committees is in their composition; the EFC comprises not only the Commission and member states (as did the Monetary Committee), but also the ECB. EFC functions are close to those of its predecessor. Under the Stability and Growth Pact, the EFC (alongside the Commission) assesses Stability Programs and Convergence Programs it submits to the Council. The Council then decides on these Programs based on EFC assessments.

3. Significance

Most generally, the implications of EMU lie in two venues: the global aspect of the world economy, and the economies of individual EMU member and candidate states. Here we focus only on the latter. The balance of membership benefits and disbenefits measures EMU significance for individual states.

Table 2

BENEFITS AND DISBENEFITS OF EMU MEMBERSHIP

Benefits	Disbenefits
Lower transaction costs	Narrowing the circle of economic policy tools for EMU member states and hence curbing their ability to counteract external asymmetric shocks. Member states lose their right to independent monetary and exchange rate policies.
Lower exchange rate volatility and less exchange rate uncertainty	One-off expenses in introducing the common currency, recalculating long-term contractual obligations, changes to accounting software and similar adjustments
Greater price transparency	
A more efficient and more competitive internal market	

II. EMU Membership Requirements

Provisions for EMU membership are set out in TEC Article 121 and Protocol 21. They comprise the nominal convergence standards known as Maastricht Criteria – five explicit conditions any state must fulfil before EMU entry:

- achievement of inflation not more than 1.5 percentage points above the average of the three EU member states with the lowest inflations. This is measured under the Harmonized Indicator of Consumer Prices (HICP), and the period for criterion fulfilment is 12 months prior to assessment;
- achievement of nominal long-term interest rates not more than 2 percentage points higher than in the three EU member states with the lowest inflations. The yield on ten-year government securities acts as the reference rate, and the period for criterion fulfilment is 12 months prior to assessment;
- achievement of budget deficit below 3 per cent of GDP. This criterion must be fulfilled in the last calendar year prior to assessment. Though the assessment rests only on data from the prior year, there must be a stable trend to low budget deficits: the criterion remains in force after EMU accession and features in the SGP;
- achievement of levels of below 60 per cent for the ratio between *gross government debt* and *GDP*. This criterion must be fulfilled in the last calendar year prior to assessment;
- maintaining a fixed rate of exchange to the euro for not less than two years by participating in the Exchange Rate Mechanism (ERM II). The national currency cannot be devalued in this period. This criterion must be fulfilled for at least two years prior to assessment.

Apart from Maastricht nominal convergence criteria, member states have to complete the legal convergence moves of adjusting their legislations to the TEC and with the Protocol on the Statute of the European System of Central Banks and ECB on the single European currency.

The moment of full EMU entry and the end of derogation is not entirely under national government control. The European Commission and ECB standpoints appear in convergence reports at least once every two years. The EU Council of Ministers and the European Council take the ultimate decision.

III. Bulgaria's Starting Positions

The Bulgarian economy shows that the country has moved rapidly towards Maastricht Criteria on nominal convergence. Bulgaria is already steadily within three of them. The main credits for this go to the combination of a strong fiscal policy and a currency board. A country's ability to adhere long-term to the budget deficit, public debt to GDP, and long-term interest rate convergence criteria depends on the combination of:

- government desire to set the aforementioned criteria as a top ranking fixed objective and set them as its economic and fiscal policy priorities; and
- government will to apply this policy flexibly through all channels, including legislative ones, in a way that guarantees unconditional attainment of objectives.

After 2001, the 1997 policy of low budget deficits changed its objectives in the direction of the aforementioned three Maastricht Criteria. Appropriate structural reforms broadened the economy's tax base by cutting tax rates, encouraging entrepreneurship, improving the revenue function, and boosting tax collectability. State finances were additionally reinforced and the lasting maintenance of a balanced budget was attained without social tension. A government debt restructuring in line with international market trends amplified these budgetary reforms in a timely manner. The current government policy has consistently sought to keep debt within the range of 25 to 30 per cent of GDP over the long term: significantly below the ceiling set by the relevant Maastricht Criterion, yet entirely adequate for Bulgarian economic development. Cutting the debt burden has helped reduce pressure on current state budgets and guaranteed currency board stability.

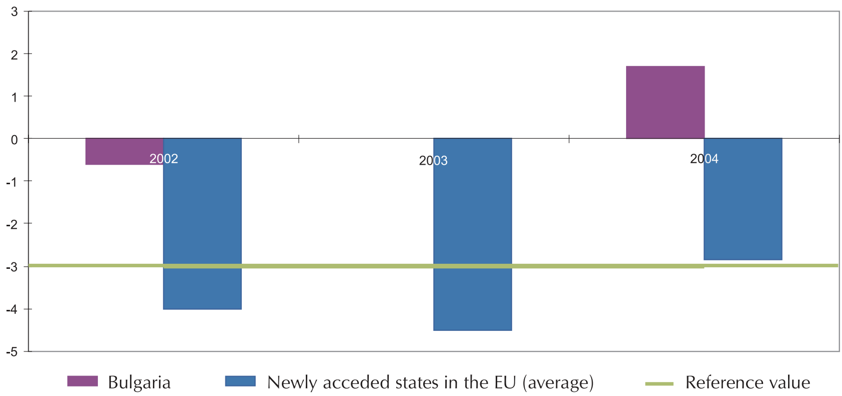
The pursuit of consistent and purposeful budget deficit and government debt policies has been the main factor behind not only currency board stability, but also the accelerated rate of convergence between long-term interest rates: the third Maastricht Criterion. Adhering to currency board rules until full EMU membership without derogation would unconditionally guarantee the compliance with the Maastricht Criterion on exchange rate stability. The ECB[13] has already pronounced that the currency board is consistent with the Exchange Rate Mechanism (ERM II).

[13] Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries. ECB, 18.12.2003.

Chart 1

BUDGET SURPLUS (+)/DEFICIT (-)

(share of GDP, %)

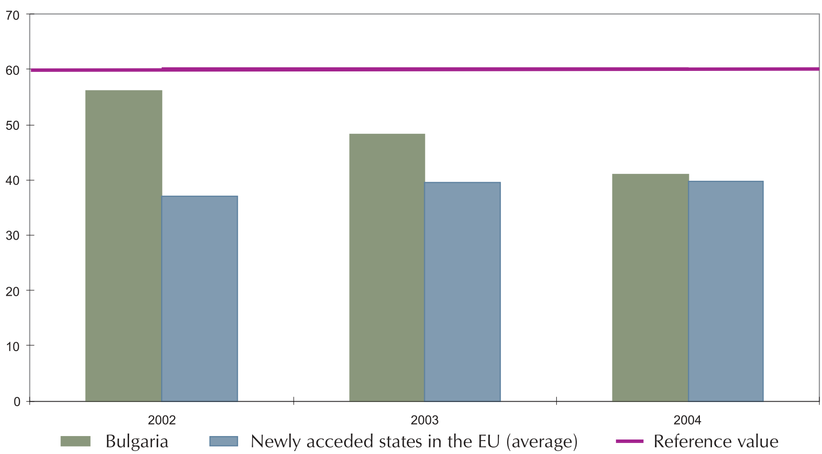


Source: NSI, MF, EC.

Chart 2

GOVERNMENT DEBT

(share of GDP, %)

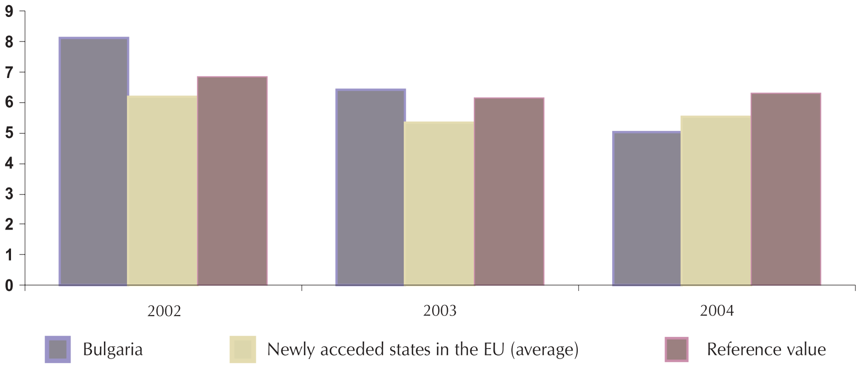


Source: NSI, MF, EC.

Chart 3

LONG-TERM INTEREST RATES

(%)



Source: BNB, ECB.

In its latest Pre-accession Economic Program (PEP) for the 2004 to 2007 period, Bulgaria undertook to continue and complete specific structural reforms. They include privatization, increasing labour market flexibility, improving healthcare and education, and further boosting entrepreneurship and business efficiency. This would stabilize the tax base in the long run and guarantee economic growth and a stable fiscal policy[14]. These policies are defined as being "in the national interest." They would allow balanced budgets over the long term and hence, until euro area entry, the necessary low values of government debt as a share of GDP, thus creating conditions for the retention of low interest rates in the long run.

Alongside the government financial policies described above, the currency board is a second lever for convergence between Bulgarian inflation rates and those of the euro area. By 2005 Bulgaria has failed to attain only the nominal inflation criterion. The following main inflationary factors have emerged in the medium run:

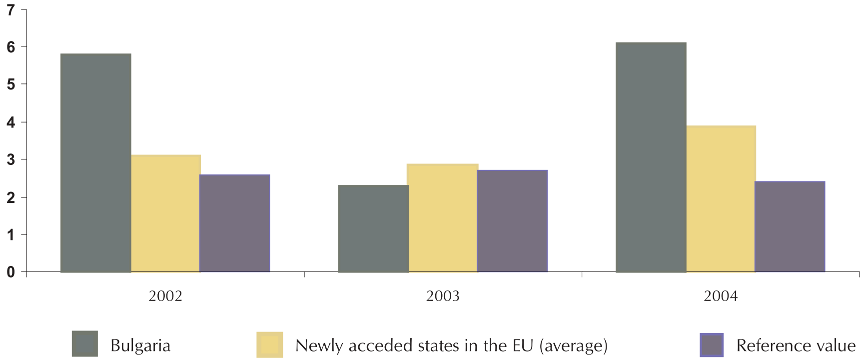
- changes in indirect taxes as required under the commitments to harmonize them with minimum EU levels; and
- price convergence with euro area levels and the related *Balassa – Samuelson* effect.

[14] See *The Preaccession Economic Program of the Republic of Bulgaria, 2004 to 2007* and *Bulgaria: Memorandum of Economic and Financial Policies of the Government and the Bulgarian National Bank*, 6 August 2004.

Chart 4

INFLATION

(%)



Source: NSI, EC.

The effect of both factors on inflation is predictable. PEP assessments of the former of the two state that it would add an average of some 0.5 percentage points to annual inflation. Various assessments[15] put the Balassa – Samuelson effect on Bulgarian inflation at between 0.4 and 3.8 percentage points annually. The combined effect of the two factors is significantly below the ECB's declared objective on euro area inflation. Bearing in mind that inflation varies little across member states[16], Bulgaria enjoys an exceptionally good starting position for meeting the final Maastricht Criterion.

A very common argument against the possibility of Bulgaria attaining the inflation criterion from the first day of derogation membership is that Bulgarian price levels are only about a third of euro area averages. Supporters of this argument claim this dooms Bulgaria to high inflation, or at least to such inflation as would preclude the fulfilment of Maastricht Criteria in the medium term (three to five years) inflation after derogated EMU membership. We feel that supporters of this argument fail to take account of at least two circumstances. *First*, the current Bulgarian consumer basket contains goods and services intrinsically different from those of euro area countries: the quality indicators of Bulgarian goods and services set them apart from their euro area equivalents or near-equivalents. *Second*, the Bulgarian consumer basket's weighting structure is rather different from the euro area one. Such distinc-

[15] Measuring the *Balassa – Samuelson* Effect for the Countries of Central and Eastern Europe, *Banque de France Bulletin Digest,* No. 122, February 2004.

[16] European Central Bank, 2005, *Annual Report 2004*.

tions, however, are hardly major in view of the rate of structural reforms in the economy, and hence both in consumers' preferences for one product compared to another, and in the rates of liberalization of individual markets (particularly commodity and capital market) and of their integration into the European market. The injection of uniformity, and hence the provision of a uniform basis for comparison and management decisions, are monitored by Bulgarian national statistics. We feel that Bulgarian inflation as measured today is only superficially different from euro area inflation, and that this may skew the economic (and especially fiscal) policy if we accept that the declared objective in the Agreement between the BNB and the government represents a top priority for both institutions and the public.

Inflation criteria (price stability) can only be attained through fiscal and economic policy instruments where the currency board and its BGN/EUR exchange rate remain in place. This is the assumption behind the November 2004 Agreement on the Introduction of the Euro in the Republic of Bulgaria. Alongside the aforementioned specific top priority fiscal and economic policy objectives, the Agreement in effect adds the new objective of additional limits, where necessary, on budget spending as a means of guaranteeing Bulgarian adherence to the Maastricht inflation criterion from 2006 onwards.

Table 3

EXPECTED FULFILMENT OF MAASTRICHT CRITERIA BY BULGARIA*

	2005	2006	2007	2008	2009
Inflation			√	√	√
Long-term Interest Rates	√	√	√	√	√
Budget Deficit	√	√	√	√	√
Government Debt	√	√	√	√	√
Exchange Rate Stability	√	√	√	√	√

* Assuming the ultimate date for Bulgarian entry into the euro area is 1 January 2010.

Most analysts of Bulgaria's PEP consider that the pursuit of the above objectives and priorities until 2007 and after EU accession would allow the country to join ERM II simultaneously with EU accession, and would allow it to fulfil the criteria for EMU membership without derogation within two years.

IV. The Benefits

The advantages of EMU membership listed here derive from the experience of member states and have long been the subject of consensus between politicians and analysts:

- lower transaction expenditure for households and businesses due to the removal of the need to exchange national currency (the lev in this case) into euro, and of the attendant uncertainty and possible losses for economic agents;
- exchange risk is removed, additionally encouraging and underwriting capital inflows into Bulgaria and speeding the convergence of interest rates and spreads;
- prices automatically become more readily comparable and transparent, broadening the opportunities for Bulgarian economic agents to shop around for best deals in goods and services, boosting competition;
- further nominal interest rate adjustments (mostly downward) are guaranteed, mostly involving Bulgarian spreads converging with euro area ones as a result of lower Bulgarian government securities risk and eliminated exchange rate risk;
- the cut in transaction costs and the removal of exchange rate risk additionally encourage trade between Bulgaria and EMU member states;
- financial intermediation in Bulgaria deepens further and the national and European financial markets become more fully integrated.

National fiscal policy becomes more flexible and manoeuvrable. Maintaining price stability becomes a fixed commitment and responsibility for the ECB and the national government may make use of the greater opportunities implicit in the SGP compared with currency board strictures. As with other EU member states with currency boards, Bulgaria would have an additional benefit: a transparent, clearly time-limited and consistently applied EMU accession strategy would grant added decision-making confidence in the national economy for its major economic agents: companies, households, and foreign investors. Its very existence and consistent implementation is an important condition for the sustainable long-term economic growth and the retention and strengthening of macroeconomic stability.

V. The Challenges

The most important decision before a state joins EMU with derogation concerns the time horizon within which it wishes (and is able) to join the euro area and adopt the euro as its currency. This decision must be formulated with regard to the state's starting position *vis-a-vis* Maastricht Criteria (reviewed for Bulgaria in Part III) and to its existing institutional framework of implementing macroeconomic policy which largely predetermines the social benefits and disbenefits of EMU membership timing. We feel that the existing institutional framework limits social costs to a minimum should Bulgaria elect to join the euro area at the first possible moment after EMU derogation membership. We derive our confidence for this belief from the analysis of the institutional framework and its concomitant challenges presented below.

By launching the currency board in mid-1997, Bulgaria took advantage of a major benefit and indeed a requirement before monetary policy from the viewpoint of euro area membership. The lev was irrevocably fixed to the euro. Bulgaria also tackled a huge challenge by renouncing most monetary policy instruments, leaving its central bank but two of them: setting minimum required reserves and refinancing of commercial banks to prevent systemic banking risk. The fixed exchange rate of the lev to the euro since 1997 has meant that Bulgaria has passively followed euro area monetary policy, removing the uncertainty hampering economic agents. This means that from the very first day of EMU membership with derogation, the ECB (a body with significantly more instruments for guaranteeing price stability than any national central bank) would effortlessly and automatically assume care for Bulgarian price stability. At the same time, economic agents would have long adjusted to the new conditions: the currency board has functioned in Bulgaria for eight years now.

During negotiations with the European Commission in 2002, Bulgaria tackled another important challenge: guaranteeing BNB independence in all its aspects (institutional, financial, and that of its Governing Council members) prior to EU accession. Amendments to the Law on the BNB of January 2005 brought the Bulgarian central bank into line with TEC requirements. After the successful end of EU membership negotiations, this was another important step towards BNB institutional and financial independence from the government. Amendments to the Law included definitions of the personal independence of Governing Council members, guaranteeing that BNB monetary policy under a currency board would assist the basic objective of price stability through a fixed BGN/EUR exchange rate, and would not be subject to political pressure. Meanwhile, the BNB is already under a legal requirement to help maintain national price stability.

The BNB has already given the most important signal linked with its new legal responsibility of maintaining price stability. In September 2004, the Bank's Governing Council adopted a Strategy for Bulgarian National Bank Development between 2004 and to 2009[17] in which it declares its will to co-operate in specific ways with Bulgaria's joining ERM II immediately after EU accession, and commits to unilateral maintenance of the currency board until euro area membership through the retention of the current exchange rate of BGN 1.95583 *per* a euro. The BNB will adhere to the EC and ECB framework, excluding as it does unilateral adoption of the euro by accession states[18].

On the basis of the adopted strategy, in November 2004 the BNB and the government signed the aforementioned Agreement on the Introduction of the Euro in the Republic of Bulgaria[19]. If both parties meet their Agreement commitments, Bulgaria is expected to join the euro area (and the BNB the eurosystem) in the second half of 2009 or on 1 January 2010. In the Agreement, the government and the independent central bank avow their acceptance of ERM II and agree for Bulgarian membership in it to rest on the principles of:

1. maintaining the currency board until euro area entry at the existing fixed exchange rate of BGN 1.95583 *per* a euro;
2. renouncing any variation of currency board conditions and exchange rates during ERM II membership;
3. adhering to the minimum term set in EU legislation for ERM II membership and timely performance of each necessary step for euro area membership;
4. introducing the euro as the national currency at the time of entering the euro area.

In line with the strategy for the earliest possible Bulgarian entry into the euro area, the BNB is pursuing a research project on the possible economic consequences of future EMU membership. Project results are due for publication in 2005 and 2006. Simulations conducted under the project show the consequences of putative deviations from the policy of a balanced budget (see box below) and confirm the key import of maintaining the current institutional framework.

[17] For the complete text, see www.bnb.org.

[18] The Bulgarian currency board is compatible with European Commission and European Central Bank requirements for ERM II participation.

[19] For the complete text, see www.bnb.org.

Possible Macroeconomic Scenarios under a Putative Fiscal Expansion Breaching the SGP Limits of a 3 per cent Budget Deficit to GDP Ratio in the 2005 to 2007 Period

All scenarios contain the assumption that fiscal expansion entails solely a capital expenditure boost, without an accompanying current expenditure stimulus. Potential results are assessed on the basis of the BNB forecasting model. The variety of scenarios depends on the manner of financing the additional budget deficit: 1. entirely from deposits and money on account; 2. half through domestic debt issues[20] and half through deposits and funds on account; 3. entirely through domestic debt issues. Since government debt management strategy favours domestic debt at the expense of foreign financing, we do not review a scenario where the additional deficit is financed entirely by foreign debt issues. The results of the various scenarios are compared with the base scenario for Bulgarian economic development as prepared by a Bank team based on available data by early December 2004.

A 3 per cent budget deficit would represent a strong fiscal impulse, particularly on the background of minimal deficits or surpluses over the past few years. Results from all three scenarios are largely similar: greater GDP growth in year one, but lower cumulative growth by the end of the period; higher inflation and lower unemployment; worsening of the trade and current account balances due to higher imports of goods and services; and lower international reserves. The fact that the effect of private sector crowding out is more marked than the direct effect of increased government spending, and that they lead to a fall in average growth for the period compared with the base scenario repays particular attention, emphasizing the need for very fine appraisal of any expansionist fiscal policy. Since inflation rises under all three scenarios, fiscal expansion may threaten the attainment of the inflation criterion and push Bulgarian euro area membership back. This would contradict Bulgaria's negotiating position under Chapter 11 (Economic and Monetary Union), Bulgaria's pre-accession programmes and the Agreement signed between the BNB and the Council of Ministers on the Introduction of the euro.

Simulations show that financing the extra deficit from the government's deposit with the BNB is practically impossible, the deposit reaching impossibly low values by year three and being practically at zero by the close of that year. The approach to this level, most likely during year two, would change debt holders' behaviour. Demand for new government debt would drop, leading to an even faster depletion of government funds and to a currency board crisis or to changes in government behaviour. Therefore, we do not review the results of this scenario in detail.

Under the second scenario, the combination of issuing new debt and recourse to deposits leads to acceptable deposit balances, yet also puts paid to the trend of a reduction in the ratio of *government debt* to *GDP*. Under this scenario, budget interest expenses grow visibly in year two, leaving a smaller resource for government capital expenditure. Where this form of financing is selected for additional investment, the overall result is that GDP grows by approximately half a percentage point over the basis scenario in year one. In 2006 and 2007, however, real GDP growth is between 0.5 and 0.6 percentage points less than the basis scenarios for the two years. Impact on inflation is relatively low, assuming that only non-tradable goods' prices rise and imports satisfy demand for tradable goods. If this obtains, the consumer price index rises by between 0.5 and 0.7 percentage points more than the basis scenario for each of the three years. The current account balance worsens by some 3 per cent of GDP for the first two years, and by 2 per cent of GDP for 2007. Despite the fact that the

[20] Simulations allow for half of the additional domestic debt issues to sell to non-residents, or else in a manner that allows an inflow of funds into the financial account.

simulation does not point to any medium-term crisis, in the long run the fiscal position grows rather unsteady.

This becomes very visible in the third scenario, where the debt ratio begins to grow. Under this scenario, new debt issues lead to crowding out of the private sector and to a significant reduction in claims on the non-government sector. The situation may also produce a secondary effect: either a limitation on the real growth of private consumption and investment, or increased foreign borrowing to continue investing. In the best case, this could lead to a position similar to that of the second scenario (similar dynamics in real GDP, inflation, and the trade and current account balances), but at the expense of increased private debt.

These simulations show that any fiscal expansion during the 2005 to 2007 period would be hard to implement and would give rise to serious threats for the stability of the currency board. It would threaten the inflation criterion in all cases, pushing back Bulgarian euro area membership by an indefinite time.

VI. Concluding Notes

The first conclusion is that Bulgaria's current institutional framework is a major factor facilitating swift EMU entry. Yet, this framework crucially also faces the major challenge of the public accepting it as the best social benefit/disbenefit compromise. In Parts III and V of this paper, we prove that future full Bulgarian EMU membership from the first possible moment entails most of all continuing the current tight fiscal policy and structural reform. This involves a flexible fiscal policy with a balanced budget, and where necessary additional fiscal adjustments to help the BNB attain inflation criteria.

Naturally, as stated by critics of the recent years' economic model, achieving Maastricht Criteria ought not to be an end in itself. It is part of a long-term government and BNB strategy aimed at the genuine convergence of Bulgaria's economy with Europe, and hence at a convergence of living standards. Strategies for the swiftest possible adoption of the euro as followed by newly acceded EU member states with small open economies and currency boards envisage full EMU membership without derogation as the precise tool for boosting growth on the basis of the benefits set out in Part IV.

Therefore, the public faces a choice of either continuing along the well trodden path to the euro area, or of seeking alternatives. At the least, the latter course would entail lengthening derogation after EMU membership in view of the obvious need for institutional framework adjustment[21]. Even if this framework were to remain unchanged, it would have to adapt to the putative new objectives of macroeconomic and mostly fiscal policy. This would inevitably impact medium-term growth; and where sustainable growth is hit, risks may even arise eroding macroeconomic stability.

[21] Simulations show that whenever macroeconomic policy objectives changed in the 1990s, the shortest term for completing the adaptation cycle was three years.

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