



BULGARIA



Macroeconomic and Market Research

„Euro Adoption: Myths and Reality“

AUTORS

Kristofor Pavlov, Chief Economist
Elena Kostadinova, Senior Economist

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INTRODUCTION

The creation of the euro was based on three key hopes. First, that it would foster further convergence among European economies and thus represent the next step in deepening European economic integration. Second, that economic convergence among Member States would lead to stronger economic growth. Third, that deeper economic integration—followed by further political and fiscal integration—would contribute to a more peaceful Europe.

The founders of the euro were visionaries seeking to create a new Europe. They were guided by the conviction that a high degree of economic interdependence among countries in Europe would make the outbreak of another war impossible. This is hardly surprising, as the architects of the euro belonged to the post-war generation of policymakers, who were acutely aware of the horrors of war and whose foremost objective was to make Europe a more peaceful place.

Famous American economist and Nobel prize winner, Joseph Stiglitz, has compared the founders of the euro to the Argonauts, sailing through uncharted waters where no one had ventured before. Indeed, never in human history before had there been an attempt to establish a monetary union among so many countries, especially in the presence of substantial differences in their economic performance.

The concept that closer economic integration would lead to faster economic growth was not new at the time when euro was created. It is rooted in ideas dating back to the eighteenth and nineteenth centuries. In the works of the great classical economists David Ricardo and Adam Smith, one finds the argument that access to larger markets fosters stronger economic growth through so-called economies of scale. The underlying idea is that unit production costs decline as output increases—an outcome made possible by access to larger markets, which allows fixed costs to be spread over a greater volume of final output. A larger market, the theory goes on, also enables greater specialization of countries in the global economy, with specialization based on the comparative strengths of individual economies.

Although not always highlighted explicitly, the architects of the euro also hoped that deeper economic integration would transform Europe into one of the world's most important economies. In their view, this would enhance not only Europe's economic weight but also its political influence on the global stage. The pursuit of geopolitical influence was not alien to the founders of a united Europe; rather, it constituted a powerful motivating factor.

According to Mervyn King, renowned British economist and former Governor of the Bank of England, one of the key reasons why so many countries initially sought to adopt the euro was the belief that by linking their exchange rates to the Deutsche Mark they would effectively import the same strong commitment to price stability that has characterized Germany's central bank.

The founders of the euro were aware that no monetary union has survived in the history of the world without being underpinned by political union. Moreover, political union needs to precede monetary union, and the greater the time gap between the two, the higher the likelihood of success.

Prior to the creation of the euro, the prevailing view in Germany was that monetary union should be established only after a fiscal union had already been put in place, and with a sufficiently long-time interval to provide clear evidence that the fiscal union was successful.

In the rest of Europe, and particularly in southern Europe, the prevailing views was different. It was widely believed that the creation of a monetary union would sooner or later trigger a crisis that would compel governments to move rapidly towards creation of fiscal and political union, to prevent a reversal of European integration and the potential disintegration of the EU.

In his very influential book “The end of Alchemy”, Mervyn King argues that the creation of a monetary union among a large number of independent states represents an exceptionally risky move, one that can be successful only if it is supported by a very high degree of mutual trust and robust institutional arrangements. While major advances in history have often required bold and risky decisions, Merwin King cautions that not all such risks result in lasting or successful outcomes.

The architects of the euro did not have at their disposal a comprehensive and fully articulated theoretical framework on which to rely. Instead, they were driven by conviction that the common European currency would contribute to deeper integration across all areas of the economy. At the time of euro creation, the dominant view was that any form of economic integration was desirable, as it was associated with benefits that exceeded costs corresponding to that.

Global interest was huge. This was not surprising given the progress that Europe had already made in terms of economic integration. At that point Europe has already had a single market with a free movement of goods, labor and capital. Tariff and non-tariff barriers have been reduced, leading to a increase in intra-European trade and significantly higher economic growth. This progress has already commanded respect internationally, prompting the world to follow the EU’s next steps very closely. Enthusiasm was so high that discussions have even begun regarding the possible formation of monetary unions in other parts of the world. Much was at stake. Should the euro fail, a strong negative reaction against European integration could be expected, potentially leading to an inglorious end to the entire European project.

CHAPTER N 1

EURO ZONE MEMBERSHIP WILL BRING SEVERAL IMPORTANT POSITIVES

Membership in the euro area will remove some of the remaining barriers to expanding trade and investment

For example, access to capital will improve, which will stimulate investment, as euro-area membership will raise financial-market assessments of the quality of the country's economic policies. This, in turn, will reduce uncertainty and help lift the sovereign credit rating.

Another example of eliminating obstacles to trade and capital flows is the reduction of transaction costs. This includes not only the costs of converting BGN into euros—estimated by some studies at the equivalent of about 0.5% of Bulgaria's GDP—but also part of the costs associated with managing currency risk.

Membership in the eurozone will improve crisis prevention and management. After becoming part of the eurozone, the risks from volatile capital flows—which typically affect small and open economies like Bulgaria's—will diminish. This is important because capital flows are inherently unstable, and Bulgaria could become vulnerable to new shocks regardless of how solid the economy's fundamentals appear now, including the currently very low levels of public debt and deficit. In addition, euro-area membership will strengthen the independence of the central bank, which in the long run will contribute to greater financial-system stability and reduce the risk of unsustainable household credit growth that could lead to real-estate bubbles and persistently high consumer-price inflation.

Entry into the eurozone will increase Bulgaria's political weight, especially among European countries, because Bulgaria will take part in shaping the euro-area's monetary policy. Bulgaria will not be a passive observer standing aside and complying with others' decisions, but a participant in the decision-making process. How large the increase in the country's political influence will be depends on how proactively it engages in the debate and on the quality of the ideas and arguments put forward by Bulgarian representatives.

Membership in the banking union will enhance the supervision of financial institutions

Eurozone membership will help to improve oversight of the financial sector. Over the past three decades, Bulgaria has experienced two, by some accounts even three, banking crises. If there are fewer crises in the next three decades, this would represent an improvement.

Bulgaria's membership in the banking union will mean that two regulators will simultaneously monitor the financial system. They will cooperate and complement each other in fulfilling their supervisory responsibilities, but to some extent, they will also compete to be the first to identify potential problems and sources of weakness, in order to protect their own reputations.

The banking union will help prevent pressure to lower supervisory standards, as well as regulatory arbitrage, whereby financial companies benefit from differences in regulatory standards between countries. While this may not seem particularly relevant to Bulgaria today, it will nevertheless be beneficial, as it will prevent the country from falling behind in meeting the minimum capital and liquidity requirements for banks in the longer term.

In times of financial crisis, national regulators, given their mandates, may attempt to limit losses for their domestic taxpayers by shifting them to other countries where the bank operates. The risk that Bulgaria would be adversely affected by such a scenario will be further reduced if the country is a member of both the banking union and the Eurozone, as member states of these two unions will have no interest in allowing problems to be transferred from one country to another and thereby become more widespread and aggravated.

Membership in the Eurozone will transform the functioning of the financial sector

Under the currency board arrangement, the role of the central bank in setting interest rates is limited, as it does not conduct an independent monetary policy using interest rate tools. Consequently, interest rates on loans and deposits for clients (corporates and households) are primarily determined by commercial banks themselves, which increases their pricing power.

Upon joining the Eurozone, an additional influential player—the Bulgarian National Bank as part of the ECB - ill participate in shaping financial conditions in the country's economy. This is expected to reduce the pricing power of commercial banks.

The interbank deposit market will gain greater importance. Credit pricing will change, with fewer offers where loan rates are directly linked to deposit rates from corporate and household clients, as such practices impede the transmission mechanism of monetary policy. Instead, the share of loans priced based on the Euribor and interbank market rates is expected to increase, improving the effectiveness of the ECB's monetary policy transmission.

The reserve requirement ratio is expected to decline to 1%. This reduction benefits banks, as the reserve requirement previously functioned effectively as an additional tax. Thus, joining the Eurozone will lower the tax burden on banks. However, this may also increase the incentive to introduce new taxes on banks to offset the resulting budgetary revenue shortfall.

Eurozone membership will bolster central bank's independence

Membership in the Eurozone provides stronger guarantees that the central bank will maintain its independence. This reduces the risk of both monetary and fiscal expansion. High inflation is most often the result of such expansions and is detrimental to household savings and welfare, particularly for those with fixed incomes—such as pensioners and social assistance recipients—who are also among the most vulnerable due to their low-income levels.

To protect the economy from high inflation, it is crucial for the central bank to remain independent. Historical experience shows that loss of central bank independence frequently leads to periods of elevated inflation or banking sector instability. Bulgaria's economic history since the introduction of the currency board arrangement also illustrates this. Between 2004 and 2008, inflation averaged 7.8% annually, compared with 2.4% in the Eurozone. This period of very high inflation was driven by a credit boom that fuelled a sharp increase in housing prices, which subsequently spilled over into general consumer prices. Additionally, following the establishment of the currency board, the failure of the fourth largest local lender—Corporate Commercial Bank—highlighted weaknesses in supervisory oversight, where regulatory lapses in accounting standards and risk management undermined confidence in the regulator and resulted in substantial costs to the local taxpayers.

As a member of the Eurozone, the likelihood of Bulgaria experiencing high inflation—or hyperinflation in a worst-case scenario—will be reduced, as the money supply will be more strictly controlled by the ECB than if this responsibility remained solely with the BNB. Households and firms in Eurozone countries hold substantial savings (deposits), which means that the ECB has a strong incentive to abstain from pursuing policies that could lead to very high inflation. In contrast, Bulgaria’s comparatively lower savings volumes imply weaker incentives to maintain policies aimed at preventing high inflation that would erode savings.

CHAPTER N 2

DRAWBACKS OF JOINING THE EUROZONE

The finality of the euro is frightening

One notable disadvantage of the euro is the absence of an established, orderly mechanism for exiting the currency union. Once the euro is adopted, there is no return. Currently, there is no mechanism that allows Eurozone member states to temporarily and in an organized manner leave the currency union to devalue their currencies and later rejoin after a transitional period. Consequently, countries facing major losses of competitiveness in the context of the fixed exchange rate must undergo the long and painful process of so-called “internal devaluation.” The experience of Greece demonstrated that any unilateral attempt to exit the Eurozone without the consent of other member states risks triggering a devastating crisis.

Proposals exist to modify this arrangement to allow for temporary, structured exits from the Eurozone; however, whether these proposals will develop into viable solutions remains uncertain. This finality of Eurozone membership is understandably a source of concern.

Nevertheless, this concern should not be overstated. It is not clear that internal devaluation (under a fixed exchange rate) is necessarily more painful than nominal devaluation, which a flexible exchange rate regime requires. Therefore, the advantages of a flexible exchange rate arrangements for a country like Bulgaria may be somewhat overstated.

Conversion of goods and services prices may lead to a one-off increase in inflation

While this risk exists, it is often overstated by opponents of the euro. Experience from the countries that joined the Eurozone shows that the immediate impact on price levels ranges between 0.1% and 0.3% inflation increase. According to Eurostat, inflation in Croatia rose by 0.2% in January 2023. The estimated effect of euro adoption on overall inflation was 0.3% in Slovenia, 0.15% in Slovakia, 0.3% in Estonia, 0.2% in Latvia, and 0.11% in Lithuania.

In the CEE countries that adopted the euro, dual prices visualization proved to be an effective measure against attempts by unscrupulous traders to unjustifiably increase prices by exploiting the introduction of the new currency.

The BNB and the Financial Supervision Commission will exercise oversight, within their respective mandates, to ensure compliance by supervised entities—such as banks, insurance, and pension companies—with relevant requirements. Key authorities responsible for monitoring compliance and sanctioning abuses related to euro adoption will include the Consumer Protection Commission, the Commission for Protection of Competition, and the National Revenue Agency. Citizens will have the right to report violations to the Consumer Protection Commission or the appropriate regulatory body.

The Eurozone is incomplete and carries a risk of disintegration

Without a fiscal and political union, the Eurozone remains an unfinished project. Historically, every successful currency unification has been preceded by state unification. By maintaining the currency

board for another ten years, Bulgaria would have the opportunity to observe whether the Eurozone undertakes the necessary reforms and to assess their outcomes.

The risk of eurozone disintegration exists and should not be underestimated. At the same time, historical failures do not necessarily imply that future attempts will fail. The likelihood of the Eurozone remaining incomplete and ultimately disintegrating is gradually declining, as member states—albeit slowly and sometimes at the last minute—take the necessary steps forward. Examples of such reforms include the establishment of the Banking Union and the creation of supranational funds to finance common expenditures during crises. These mechanisms effectively introduce additional automatic stabilizers, which the Eurozone needs to strengthen the resilience of its economy and enhance reforms momentum.

For Bulgaria, joining the Eurozone brings tangible benefits that will be available from the first day of the membership. Concerns about the Eurozone's unfinished institutional architecture or the finality of euro adoption are important factors to consider. However, in my opinion, these considerations are not sufficient to justify forgoing euro adoption. While these are real risks, the probability they to materialize is moderate, in my assessment. Even if these risks were to materialize, it is not clear that remaining outside the Eurozone would spare Bulgaria from a significant portion of the economic pain associated with such a scenario.

Bulgaria faces different circumstances compared with countries such as Denmark or the Czech Republic. Bulgaria does not have a successful and independent monetary policy, and any attempt to create one from scratch is likely to prove a very risky venture.

CHAPTER N 3

IMPACT ON INFLATION AND GROWTH

Over the past almost three decades, Bulgaria has recorded relatively high growth rates and low average inflation compared with other countries in the region

The Bulgarian economy is closely integrated with that of the euro area. Based on 2024 data, the overall price level in Bulgaria stands at 57% of the euro area average, while household incomes are slightly higher relative to this benchmark, amounting to 63% of the euro area average, as measured by GDP per capita.

Euro adoption will further deepen the integration of the Bulgarian economy with that of Europe. As a result, both prices and incomes in Bulgaria are expected to continue to grow at a somewhat faster pace than in the euro area. If euro area prices increase by around 2% per year over the next decade, it would not be surprising for prices in Bulgaria to rise by approximately 2.5–3%. A price increase in Bulgaria of 2.5–3% should not be regarded as a cause for concern.

In fact, a price increase of 3% may be preferable to an increase of 2%, as it allows resource reallocation processes—namely reallocation of capital and labour—to take place more rapidly. When prices rise somewhat faster, differences in relative prices tend to be slightly larger. It is precisely these relative price differentials that investors monitor very closely when they take decisions from which sectors to withdraw resources and to which sectors to reallocate them. In this sense, a somewhat higher rate of inflation in the Bulgarian economy would make it more dynamic and could support a faster pace of economic growth. I am not aware of any robust empirical study suggesting that a 3% rate of price growth is close to levels that could be considered detrimental for a catching-up economy that still faces a long path towards reaching the living standards of the most advanced European economies.

What matters most for Bulgarian households is the evolution of the purchasing power of their incomes. If household incomes in Bulgaria grow faster than inflation—that is, if incomes increase in real terms—while continuing to converge towards euro area averages, there is no cause for concern. While such a favorable scenario cannot be taken for granted, historical evidence suggests that it is the most likely outcome.

What shows the experience of other CEE countries that joined the euro area?

The most relevant example for Bulgaria appears to be Estonia and Latvia, as these two CEE countries entered the euro area with income levels and price levels that were closest to those expected for Bulgaria at the time of its accession.

Available data indicate that following euro adoption, both prices and incomes in these two countries grew faster than the euro area average. More specifically, over the first ten years of euro area membership, the price level in Estonia relative to the euro area average increased from 70% in the beginning of the period to 81%, while in Latvia it rose from 69% initially to 78%. Over the same period, income per capita in Estonia relative to the euro area average increased from 59.7% at the time of entry to 81.5%, while in Latvia it rose from 55.5% at the point of accession to 67.8% ten years later (Table 1).

Therefore, during the first decade following euro adoption, the relative price level increased by 11.3 percentage points in Estonia and by 9.4 percentage points in Latvia (Table 2). Over the same period, income per capita relative to the euro area average rose by 21.8 percentage points in Estonia and by 12.3 percentage points in Latvia, respectively. If Bulgaria were to replicate developments observed in these two economies, then ten years after euro adoption—around 2036—income per capita could be expected to reach approximately 73–78% of the euro area average, compared with a pre-accession level of around 63%. At the same time, Bulgaria’s price level, estimated at around 57% of the euro area average prior to euro adoption, could potentially increase to a range of approximately 67–72% of the euro area average after ten years.

TABLE 1: INCOME CONVERGENCE - GDP PER CAPITA IN EU COUNTRIES (PPS, EA=100)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
EU	85	86	86	87	87	88	88	89	90	91	91	92	92	92	93	93	93	94	94	95	96	95	96
Euro area	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Belgium	105	107	107	107	107	105	104	104	107	109	109	111	111	111	111	110	109	109	110	112	111	113	113
Bulgaria	26	27	29	30	33	34	36	39	39	40	41	43	43	44	45	47	48	50	52	55	57	60	61
Czechia	65	64	68	70	71	71	74	76	78	77	77	77	78	81	82	83	86	88	90	91	88	85	87
Denmark	108	108	107	110	111	112	111	113	114	118	117	117	118	118	118	118	120	119	118	126	128	129	120
Germany	106	105	106	107	106	105	106	107	108	111	114	116	116	118	117	117	117	117	115	117	115	112	111
Estonia	38	41	45	48	54	58	63	62	58	59	65	68	70	73	72	73	75	77	79	81	81	80	77
Ireland	119	124	126	129	131	132	132	121	117	118	120	122	124	130	173	166	175	180	179	196	215	227	204
Greece	74	77	81	83	81	84	82	83	84	76	68	64	65	65	64	62	62	62	62	59	61	64	66
Spain	84	86	87	87	89	92	92	91	91	87	84	83	82	83	85	86	86	86	86	79	81	84	87
France	100	100	97	97	99	97	97	96	98	99	99	99	101	100	99	98	97	97	99	99	96	93	95
Croatia	43	45	47	49	50	53	55	57	57	55	56	56	56	56	56	58	59	60	64	63	67	69	73
Italy	103	101	101	99	97	97	97	97	97	96	96	95	92	90	90	92	91	91	91	89	91	93	94
Cyprus	84	83	84	87	90	90	93	95	95	92	88	83	77	74	77	82	83	85	88	87	90	93	93
Latvia	32	34	37	39	43	45	49	51	47	48	49	54	55	57	58	59	60	62	63	66	68	66	67
Lithuania	35	37	42	44	47	49	54	57	51	54	60	64	67	69	69	70	73	76	79	83	84	84	83
Luxembourg	205	206	208	216	222	235	241	248	244	247	248	252	254	259	260	257	249	242	235	244	248	240	227
Hungary	48	51	54	54	55	55	54	57	58	59	61	61	62	64	65	64	64	67	69	71	71	73	73
Malta	67	69	72	72	72	69	71	73	75	79	77	80	84	87	92	93	99	100	100	100	104	100	103
Netherlands	122	122	119	120	122	123	125	128	127	124	124	125	125	123	123	121	121	122	121	125	126	128	128
Austria	108	109	111	112	112	112	111	112	115	114	116	121	120	119	120	119	117	118	117	117	116	117	115
Poland	41	42	43	45	45	45	48	50	54	57	60	62	62	63	65	64	65	67	70	75	75	75	74
Portugal	71	72	72	72	73	74	73	73	75	75	71	69	71	71	71	72	71	72	73	71	71	74	77
Romania	24	25	26	30	31	35	39	46	47	48	49	52	50	51	52	54	58	62	65	69	69	70	75
Slovenia	69	70	72	75	76	76	78	81	77	76	76	75	75	76	75	76	79	80	82	84	84	85	88
Slovakia	45	47	49	51	53	56	60	64	65	69	69	71	71	72	73	68	66	66	66	71	70	68	71
Finland	102	101	101	104	103	103	107	110	107	107	108	106	104	103	102	101	102	103	102	107	104	102	101
Sweden	109	109	110	113	110	112	116	115	113	115	117	118	117	116	117	114	112	111	111	115	115	110	109

Source: Eurostat, UniCredit Bulbank

TABLE 2: PRICE LEVELS BY COUNTRY, HICP (EA27 = 100)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
EU	96	96	96	95	96	96	96	96	95	96	95	95	95	95	95	95	95	95	95	94	95	95	95
Euro area	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Belgium	106	104	105	104	105	106	106	107	106	106	106	106	106	106	105	107	108	109	109	107	109	111	112
Bulgaria	39	39	38	40	41	44	46	49	51	51	50	49	48	47	47	47	49	49	51	52	53	55	56
Czechia	51	58	55	55	59	63	64	71	66	70	71	70	67	62	63	65	67	70	71	72	79	85	88
Denmark	140	140	140	137	138	136	133	133	133	134	135	136	135	136	135	138	136	134	136	134	133	140	138
Germany	107	107	105	103	103	103	102	102	102	101	100	100	101	101	101	101	101	100	101	101	101	103	104
Estonia	61	60	60	61	63	67	71	73	70	70	71	72	73	74	73	75	77	79	80	81	86	94	96
Ireland	118	123	122	121	121	122	122	125	120	115	116	116	118	121	121	122	125	127	129	134	131	131	131
Greece	83	81	83	84	86	87	90	89	91	93	93	91	88	84	84	83	82	82	82	83	83	83	82
Spain	87	86	87	89	90	91	93	93	94	95	95	94	93	91	90	90	90	91	91	92	89	89	87
France	104	104	106	107	106	106	106	108	107	107	106	106	105	105	106	106	107	108	107	107	108	107	107
Croatia	67	68	66	68	71	72	71	72	71	71	69	68	67	65	64	65	66	67	67	67	66	69	71
Italy	99	100	99	101	101	101	100	98	98	97	99	100	100	101	101	99	98	98	96	96	96	95	93
Cyprus	89	89	88	89	89	90	87	87	88	91	92	92	91	90	87	85	85	86	86	85	88	89	89
Latvia	58	57	54	55	57	63	69	75	71	67	69	70	69	70	69	70	71	73	74	74	71	76	78
Lithuania	54	54	51	52	54	57	59	63	63	61	62	62	62	61	61	62	63	64	64	66	68	75	78
Luxembourg	109	108	107	110	110	109	111	111	114	116	117	117	118	119	119	121	122	120	125	130	131	130	128
Hungary	54	59	57	61	63	61	67	68	60	62	60	60	58	57	58	59	62	62	64	62	65	64	71
Malta	79	79	72	72	73	76	75	76	77	76	77	77	80	80	79	80	82	82	82	84	87	88	87
Netherlands	103	103	105	103	103	102	100	101	103	105	106	106	107	108	108	110	109	108	111	110	109	109	112
Austria	106	104	102	101	101	101	101	101	102	102	102	103	103	104	104	104	106	106	107	105	103	103	107
Poland	64	60	52	51	60	62	61	66	55	58	56	55	55	55	55	53	56	56	57	56	57	58	64
Portugal	81	83	81	81	80	80	82	83	83	83	84	83	81	82	82	83	84	83	83	85	84	83	83
Romania	41	42	41	40	52	55	61	58	52	52	52	50	52	52	52	51	52	53	52	52	53	57	58
Slovenia	75	75	75	74	75	76	78	80	83	83	82	81	81	82	81	82	82	82	82	82	82	84	85
Slovakia	43	45	49	53	55	58	64	68	70	68	68	68	67	67	67	74	78	80	81	78	78	81	80
Finland	125	125	124	121	121	120	116	115	116	116	117	119	120	120	119	119	119	119	119	119	119	120	119
Sweden	117	120	121	118	117	115	112	108	100	114	120	124	128	123	121	124	124	118	116	118	122	116	109

Source: Eurostat, UniCredit Bulbank

CHAPTER N 4

THE STATE OF THE BULGARIAN ECONOMY ON THE EVE OF EURO AREA ACCESSION

Bulgaria is ready for the euro area

The Bulgarian economy is competitive, a fact best illustrated by the balance of the net international investment position, which reflects the difference between the foreign assets and liabilities of the Bulgarian government, households, non-financial corporations and financial institutions. At the end of 2024, only two CEE countries recorded a stronger net international investment position balance than Bulgaria. This outcome reflects an extended period in which the economy produced more than it consumed, allowing Bulgaria to substantially reduce the large stock of external private sector debt accumulated by the end of 2008, just prior to the onset of the global financial crisis.

The sophistication of the economy is increasing and Bulgarian companies, albeit more gradually than desirable, are moving up the value chains towards the production of goods and services with higher value added. This process supports income growth and wealth generation without the detrimental build-up of macroeconomic imbalances.

Indeed, aside from pronounced income inequality, Bulgaria does not exhibit significant macroeconomic imbalances on the eve of eurozone membership. It is true that stretched valuations are evident in certain segments of the residential real estate market; however, the central bank is closely monitoring developments and appears prepared to take additional measures to address overheating risks, should this be deemed necessary.

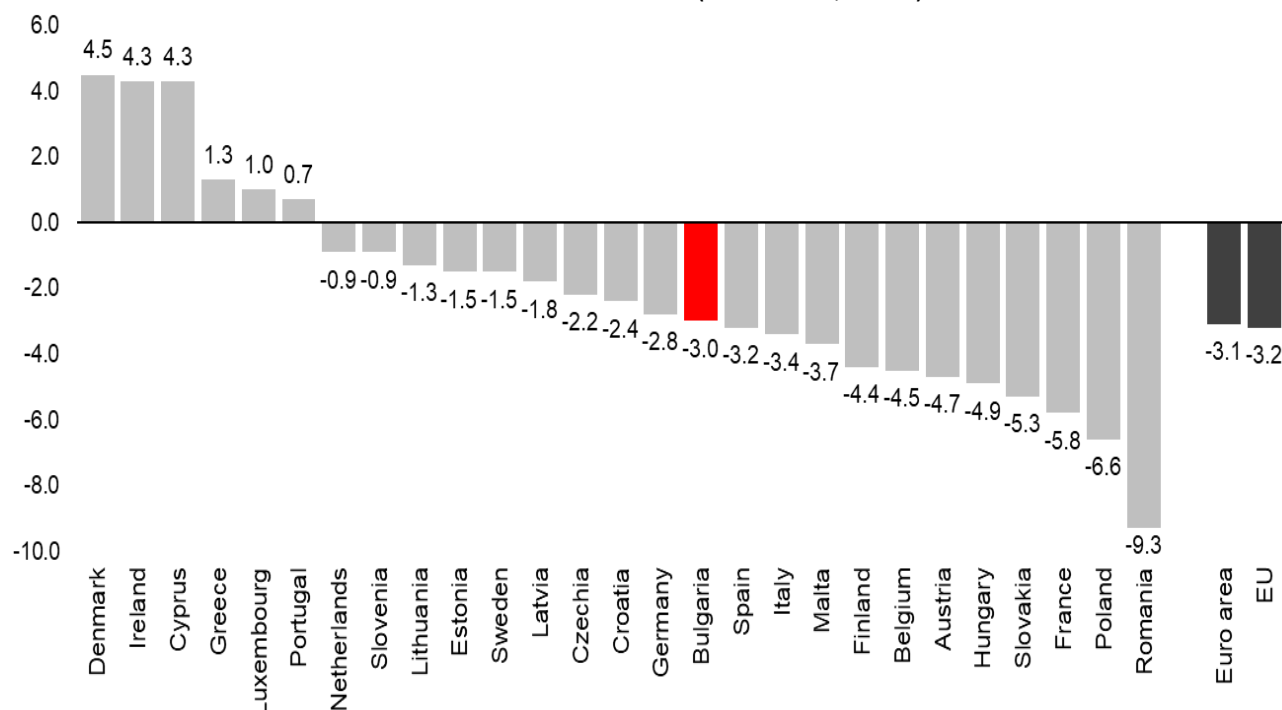
Fiscal policy remains accommodative but in smaller proportions than in many other economies

Fiscal policy appears accommodative, given that real GDP growth is around 3.5%, while the general government deficit has been close to 3% of GDP in three of the past four years. This development, however, takes place against the backdrop of a still very low level of public debt and a continued strong commitment to prudent fiscal policy on the part of the political parties providing parliamentary support to the government of Prime Minister Rosen Zhelyazkov.

This takes place in an environment where budget deficits in the world's largest economies have reached increasingly unsustainable levels. In the United States, GDP growth has been around 2.5% over the past several years. This growth, however, has been supported by substantial fiscal stimulus, which has pushed the federal government budget deficit to levels of around 7% of GDP. A similar pattern can be observed in China, where the budget deficit is even higher than in the United States, while GDP growth is expected to slow to just above 4.5% this year. In Europe, fiscal deficits are lower, but real GDP growth remains weak (Chart 1). On average, the euro area budget deficit is expected to reach 3.5% of GDP by the end of this year, while more than ten of the European Union's twenty-seven Member States are projected to record deficits exceeding 3% of GDP.

CHART 1: EU DEFICITS - BELOW GLOBAL EXTREMES, DESPITE WEAK GROWTH

GOVERNMENT BUDGET BALANCE BY EU COUNTRIES (% OF GDP, 2024)



Source: Eurostat, UniCredit Bulbank

The risk of a Greek-style scenario exists, but should not be overstated

What distinguishes successful from unsuccessful countries that have joined the euro area is the implementation of the structural reforms. These refer to changes in the economic structure that enhance competitiveness, or, in other words, improve the economy's capacity to produce a greater volume of goods and services with a given, fixed level of resources—capital and labor.

Countries that joined the euro area and continued to pursue structural reforms remained competitive, even though labor costs and prices in those economies increased at somewhat faster rates than in the core euro area countries.

A scenario like the one experienced by Greece is possible, but it is unlikely. The experience of most countries that have joined the euro area points in the opposite direction: the process of convergence towards the living standards of the most advanced euro area economies can—and most likely will—continue without being accompanied by a loss of competitiveness.

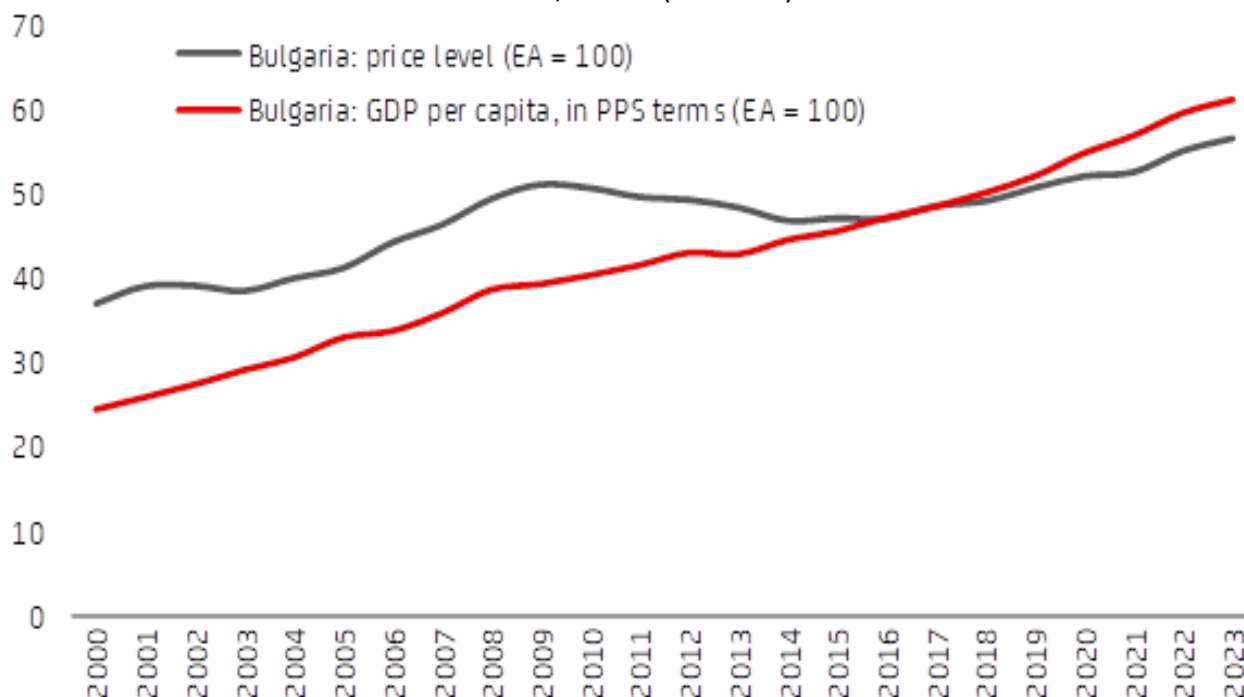
CHAPTER N 5

THE NEXT STAGE OF REAL CONVERGENCE WILL BE HARDER

Progress so far

Bulgaria has achieved an impressive convergence towards the standards of living in the more advanced economies since the country joined the EU in 2007. Bulgaria's GDP per capita rose from about 34% of the eurozone average in 2006 to 61% in 2023. At the same time, Bulgaria's aggregate price level grew from around 44% of the eurozone average in 2006 to 56% in 2023 (Chart 2). Over the past seventeen years, GDP per capita in Bulgaria has grown by an average of 3.4% per year, considerably outpacing the eurozone's average of 0.7%. Similarly, prices in Bulgaria have risen by 3.5% per year, whereas the eurozone has posted an average price increase of 2.1% accordingly.

CHART 2: BULGARIA'S INCOME AND PRICE LEVELS ARE FAR FROM THOSE IN THE EUROZONE
PRICE LEVEL INDICES AND GDP PER CAPITA, IN PPS (EA = 100)



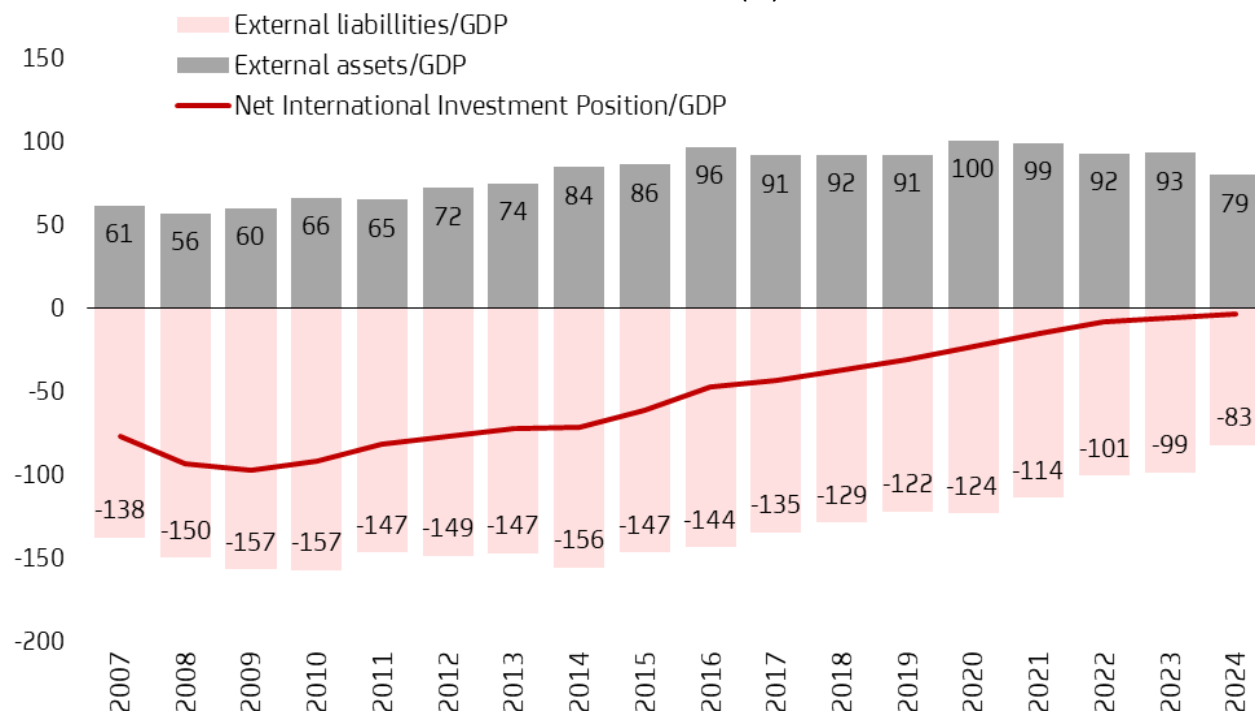
Source: Eurostat, UniCredit Bulbank

The remarkable progress in bringing Bulgaria's income and price levels closer to the eurozone average took place under a fixed-exchange-rate regime and without the economy losing competitiveness. Perhaps the best evidence that competitiveness has improved is the remarkable transformation of the country's current account balance, which went from an unsustainable shortfall equivalent to a whopping 24% of GDP in 2007 to a small and manageable deficit of just 1.8% of GDP in 2024. As a result, Bulgaria's net international investment position (NIIP), which represents the balance between the country's stock of external financial assets and liabilities, improved from a massive shortfall equal to 77.0% of GDP in 2007 to a small deficit of only 3.7% of GDP in 2024 (Chart 3).

This impressive performance is primarily attributable to the country's solid progress in implementing the structural reforms aimed at improving the quality of its institutions. These reforms, in turn, increased competitiveness, thereby more than compensating for the loss of competitiveness stemming from the alignment of income and price levels in Bulgaria with the aggregate levels prevailing in the eurozone economies.

CHART 3: PRESERVING COMPETITIVENESS

EXTERNAL FINANCIAL ASSETS AND LIABILITIES AND NIIP (%)



Source: Bulgarian National Bank, UniCredit Bulbank

Not enough

There is no room for complacency, however, as the next stage of the convergence process will likely be harder. Since full alignment has not yet been achieved, we expect both income and price levels to continue to grow at a faster pace compared to those in the eurozone. For example, if eurozone prices were to increase by 2% annually during the next decade, it would not be surprising if prices rose by 2.5-3% in Bulgaria at the same time.

At 2.5-3% per year, inflation does not look worrisome. In fact, inflation of 3% can be better for the economy than 2%, as slightly higher inflation allows for the acceleration of resource reallocation. When inflation is higher, the difference in relative prices is larger, increasing the likelihood of investors withdrawing resources (capital and labour) from underperforming sectors and channeling them to sectors with an improving outlook. In other words, slightly higher inflation will make the Bulgarian economy more dynamic and will help to accelerate investment growth, because stimulus to speed up country's reallocation of resources will increase.

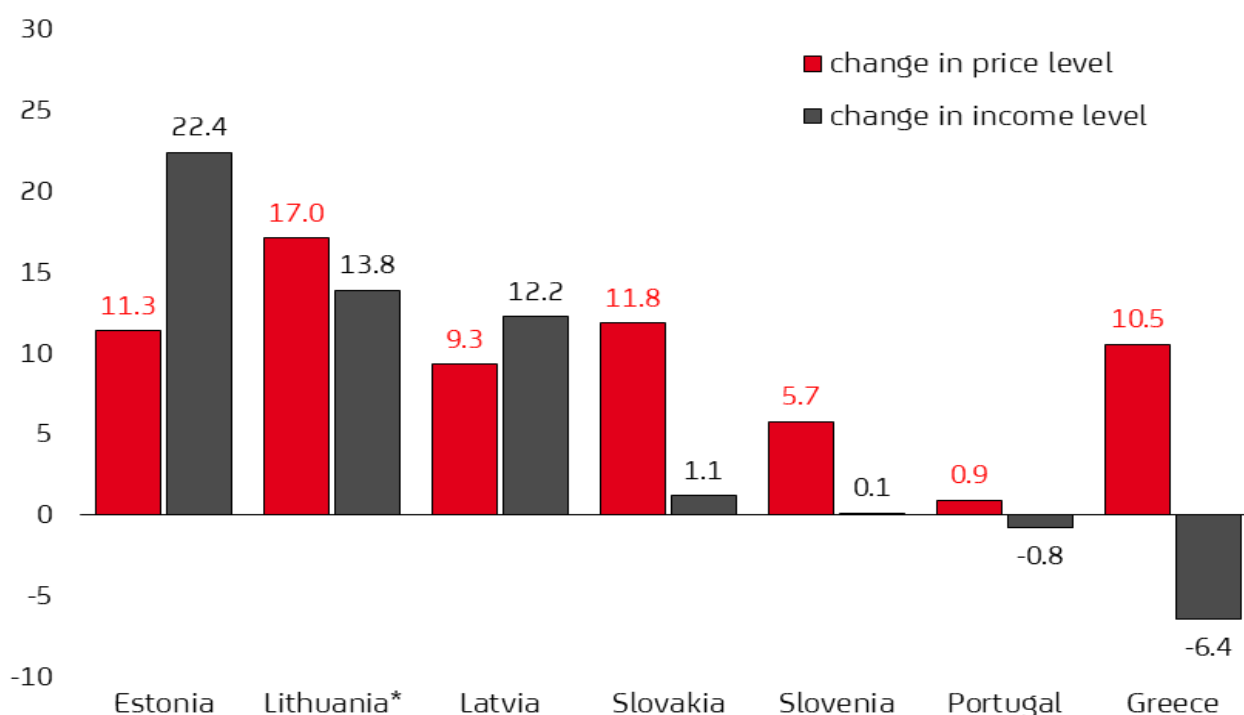
What matters more for Bulgarian households, however, is what happens to the purchasing power of their income – namely whether it is increasing, and, if so, how the rise in the purchasing power of the country's incomes compares with that in other eurozone economies. If Bulgarian incomes

grow faster than inflation, while, at the same time, catching up with those in the more advanced eurozone countries, there is no cause for concern.

Such a positive scenario is not guaranteed but empirical data suggest that this would be the most likely outcome. Chart 4 shows the degree of convergence achieved in the first decade after eurozone entry for seven countries, which, similarly to Bulgaria, exhibited large initial gaps in income and prices when compared to those in the eurozone.

CHART 4: FOLLOW THE BALTIC EXPERIENCE

CHANGE DURING THE FIRST TEN YEARS AFTER EUROZONE ENTRY (EA = 100)



Source: Eurostat, UniCredit Bulbank

Note: *Lithuania - change during the first nine years after eurozone entry.

The performance of individual countries seems to be driven by several factors. The starting point of the income and price gap matters, as countries that joined the eurozone with larger initial gaps have achieved stronger progress in terms of convergence in the first decade of their eurozone membership. The performance of Greece, Slovenia and Slovakia was more severely affected by the shocks triggered by the global financial crisis than those in the Baltic countries, which joined at a time when the global downturn was pretty much over. Most importantly, countries' performance was driven by their progress in implementing the structural reforms to improve the quality of their institutions. The countries leading in the implementation of reforms experienced the most significant improvements in competitiveness and were thus able to fully compensate for the loss of competitiveness resulting from the alignment of incomes and prices with the aggregate levels prevailing in the eurozone. The countries' performance was therefore mostly driven by their own progress in implementing the above-mentioned structural reforms.

During the transition from centrally planned to a market-based economy, Bulgaria successfully implemented a long list of reforms. Initially, the reforms were focused on creating the institutional

and legal framework necessary for the free market to operate, and were accompanied by macroeconomic stabilization policies, which were aimed at minimizing social costs and smoothening the transition process. Later, the focus shifted on the deepening and consolidating the reforms necessary to build a fully functioning, efficient, and competitive market economy.

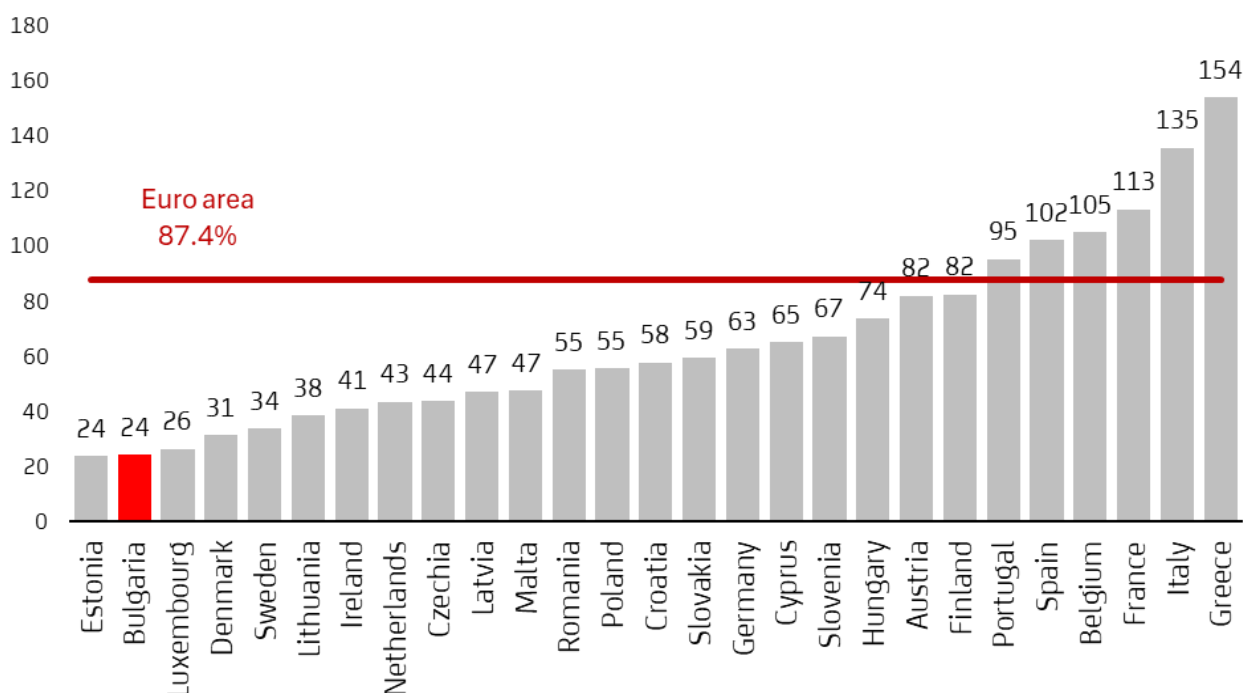
The reforms that lie ahead tend to be harder to implement. These reforms not only focus on fixing past problems, but also on preparing the Bulgarian economy for future challenges. They include structural measures aimed at ensuring long-term sustainability and fulfilling global climate commitments, helping labor market adopt to changing technology and demographics, promoting innovations and knowledge-based economy, while deepening citizen trust in institutions and markets. These reforms, sometimes referred to as third generation reforms, require adaptive governance and continuous improvement, which make them more complex, nuanced, and longer term oriented.

Structural reforms will continue to shape the economy's performance

First and foremost, eurozone membership does not remove Bulgaria's obligation to continue to pursue a prudent fiscal policy. Maintaining lower levels of debt and deficit in country's public finances compared with the eurozone average must continue, especially given the unfavorable demographic trend in Bulgaria, where the pace of ageing and the decline in the population are among the most worrisome in Europe (Chart 5).

CHART 5: EUROZONE MEMBERSHIP IS NO SUBSTITUTE FOR FISCAL PRUDENCE

GENERAL GOVERNMENT DEBT BY EU COUNTRIES (% OF GDP, 2024)



Source: Eurostat, UniCredit Bulbank

Maintaining lower levels of public debt and fiscal deficits compared to euro area averages should remain a priority, particularly in light of Bulgaria's less favorable demographic outlook, with population ageing and decline proceeding at among the fastest rates in Europe.

Efforts should focus on reducing inefficiencies and waste in public spending, without using this as a pretext to hinder increases in investment in education, healthcare, and other socially important sectors.

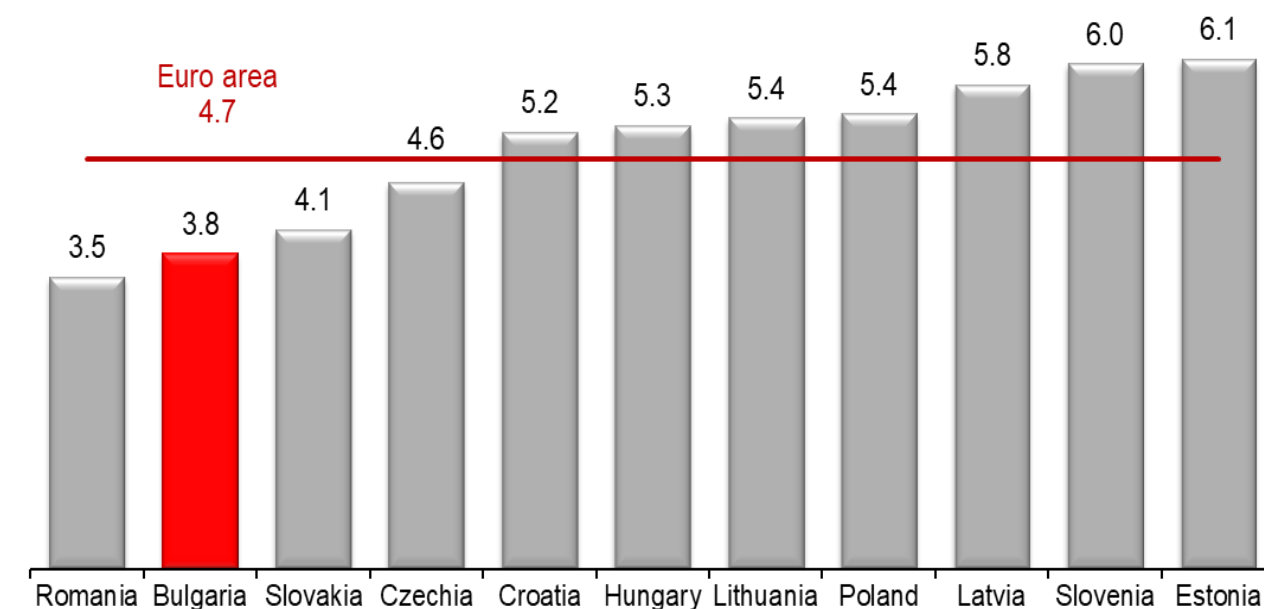
Containing inflationary pressure with appropriate structural policies is also key. To this end, Bulgaria needs to strengthen national policies aimed at enhancing competition in product markets and take decisive steps to build up the administrative capacity needed to reduce money laundering and tax evasion to more tolerable levels.

Furthermore, it would be essential for Bulgaria to press ahead with the modernization of its infrastructure and education sectors, which are crucial to boosting productivity.

It is essential to accelerate the implementation of structural measures aimed at improving the education sector and increasing investment in human capital (Chart 6). This is particularly important given the rapidly declining population.

CHART 6: LOW EDUCATION SPENDING HOLDS BACK BULGARIA'S COMPETITIVENESS

PUBLIC SECTOR EXPENDITURE ON EDUCATION IN CEE COUNTRIES (% OF GDP, 2024)



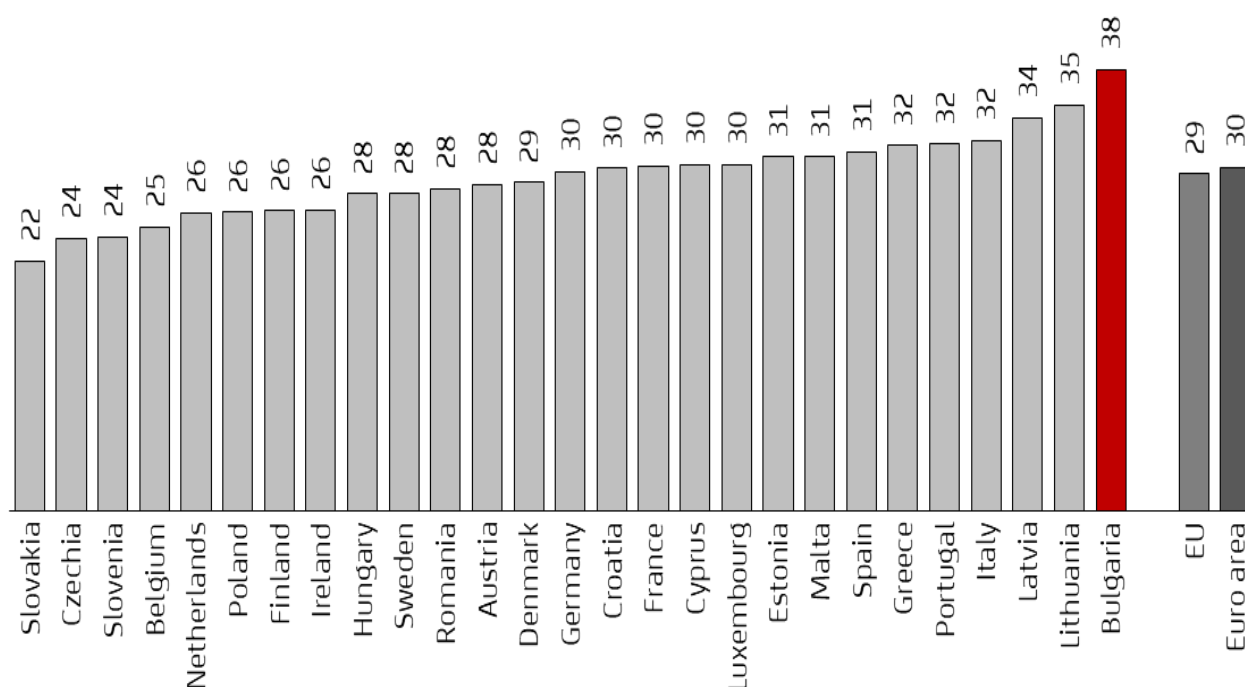
Source: Eurostat, UniCredit Bulbank

In addition, structural reforms to reduce corruption are of key importance to attract more investment. Bulgaria has already done a lot to cutback corruption, but more is needed to prevent cases where defendants with money and connections are able to escape justice.

It is key that there are not too many households who feel left behind and fail to benefit from the convergence process. This is particularly important for Bulgaria, where income inequalities (Chart

7) and the share of people at risk of poverty and social exclusion have remained elevated. Reinvigorating such policies will be crucial for the way the eurozone membership will be perceived and evaluated by the Bulgarian citizens in the decades to come.

CHART 7: IN 2024, BULGARIA HAD THE MOST ELEVATED INCOME INEQUALITY IN THE EU27
GINI COEFFICIENT IN EU MEMBER STATES



Source: Eurostat, The Investment Institute by UniCredit

Note: The Gini coefficient measures how income is distributed across a population. A Gini coefficient of zero indicates perfect equality where all values are the same (where everyone has the same income). A Gini coefficient of one (or 100%) reflects maximal inequality among values (for example, where one person has all the income).

Achieving strong productivity growth (and thereby preserving high competitiveness) requires relentless and sustained efforts in the form of structural measures and reforms aimed at improving the quality of institutions. Without such structural reforms, competitiveness will cease to improve, and the loss of competitiveness driven by rising prices and wages could push the country into a crisis similar to that experienced by Greece. Ultimately, high-quality institutional performance is what makes it possible to achieve strong, sustainable, and inclusive economic growth (Chart 8).

CHART 8: STRONG INSTITUTIONS DRIVE PRODUCTIVITY AND COMPETITIVENESS

WORLDWIDE GOVERNANCE INDICATORS (WGI), 2024 (INDEX: 0 = WORST, 100 = BEST)



Source: World Bank, UniCredit Bulbank

Note: The World Bank's Worldwide Governance Indicators provide a comprehensive assessment of governance across various countries (over 200 countries and territories). The WGI are compiled by combining data from various sources like think tanks, international organizations, and NGOs, and measure six dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. Percentile rank (0-100) indicates rank of country among all countries in the world. 0 corresponds to lowest rank and 100 corresponds to highest rank. The chart shows the simple average value of the six indices for the respective country.

To prosper, any economy needs a stable and credible national currency. The adoption of the euro is an important moment for Bulgarian economy. It will remove some obstacles to trade and investment, while, at the same time, will create the preconditions necessary for the acceleration of some structural measures, particularly those related to the functioning of the financial system and the central bank, but only that. However, eurozone membership does not provide an autopilot that helps to achieve convergence of incomes toward the levels prevailing in the more advanced economies by itself. To achieve that goal relentless efforts are needed to improve the quality of the country's institutions.

CHAPTER N 6

THE EURO ADOPTION WILL INCREASE BULGARIA'S MONETARY SOVEREIGNTY

Sovereignty, from a legal point of view, refers to the power to enact laws

A broader definition, attributed to John Locke, the English philosopher of the seventeenth and eighteenth centuries, defines sovereignty as “the ability to control outcomes and to respond to the fundamental needs of the people, such as peace, safety, and other important public goods.” In this broader sense, when applied to monetary policy, sovereignty should be understood as the ability to control outcomes rather than as the mere capacity to make independent decisions.

In other words, monetary sovereignty does not primarily depend on whether a country can independently choose specific policy instruments—such as the scale of government securities purchases, interest rates, or minimum reserve requirements, which constitute the standard toolkit of modern central banks. Rather, it depends on the extent to which the monetary authority can influence the outcomes of monetary policy, namely inflation, employment, and the exchange rate, which are the main objectives of monetary policy, and on whether the resulting levels of these variables are aligned with the preferences of the authorities.

When it comes to monetary policy, only a few economies in the world can be considered both sovereign and independent

In the global economy, national economies are interconnected in multiple ways. The greater the degree of interconnection, the more exposed countries are to the effects of economic policies conducted elsewhere. These spillover effects reduce a country's ability to control economic outcomes within its own economy and therefore limit its sovereignty. Moreover, these losses of control are not symmetric: the smaller the economy, the greater the impact of external spillovers, while larger economies are better able to absorb or offset them.

In today's global economy, technological, financial, and commercial interlinkages are so strong that only the very largest economies can simultaneously maintain both independence and sovereignty in the conduct of economic policy. In the area of monetary policy in particular, the number of economies that are both sovereign and independent is very limited. These include major geopolitical and financial centers such as the United States and the Eurozone and, to a lesser extent, China and possibly Japan. For most other countries, including Bulgaria, sovereignty and independence in monetary policy do not coexist; policy outcomes are heavily influenced by external conditions and decisions taken in larger economies.

The Eurozone enables small countries to increase their sovereignty

There is a strong incentive for small countries to cooperate with others to protect their citizens from negative externalities. The EU provides such a framework, enabling its member states to benefit from economic openness—namely, participation in the process of globalization—while at the same time mitigating the adverse effects arising from the high degree of interconnectedness characteristic of modern economies.

Not only does the Eurozone invite small countries to join, but it also grants them a disproportionately large role in the decision-making process relative to the size of their economies. It is misleading to assume that a small open economy can conduct an independent monetary policy. Consequently, a European country that is not a member of the Eurozone is, in practice, compelled to align its monetary policy with that of the ECB. Deviating from this is likely to entail negative consequences for macroeconomic stability, particularly in terms of growth and inflation. By contrast, membership in the Eurozone provides a country with direct representation in the decision-making process, allowing it to influence monetary policy through participation, argumentation, and, where applicable, voting rights.

Monetary Sovereignty under Eurozone Membership

As a member of the Eurozone, Bulgaria would enjoy a higher degree of monetary sovereignty than it does under a currency board arrangement. A small open economy operating under a currency board may appear to retain monetary sovereignty, insofar as it formally makes decisions regarding the use of certain policy instruments available to its central bank. However, such arrangements provide only very limited control over inflation, employment, and the exchange rate. In this sense, Bulgaria retains some degree of monetary sovereignty under the currency board arrangement, but this sovereignty is severely constrained.

If Bulgaria becomes a member of the Eurozone, it will participate in the formulation of the ECB's monetary policy, including decisions on interest rates and the external value of the common currency, the euro. This participation would grant Bulgaria greater influence over inflation and employment in its own economy and, therefore, a higher degree of monetary sovereignty than under the currency board arrangement.

The monetary sovereignty gained through Eurozone membership would be shared with other member states participating in the decision-making process. For a small and open economy such as Bulgaria, however, this form of shared sovereignty may represent the highest attainable degree of effective control over monetary outcomes.

CHAPTER N 7

WHY SOME EUROPEAN ECONOMIES ARE IN NO RUSH TO JOIN THE EUROZONE

The number of Eurozone member states reached 20

With Croatia joining the euro at the beginning of 2025, the number of Eurozone member states has increased to 20, representing nearly two-thirds of all EU countries. Initially, most countries adopted the euro driven by the belief that, by effectively anchoring their monetary policy to the Deutsche Mark, they would benefit from the strong commitment to price stability associated with Germany's central bank. Following the EU's eastward enlargement, several countries from Central and Eastern Europe also joined the Eurozone, replacing their own—often not so strong and underperforming—national currencies with the common European currency.

These countries share the view that conducting monetary policy jointly with most other EU member states allows them to reap the benefits of participation in the world's second most important reserve currency, while at the same time they have a monetary policy and exchange rate arrangement that mitigates some of the vulnerabilities arising from economic openness and deep international interdependence.

At present, apart from Bulgaria, six EU member states remain outside the Eurozone

Denmark has negotiated a formal opt-out from the euro and is therefore not legally obliged to adopt it. Sweden, Czechia, and Poland are formally committed to adopt the euro when they fulfill all five-euro adoption criterion but have not yet done so. The United Kingdom and Switzerland, by contrast, are not members of the European Union, and for these countries the question of euro adoption does not exist at all.

Four countries - Denmark, Sweden, Czechia and Poland - are among the best performing European economies. These are countries with their own national currencies that are believed to be so stable by their governments and citizens that they feel they do not need the extra stability that eurozone membership could provide.

Two of them, Denmark and Sweden, understand that they cannot have an independent monetary policy when a very large part of their trade and capital flows are denominated in euro. However, they do not have a mandate to adopt the euro, because this is the will of their citizens, as both countries have held unsuccessful referendums to adopt the euro in the past. In this situation, what the central banks of these two countries can do is to de facto fix the exchange rate of the national currency to the euro and make every effort to preserve this key anchor of their economic policy making.

Czechia also admits that what it has are rather its own banknotes and coins, but not an independent monetary policy, because it is very dependent on what ECB does.

These countries prefer to remain outside the Eurozone for three main reasons

Apart from having their own highly stable national currencies, these countries prefer to remain outside the Eurozone for three main reasons.

First, they argue that, in the absence of a fiscal union and a political union, the Eurozone remains institutionally incomplete. They therefore prefer to wait and observe whether the necessary structural reforms will be undertaken and what their outcomes will be. Second, they are reluctant to relinquish the option of using exchange-rate depreciation as a last-resort policy tool and as a form of macroeconomic “shock absorber” in the event of adverse economic shocks. Third, some of these countries remain concerned that income and price convergence with existing euro area member states is not yet complete and that premature euro adoption could lead to a loss of price competitiveness in the long run.

The national currencies of Hungary and Romania are in a different situation

Hungary operates under the belief that, by remaining outside the Eurozone, it can exert greater control over inflation, employment, and the exchange rate in its domestic economy. In recent years, however, the share of Hungarians who believe that their country would be better off as a member of the Eurozone than outside it has risen to nearly two-thirds of the population. This view appears particularly compelling given recent developments: Hungary’s central bank has been forced to raise its key policy interest rate to 13 percent to prevent capital outflows, while the harmonized consumer price inflation reached 25 percent year-on-year at the end of 2022, the highest level among all EU member states. In December 2022, the interest rate on newly issued long-term corporate loans rose to 13.53%, while mortgage lending rates reached 8.80%. Against this backdrop, concerns have grown that if borrowing costs remain elevated for a prolonged period, credit quality may deteriorate, thereby putting the stability of the financial system under significant pressure.

In Romania, the situation is more nuanced. At the outset of the transition to a market-based economy three decades ago, it would have been difficult to argue that the country possessed a stable national currency. Over the past decade, however, Romania’s economic performance has improved markedly. Progress in terms of real convergence has been particularly notable, including the convergence of Romanian income levels toward those prevailing in the Eurozone. Advances in curbing corruption and efforts to strengthen the rule of law have also contributed to greater confidence in the national currency. This is especially important, as sustained currency stability is difficult to achieve in countries characterized by persistent political instability, high levels of corruption, and weak legal institutions. At the same time, Romania’s relatively large domestic market limits the impact of external economic developments on the national economy. A relatively favorable demographic outlook further supports the stability and creditworthiness of the country’s national currency.

INSTEAD OF CONCLUSION:

WITHIN THE HIERARCHY OF THE MOST STABLE, BEST-PERFORMING, AND MOST TRUSTED CURRENCIES GLOBALLY, THE EURO RANKS FAR HIGHER THAN THE BGN

The stability of, and confidence in, a national currency depend on a wide range of factors, most importantly the level of productivity and the quality of economic institutions, particularly those related to the functioning of the financial and credit system. In general, countries with the most stable and well-functioning currencies tend to have relatively large and diversified economies, high levels of productivity, high income levels, and strong external positions, as measured by the balance between external assets and external liabilities. Political stability and high institutional quality—especially in areas related to the financial system functioning—also play a key role.

The BGN has demonstrated a solid performance since the introduction of the currency board arrangement in Bulgaria in 1997. Nevertheless, the euro ranks significantly higher than the BGN in international comparisons of currency stability, performance, and credibility.

Alongside a prudent fiscal policy, confidence in the BGN largely stems from the fact that every BGN issued by the BNB is fully backed by euro-denominated reserves. The exchange rate is legally fixed, and this arrangement has remained unchanged since its initial adoption by the Bulgarian parliament in 1997. However, while banknotes and coins in circulation, as well as commercial banks' and government deposits at the BNB, are fully covered by these reserves, the deposits of companies and households held at commercial banks are not. Consequently, in a low-probability scenario where all corporate and household deposits would need to be converted into euros and withdrawn simultaneously, the BNB's foreign reserves would be insufficient.

Prolonged periods of political instability during the past four years have also negatively affected the confidence in the national currency. Similarly, insufficient progress in curtailing corruption and the continued need to strengthen the rule of law weigh on the creditworthiness and overall resilience of the country's national currency.

For any economy to prosper, a strong and credible national currency is essential. The currency board arrangement has had a positive impact on the Bulgarian economy since its introduction in 1997. However, this does not alter the fact that the euro is a more stable and credible currency, and that adopting the euro as a national currency would bring several important benefits to Bulgaria.

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