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THE REFORMS IN THE EMU TOWARDS BANKING AND CAPITAL UNION: CONSEQUENCES AND CHALLENGES TO THE FINANCIAL SECTOR IN BULGARIA

Abstract

The economic 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.

Key-words: *European integration, EMU, Maastricht criteria, financial stability, EU reforms in the financial sector, financial integration.*

JEL: G12,G28,G32,F36,F450.

1. 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] Due to the fact that the EU itself has

[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.)

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

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[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.

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 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 two aspects of discussion of the present issues of Bulgaria’s economic and financial integration To the EMU. The first part discusses the macroeconomic performance of Bulgaria with focus on the public finances’s compliance with the Maastricht criteria as required framework for convergence to the EMU. The second part presents the reforms in the financial sector of Bulgaria as an ongoing further adjustment to the requirements for the EMU entry.

2. THE MACROECONOMIC PERFORMANCE OF BULGARIA IN 2007- 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

[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.

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).

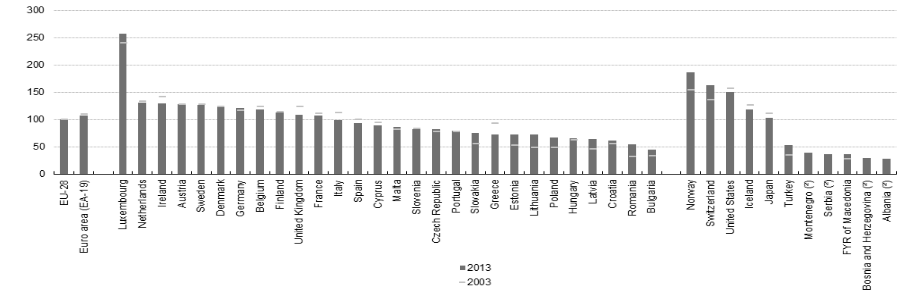
Since 2010 began a gradual recovery of the Bulgarian economy, but at a very slow pace. In 2010, growth was only 0.7%, in 2011 rose to 2% and in 2012 was only 0.2%. In 2013 and 2014 the economic growth remained rather modest at the rate respectively of 1.1 and 1.7%. For achieving the pre-crisis level 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.

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

Source: European Commission (Eurostat) National accounts of Bulgaria.

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.

Figure 2. EU Member States: GDP per capita at current market prices, 2003 and 2013([1])
(EU-28 = 100; based on PPS per inhabitant)



(¹) Break in series.
(²) 2003: not available.
Source: Eurostat (online data code: tec00114)

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.

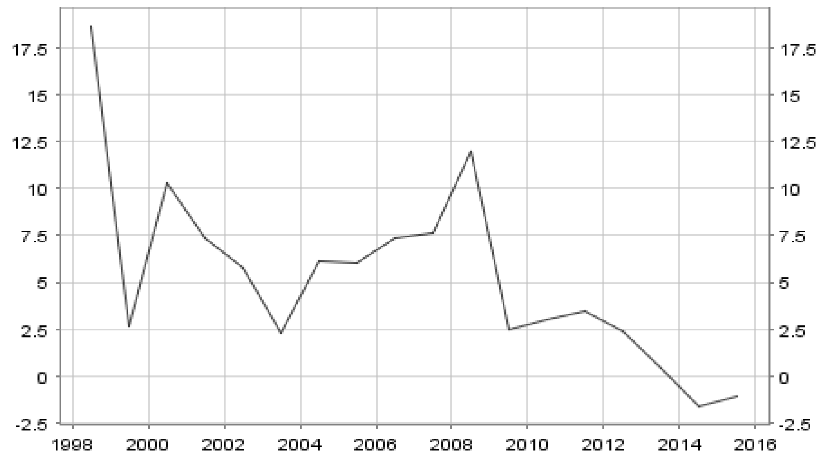
For the period (2004-2008) the price criterion was not accomplished as the inflation was higher than the referent value threshold. The structural readjustment and credit expansion related to the higher rates of growth caused higher rates of inflation in the period (2004-08). The economic decline has 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 (Figure 2).

Figure 3. Inflation in Bulgaria: Overall Index HICP



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

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.

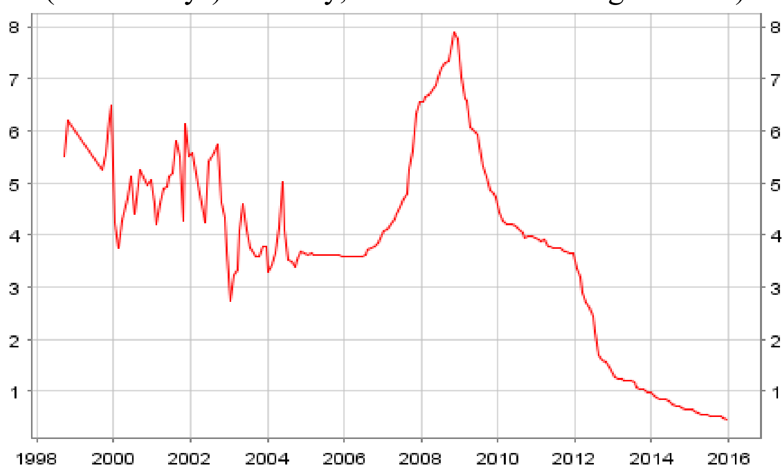
However, also being out of the EMU has its risk of adverse impact of the pro-inflationary trends through the channels of imported inflation. These risks may be even higher for a country that is ou of the EMU if one takes into consideration the exchange rate risks related to impact of the import prices 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.

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



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

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.

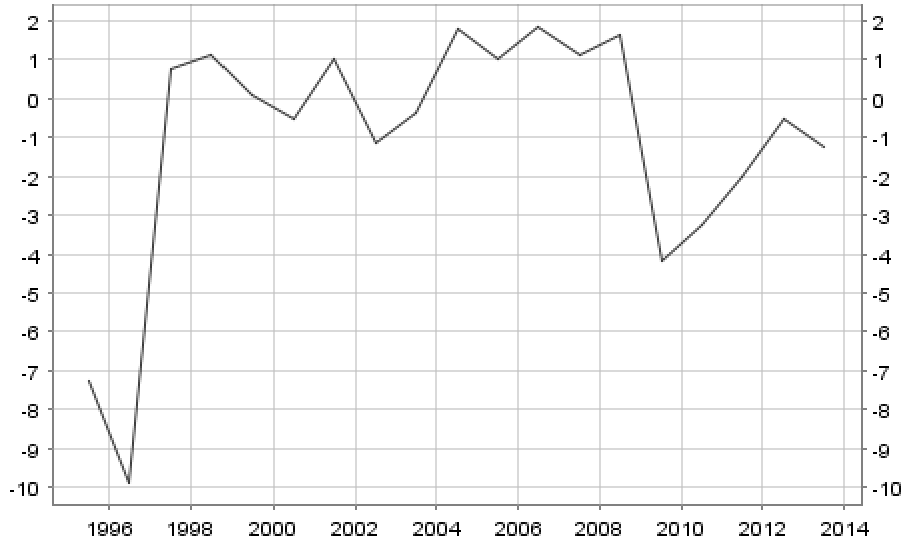
Figure 5. Bulgaria, Long-term interest rate for convergence purposes

Source: Eurostat, National accounts statistics.

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 Figure 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.

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



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

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.

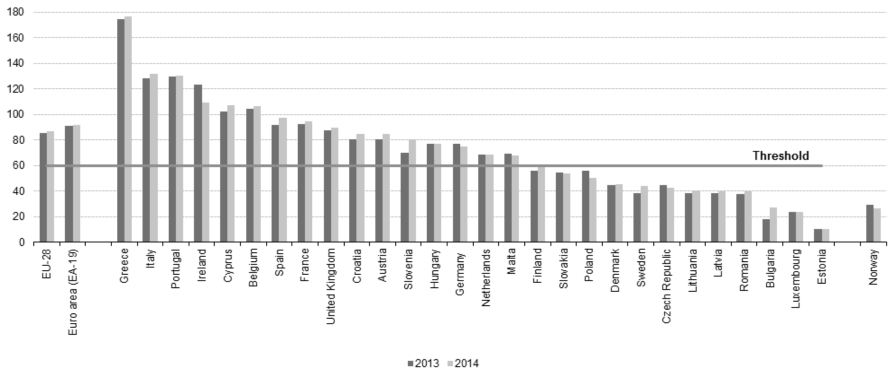
As regards the *indicator for an average annual rate of growth of the public debt-to-GDP* Bulgaria has had consistently consolidated its fiscal policy throughout the period (1998-2015) and fiscal discipline has been much strict if compared with other EU countries (figure 6). The need to provide state 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. (Figure 6).

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% .

Figure 6. Comparison of EU countries in Maastricht criterion indicator for share of public debt in GDP (%)



(¹) Data extracted on 21.04.2015.
Source: Eurostat (online data code: tsdde410)

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 institution. 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.

4. THE IMPLEMENTATION OF THE REFORMS IN THE FINANCIAL SECTOR

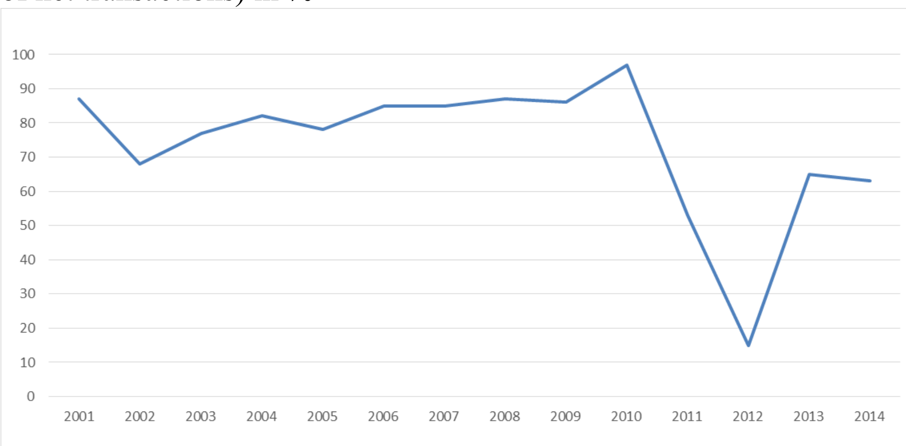
The financial sector of Bulgaria has undergone important changes since the accession to the EU in 2007. In compliance with the EU law for the banking and nonbanking activities regulation has been introduced to implement the Single market for the financial services and the accession to the European financial space. There are economic reasons to deepen the financial integration of Bulgaria at present on the basis of the level of the achieved forms of penetration of the investments from the EU.

One one side, the Bulgarian banking system is characterised by the predominance of foreign banks which are subsidiaries of EU banking groups.Their market share is 73 percent while less than a quarter of the market share (23 percent) is held by domestic banks. Approximately a quarter of the market share, 24 percent, is held by Greek-owned subsidiary banks. Altogether there are 28 banks in Bulgaria (excluding one recently failed bank), of which 6 are branches. Banking establishments from outside of the EU represent less than 1.5 percent of the banking system.

On the other side, the foreign direct investments from the EU present the biggest share of the total inflow of FDU in Bulgaria traditionally but especially since the end of the 90s when the privatization began. The abrupt fall of FDI as a result of the Global and European sovereign crisis in the period 2009-2012 has had a very negative effect on the Bulgarian economy and is indicative of the complementarities that have already being created with partners from the EU (Figure 7).

In assessment of the impact of the European financial crisis on the Bulgarian banking system one may distinguish two periods of structural adjustment of the financial sector as follow-up of Bulgaria's accession to the EU.

Figure 7. FDI from the EU as % from the total FDI in Bulgaria (flow of net transactions) in %



Source: Eurostat

Under the conditions of the Global crisis and its impact on the European banks the BNB as central bank of Bulgaria introduced important anti-crisis measures to support the liquidity management of the banks. [4] Bulgaria has harmonised its legislation with the EU law that has been urgently introduced in 2008 as regards the deposit insurance schemes. In compliance with the EU regulation the

[4] On November, 27, 2008, the BNB Governing Council adopted amendments to Ordinance No. 21 on the minimum required reserves maintained by banks with the central bank: (i) effective December 1, 2008, the minimum required reserves on all attracted funds of the banks are decreased from 12 percent to 10 percent;
(ii) effective January 1, 2009, the minimum required reserves on funds attracted by the banks from abroad decreased from 10 percent to 5 percent; and (iii) effective January 1, 2009, no minimum required reserves is imposed on funds attracted from the state and local government budgets.

threshold for the deposit schemes guarantee has been raised and Bulgaria's Central bank has joined the Vienna initiative of the Central banks of the new EU member states.[5] The banks' capital cushions have been kept adequate compared to other European countries: the average capital ratio for the system is reportedly close to one quarter above the regulatory minimum at around 16%.

Since the beginning of the Global crisis there is a deterioration in the portfolios of commercial banks with the growth of non-performing loans (amounting to 20% of total volume of bank loans in 2011, respectively 18.1% in 2014), This increase has mainly been in unsecured consumer loans, while mortgages and credits for corporations have not shown a sharp increase. Banks that were more aggressive in their lending experienced the largest increase in non-performing loans.The crisis has made necessary for the banks to be more selective in the assessment of the creditability of the clients and to improve substantially the risk management.

The overall negative impact of the post-crisis slow recovery of the world and European economy contributes to the uncertainty in the business climate in Bulgaria and the low demand of new loans and investments. The most significant decline is observed as regards loans to non-financial institutions, which reflects the ongoing economic stagnation in the real sector. This decrease is to some extent a reflection of depleted debt capacity of companies in the real sector for new loans. This has also confirmed the trend that along with the sharp reduction in new loans is observed decrease in deposits of non-financial institutions. To a lesser degree, but continuing trend is the decline in the volume of mortgage lending, reflecting the economic stagnation.

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[5]The Bulgarian Deposit Insurance Fund (BDIF) is a legal entity established by the 1998 Law on Bank Deposit Guarantee. The Fund protects depositors' funds in banks up to BGN 196,000 (EUR 100.000) as well as creditors' interests in bank bankruptcy proceedings .

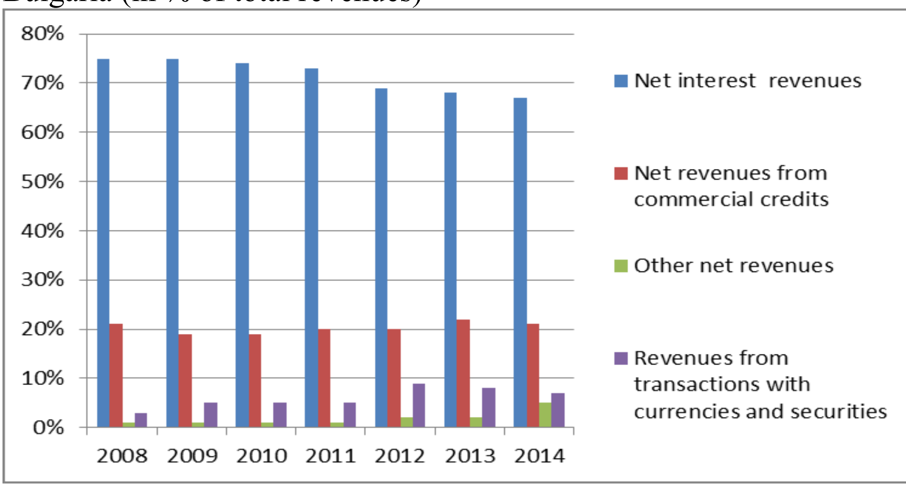
Figure 7. Annual growth rate of banks' loans to non-financial institutions in Bulgaria (in%)

Source: Eurostat. Bulgaria, MFIs excluding ESCB reporting sector - Loans, Total maturity, All currencies combined - Domestic (home or reference area), Non-Financial corporations sector, Annual growth rate, data Neither seasonallynor working day adjusted.

Overall dominant trends in bank lending reflect also the deflationary trends that contribute to lowering the interest rates on deposits and to a smaller extent on credits. The risk of deflation and the reduction of demand are negatively influencing the business expectations and thus add up to the credit crunch. On the one hand, companies are reluctant to draw new credits and investment loans; on the other hand, households are limited to demand for new loans mainly as already have high exposure to servicing debt and current spending. mortgage loans since 2008, also

Despite the growth of deposits of savings in the banking system (nearly 10% annual growth in deposits of non-financial legal entities and individuals and households) there is not an increase in loan demand and new loans. Increased liquidity of the banks makes easier the drastic decline of interest rates on deposits. In the presence of the growth of deposits in the banks the competition increased among the banks. The fact is that in conditions of global crisis the growth of domestic savings allow to avoid adverse effects of certain reduction of cross-border lending liquidity resourcesfrom abroad for subsidiary foreign banks in Bulgaria. This reflects the general trend observed in the global economy, i.e. by increasing the role of domestic savings as a possible source of credit resources of banks to stimulate the credit.(IMF, 2015). There is a process of reduction of interest rates on deposits, which since mid-2014 has accelerated across the banking system. The growth of deposits testifies to the sinking aggregate demand of goods and services and risks of the deflationary trends. The consequence of these trends is a small reduction of the net interest revenues from loans to banks and to a less extent the reduction of the net revenues from commercial credits.(Figure 8)

Figure 8. The structure of the revenues of the banking sector in Bulgaria (in % of total revenues)



Under these conditions the transposition of important EU directives in the banking sector of Bulgaria is inevitably associated with substantial changes which are to contribute to the preparation for the EMU entry.

Due to the need to introduce newly Capital Requirements Directive and a Regulation on the capital requirements serious changes were made to the Credit Institutions Act and in the secondary legislation. For example,a fundamental change is the elimination of Ordinance № 9 of BNB, which lays down specific provisions for credit risk. In place of the appropriations to the change in the legal framework specific provisions, banks should carry out additional accounting provisions in International Financial Reporting Standards, aimed at reduction of the carrying value of loans in arrears over 90 days. All these changes have a particular impact on individual credit institutions at home and mid-term will lead to a further deepening of the process of harmonization of regulatory changes in the European financial space.

The recent changes to the EU framework have, however,limited some flexibility of the supervisory department of the BNB. Previously the BNB applied a minimum capital adequacy ratio of 12 percent, but this requirement is now capped at 8 percent under the Capital Requirements Regulation. In response, and at a period of heightened systemic stress, the BNB has "frontloaded" capital buffers so that the capital conservation buffer and the systemic risk buffer are both currently in force. The advent of the CRR and its implementing technical standards has also removed the BNB's former power to set supervisory provisions against problem exposures. The BNB retains, however, the power to set higher capital requirements in respect of problem assets. At present the BNB is practicing close monitoring of the evolution of the relevant portfolios and is exercising what might be termed an "informal Pillar 2 approach." The BNB does, however, need to be ready and able to apply additional capital requirements through Pillar 2 in future.[6]

In implementation of EU law, Bulgaria introduces the reforms undertaken in the EU, as regards the explicit consideration for the financial sector responsibility for sharing the losses by establishing a new regime for recovery and resolution of credit institutions and investment firms. The reform in the EU has to achieve in an accelerated mode the results similar to normal insolvency proceedings regarding the allocation of losses to shareholders and creditors, but improved management with a view to preserving financial stability

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[6] Capital adequacy has been calculated under the EU Capital Requirements Regulation since January 2014, which permits a slightly more generous treatment for some risk weights than the previous BNB regime. As of December 2014, the system CAR stood at 22 percent, and the Tier 1 capital ratio was 19.9 percentIn Bulgaria, the majority of tier 1 is held in common equity and the system wide ratio was 19.5 percent. With the advent of the CRR, the BNB can no longer apply a minimum 12 percent CAR as it had formerly done. The BNB has however, imposed the capital conservation buffer of 2.5 percent since May 2014 and has also applied a capital buffer for systemic risk of 3 percent of total risk weighted exposures located within the country and calculated in accordance to Article 92 (3) of Regulation 575/2013/EC.

and limit losses to taxpayers when the announcement of the bank/firm in bankruptcy would threaten the public interest and would constitute a threat to financial stability.

For this purpose, the transposition in the Bulgarian legislation of Directive 2014/59/EC by a special law creates legal prerequisites for a framework for the recovery and resolution of credit institutions and investment firms. The Directive aims to establish an effective framework at European level to deal with banking crises enough at early stage, so as to prevent the spread of the financial problems of individual credit institutions on the entire banking system, and to eliminate in as much need to use

At the present stage there are further changes in the regulatory framework which the banking system in Bulgaria will undergo to implement the new European regulations,standards and practices.

In 2015 the BNB as Central Bank declared its readiness to review the quality of assets in all banks operating in Bulgaria. This review will be a key requirement if the government initiates a negotiating process with the ECB to join the single supervisory mechanism. The methodology of the review will be built on the highest standards already developed and implemented by the ECB in 2014 in reviewing the quality of the assets of the largest banks in the euro area. The launch of the process will be a function of the progress and implementation of the new Directive on recovery and resolution of banks.

Agenda priority for 2015 has been to restore confidence in the BNB as Central Bank and in the institutional order that ensures the stability of the banking system. Not only the election of the Governor of the National Bank, but the implementation of comprehensive reforms in the financial intermediation are undertaken to ensure the sustainability of financial intermediation and its significant role in the economic development of Bulgaria.

The banks and investment firms are setting new the requests for the preparation and updating recovery plans containing measures and procedures for: 1) taking early action in case of worsening of their financial situation; 2) preparing the development and restructuring plans for the restructuring of a bank or investment firm; 3) compliance of the plans with the requirement to minimize losses to taxpayers and preserve critical core activity of the institution functions.

The expected establishment of a Fund for the restructuring of banks (which will be managed by the Board of the Fund for Guaranteeing Bank Deposits) and Restructuring Fund investment intermediaries (which will be managed by the Board of the Fund for Compensation of Investors) builds the necessary institutional structure in Bulgaria for conducting modern reforms in EU financial sector. In accordance with the requirements of the Directive, the Bulgarian Law on Resolution and Restructuring of Credit Institutions and Investment Intermediaries previews the following tools of restructuring: sale of business, bridging institution, separation of assets and sharing of losses. Two additional tools for restructuring are introduced: a tool for government capital support and tool for temporary state ownership, which are state tools for financial stabilization. Competent authority for deciding on the application of these instruments is the Council of Ministers on a proposal of the Minister of Finance.

The Bulgarian National Bank (BNB) has encountered difficulties with the banking crisis in 2014 but its actions have helped to ensure financial stability in the banking sector. The crisis began in June 2014 with two bank failures – the KTB and Viktoria Bank. Following runs on deposits, the BNB put the two banks into conservatorship. Soon after this intervention, a third domestic bank suffered a depositor run and was supported by emergency liquidity (state aid has been approved by the EC and provided successfully). The KTB crisis clearly demonstrated the lack of an institutional framework for crisis management, both in terms of a strengthened preventive role of banking supervision and for regulating the bank resolution processes.

With entry into force of the Law on Recovery and Resolution of Credit Institutions and Investment Firms in 2015, a regulatory framework governing such processes was established. The relevant organisational structures should be established for the resolution activities and drawing up of operational procedures for interaction with the Banking Supervision Department. The BNB has actively monitored and tried so far to mitigate the impact of the global financial crisis. Actions taken to increase banks' capital and liquidity cushion include releasing existing prudential "buffers", for example by lowering the reserve requirements and working with parent banks to ensure credit lines to foreign-owned subsidiaries remained available and profits are recapitalized. The BNB intensified its monitoring, strengthened stress testing capabilities and reviewed the crisis management framework as a contingency measure.

According to an independent external assessment of the effectiveness of the banking supervision in Bulgaria by a joint IMF – World Bank team in 2015 important findings and recommendations on the BNB banking supervision activities are made.The IMF and the World bank assessment indicate some issues of the insufficient degree of conformity of Bulgaria's supervisory practices with the Basel principles and point out how to improve the banking supervision.(IMF,WB, 2015).

In accordance with the Law on Resolution and Restructuring of Credit Institutions and Investment Intermediaries that was adopted in 2015 the BNB is granted a mandate to organize the Asset Quality Review of the banking system, including the check of the quality and the adequacy of the estimations used for the assets' valuations, collateral and the practices for devaluation and provisioning as instruments previewed by Law.[7]

5. CONCLUSION

The main macroeconomic challenges to Bulgaria are: (i) how to sustain high GDP growth, and 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

[7] The review is going to be done in 2016 in direct cooperation with the European Commission and the European Banking Authority and it is going to be based on the methodology corresponding to the one that has been already applied by the European Central Bank at the start of the European Supervisory Mechanism in the euro area in 2014.

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:

- 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,
- 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,
- 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 mid 2015 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. 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 EMU 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.

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