

BULGARIA



Macroeconomic and Market Research

„Euro Adoption: Myths and Reality“

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This publication contains analytical materials prepared by the economists of UniCredit Bulbank over the past three years, preceding Bulgaria's accession to the euro area. The focus of the research is on assessing the balance between the benefits and potential costs of euro adoption, as well as the opportunities and risks arising for the Bulgarian economy.

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INTRODUCTION: HISTORICAL REMARKS

The establishment of the euro was underpinned by three fundamental hopes. First, that it would promote sustained economic convergence among the Member States of the EU, thereby constituting a decisive step toward deeper European economic integration. Second, that such convergence would, in turn, generate stronger and more stable economic growth across the Union. Third, that enhanced economic integration—subsequently reinforced by closer political and fiscal integration—would eventually contribute to securing lasting peace and stability in Europe.

The founders of the euro are frequently portrayed as visionaries committed to the construction of a new European order. Their project was grounded in the belief that a high degree of economic interdependence among European nations would significantly reduce—if not eliminate—the risk of renewed military conflict. This perspective reflected the historical experience of the post-Second World War generation of political leaders, who were profoundly shaped by the devastation of the war and whose overarching objective was to embed peace in Europe through institutional and economic integration.

As the distinguished American economist and Nobel laureate Joseph Stiglitz has observed, the founders of the euro resembled the Argonauts venturing into uncharted waters. The creation of the euro area represented an unprecedented institutional experiment: never before had a monetary union been established among such a large and economically diverse group of sovereign states. The magnitude of structural differences in productivity, competitiveness, fiscal capacity, and economic performance made the endeavour both ambitious and inherently complex.

Although not always explicitly emphasized, an important motivating factor for the founders of the euro was the expectation that deeper economic integration would enhance Europe's geopolitical influence. In their view, if the common monetary policy proved successful, it would strengthen not only Europe's economic weight but also its political standing on the global stage.

The architects of the euro were fully aware that, historically, no monetary union had survived without being underpinned by a fiscal and political union. Prior to the creation of the euro, the dominant view in Germany was that a monetary union could succeed only if it were established after a fiscal union was already in place and following a sufficiently long period that would provide clear evidence of its sustainable functioning. In the rest of Europe—and particularly in Southern Europe—it was widely believed that the establishment of a monetary union would sooner or later trigger a crisis that would force governments to move rapidly toward fiscal and political union, to prevent a reversal of the integration process and a potential disintegration of the EU.

Most influential American economists approached the plans for the creation of the euro with scepticism. According to Milton Friedman, the euro would prove to be a source of difficulties, as it would increase political tensions among Member States by transforming economic shocks—easy to absorb under flexible exchange rate regimes—into political conflicts. Martin Feldstein of Harvard University went even further, warning in a 1997 article that even deep political ties tend to unravel in the absence of shared fiscal shock absorbers. In his view, an unstable currency union could intensify economic and political divergences among Member States to such an extent that it might ultimately lead to war between France and Germany. For Rudiger Dornbusch of the Massachusetts Institute of Technology, the creation of the euro was a “European fantasy” that failed to consider

the consequences of price differentials and wage rigidities. He argued that it threatened to undermine the competitiveness of Southern European economies and to generate asset price bubbles, which could eventually necessitate policies of severe fiscal austerity to avoid disruptive breakdowns with far-reaching adverse consequences for the Member States.

The architects of the euro did not possess a comprehensive and fully developed theoretical framework upon which to rely. Rather, they were guided by the conviction that a common European currency would foster deeper integration across all areas of economic activity.

Global interest surrounding the creation of the common European currency was considerable. This was hardly surprising, given the progress the EU had already achieved in the field of economic integration. By that time, Europe had established a single market characterized by the free movement of goods, labour, and capital. Tariff barriers had been substantially reduced, leading to a marked increase in intra-European trade and higher economic growth. This progress had already earned international recognition and prompted close global attention to the EU's subsequent steps. Enthusiasm was so pronounced that discussions even emerged regarding the formation of monetary unions in other parts of the world. The stakes were exceptionally high. Had the euro failed, a serious backlash could have been expected—one that might have brought about a discrediting, if not the collapse, of the broader European integration project.

Today, twenty-six years after its launch, the common European currency can be regarded as an unequivocal success. The euro is the world's second most important currency in international trade, accounting for approximately 30 percent of invoiced transactions in goods and services globally. Around 21 percent of global central bank reserves are in euro denominated financial assets, while, at the same time, roughly 28 percent of all international loans are extended in euro.

When the euro faced severe tests during the global financial crisis of 2008 and the sovereign debt crisis that followed in 2010, Member States chose to act collectively and ultimately succeeded in safeguarding Europe's autonomy in the conduct of monetary policy. At these pivotal moments in the history of European integration, the euro proved to be a factor enhancing stability and sovereignty. It helped shield the European economy from external shocks and created conditions for greater solidarity among Member States—precisely as its founders had hoped.

Initially, the introduction of the euro in Bulgaria looked like a relatively straightforward policy decision. This assessment was based on substantial evidence that the Bulgarian economy had performed well under a fixed exchange rate regime pegged to the euro—and previously to the Deutsche Mark—following the introduction of the currency board arrangement in 1997.

However, the prolonged absence of a stable pro-European government adversely affected the process. As a result, Bulgaria adopted the euro three years after Croatia, despite the fact that both countries joined the Exchange Rate Mechanism II (ERM II) simultaneously in 2020.

An additional factor that negatively influenced the accession was a disinformation campaign—allegedly financed and coordinated through Russian influence networks—aimed at fostering distrust toward the common European currency. This campaign intensified significantly in the context of the war in Ukraine, which has now continued for more than four years. Anti-euro activism was led primarily by the political party Vazrazhdane (Revival). At the core of the hybrid attacks and disinformation campaign directed against euro adoption were claims that the single currency serves interests of the elite and would undermine the country's national sovereignty and identity.

What under different circumstances might have represented a logical and uncontroversial next step in the deepening of the Bulgarian integration into European value chains proved to be considerably more divisive. Two public opinion polls conducted by Eurobarometer in 2025 indicated that support for the euro stood at just over 40 percent, while around 50 percent of respondents were against. Nevertheless, the government led by Prime Minister Rosen Zhelyazkov succeeded in completing the process, and Bulgaria became the twenty-first member of the euro area on 1 January 2026.

Experience during the first weeks following the euro's introduction at the beginning of 2026 suggests that, from a technical perspective, the transition to the new currency was smoother than many has initially anticipated. It remains unclear, however, to what extent the changeover may have led to speculative price increases by unscrupulous traders. In most Member States, the measured increase in prices in the months preceding and shortly following the adoption of the euro was small. The situation in Bulgaria proved more complex, however, as a renewed surge of political instability forced the government of Prime Minister Rosen Zhelyazkov to resign at the end of 2025. Consequently, efforts by the administration to prevent unjustified price increases were conducted by a government with limited political legitimacy, which further amplified public concerns about inflation. These concerns were heightened by the fact that consumer prices inflation had already reached relatively high levels immediately prior to the euro's introduction in late 2025.

For the authors of this publication, the adoption of the euro represents another significant milestone in the process of deepening Bulgaria's integration into Europe. The euro is associated with tangible benefits that are expected to help remove some of the remaining barriers to trade and investment, thereby contributing to faster economic growth. Euro area membership is also likely to facilitate the implementation of important structural reforms, particularly those in the financial sector, strengthening both price stability and financial stability in the country.

At the same time, the euro is not a panacea. Membership in the euro area does not relieve Bulgaria of the obligation to pursue prudent fiscal policy. Containing inflationary pressures through appropriate structural policies and measures to boost competition will remain essential. For the euro to become a lasting success, it will be necessary to reduce inefficiencies and waste in public expenditure, without allowing such efforts to serve as a pretext for curtailing investment in education, healthcare, and other socially significant sectors. Ensuring that a broad share of households benefit from the income convergence process will be fundamental, as only shared prosperity can be durable and sustainable.

CHAPTER N1

EURO ZONE MEMBERSHIP WILL BRING SEVERAL IMPORTANT POSITIVES

Membership in the euro area will remove some of the remaining barriers to 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.

Membership in the euro area will help to reduce 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 crisis 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 are, 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 enhance financial-system stability and reduce the risk of unsustainable household credit growth that could lead to real-estate bubbles and persistently high 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 in the central monetary authority of the euro area.

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 (CCB)—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 N2

THE DRAWBACKS TEND TO BE OVERSTATED BY CRITICS OF EURO AREA MEMBERSHIP

The finality of the euro appears 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.

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

While this problem 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.

These estimates, however, capture only the effect of price rounding in the first month following the transition to the new national currency. Therefore, they do not incorporate the impact stemming from speculative price increases by unscrupulous traders over a broader time horizon, beginning immediately after the announcement of the decision to introduce the new currency - in Bulgaria’s case, in mid-2025 - and potentially continuing into the first few months of the membership.

This implies that the one-off effect of the introduction of the euro on inflation is more broadly based, comprising at least two separate components. First, the higher inflation resulting from price rounding, which materializes in the first month following the introduction of the new currency. Second, instances of speculative price increases attributed to the euro changeover by unscrupulous traders, which may be observed over an extended period - ranging from several months up to a year - commencing with the decision of the EU Council on the country’s accession to the euro area, which in the case of Bulgaria was adopted by the Ministers of Finance (ECOFIN) on 8 July 2025.

Such a broader interpretation would imply an estimate of the initial impact of the euro introduction on inflation that exceeds the rise in consumer prices recorded by official statistics in the first month after the changeover. The precise magnitude of this broader inflationary effect is difficult to assess at present, not least because, at the time of preparing this publication, inflation data were available only for the first month following Bulgaria’s accession to the single European currency.

Even if this broader initial inflationary effect were to prove significant, what matters more for households is the evolution of the purchasing power of their incomes. If the inflationary pressures

in question are adequately captured by official statistics and households receive income increases fully compensating for the cumulative inflation recorded in the year preceding and the year following the adoption of the euro, the purchasing power of incomes would continue to rise. In such a case, the introduction of the euro would not be associated with a decline in real incomes.

In the Central and Eastern European (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 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 small-to-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 a scenario eventually leading to eurozone disintegration.

CHAPTER N3

IMPACT ON INCOMES AND INFLATION

The adoption of the euro will further deepen integration processes

The Bulgarian economy is already closely integrated with that of the euro area. According to data available for 2024, income levels in Bulgaria, measured by GDP per capita, amount to 63% of the euro area average. At the same time, the price level in Bulgaria stands at 57% of the average price level calculated for the euro area countries in 2024.

The adoption of the euro will further deepen the integration of the Bulgarian economy with that of the euro area. As a result, both incomes and prices in Bulgaria are expected to continue growing at a somewhat faster pace than in the euro area.

If prices in the euro area increase by around 2% per year over the next decade, it would not be surprising if prices in Bulgaria were to rise by approximately 2.5–3% annually. An annual increase in prices of 2.5–3% should not be a cause for concern. Indeed, inflation of 3% may be preferable to 2%, as it would allow processes of resource reallocation - of both capital and labor - to proceed more rapidly. When prices increase at a slightly faster pace, differences in relative prices tend to widen somewhat. Such relative price differentials are important for investors when deciding from which sectors to withdraw resources and to which sectors to allocate them. In this sense, a bit higher inflation in the Bulgarian economy could enhance its dynamism and potentially contribute to faster economic growth. I am not aware of any credible empirical study demonstrating that inflation of around 3% is close to levels that could be considered detrimental for a catching-up economy such as Bulgaria's, which still faces a considerable distance before converging to the standard of living of the most advanced economies in Europe.

For Bulgarian households, what matters is the purchasing power of income. If nominal income growth outpaces inflation - that is, if incomes increase in real terms - while continuing to converge towards the euro area average, there would be no grounds for concern. Although such a favorable scenario is not guaranteed, historical evidence suggests that it is the most likely outcome.

The experience of the Central and Eastern European countries already participating in the euro area has been positive

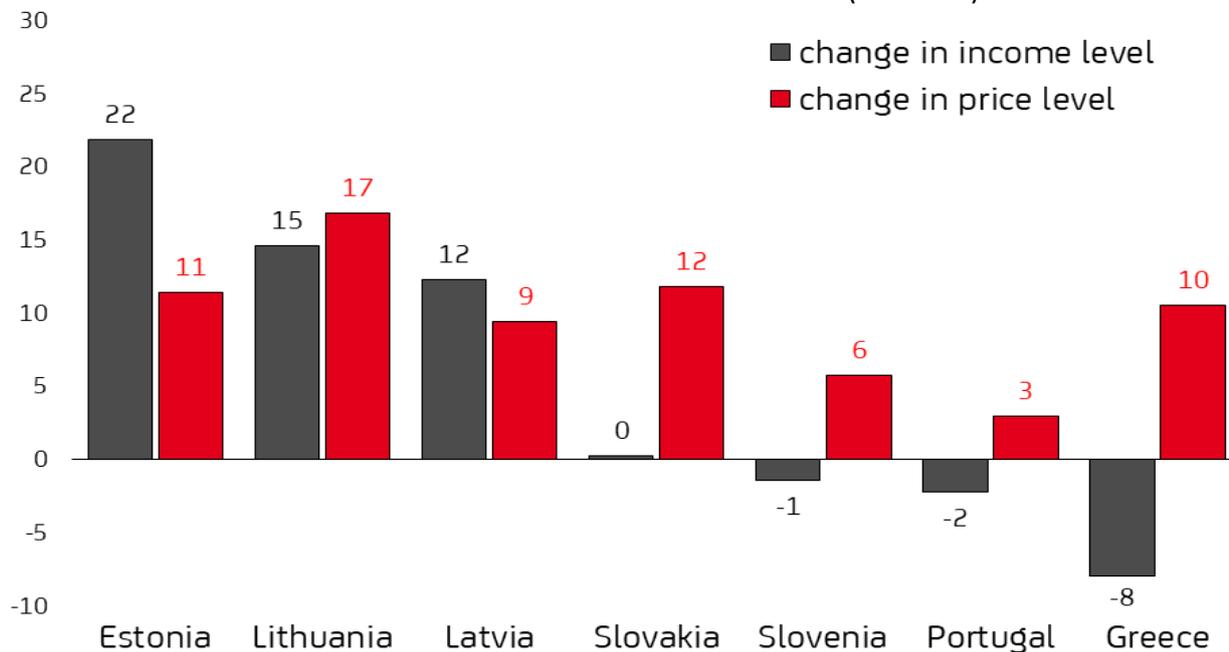
Chart 1 illustrates the degree of convergence achieved during the first decade following euro area accession for each Member State. For Bulgaria, the experience of the Central and Eastern European (CEE) countries is of particular relevance, especially those that joined the euro area with relatively large initial gaps in income levels and price levels compared with the euro area averages.

From this perspective, the cases of Estonia and Latvia appear to be the most pertinent for Bulgaria. These two CEE countries acceded to the euro area with income levels and price levels closest to those at which Bulgaria is expected to join.

Reported data indicate that, following the adoption of the euro, both income levels and prices in Estonia and Latvia grew at a faster pace than the euro area average. More specifically, during the first ten years after euro area entry, GDP per capita in Estonia, expressed as a percentage of the euro area average, rose from 60% to 81%, while in Latvia it increased from 56% to 68% (Table 1).

CHART 1: FOLLOW THE BALTIC EXPERIENCE

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



Source: Eurostat, UniCredit Bulbank

Over the same period, the price level in Estonia relative to the euro area average increased from an initial 70% to 81%, while in Latvia it rose from 69% at the time of euro adoption to 78% ten years later (Table 2).

Overall, this corresponds to a cumulative increase in income levels relative to the euro area average of 22 pp in Estonia and 12 pp in Latvia during the first decade following the adoption of the single European currency (Chart 1). Over the same time horizon, the relative price level increased by 11 pp in Estonia and 9 pp in Latvia, respectively.

If Bulgaria were to replicate the experience of the CEE countries that have adopted the euro, income and price convergence would be expected to deepen further

If developments in these two CEE economies are taken as indicative of potential dynamics in Bulgaria, then, ten years after euro adoption—i.e. by around 2036—GDP per capita could reach approximately 75–80% of the euro area average, compared with an estimated level of around 65% prior to euro area entry (projected for 2025).

Similarly, the price level in Bulgaria, expected to stand at around 59% of the euro area average in the year preceding accession, could potentially increase to between 69% and 74% of the euro area average over a ten-year horizon.

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	2024
EU	87	88	88	89	89	89	90	91	91	92	92	92	92	93	93	93	93	94	94	95	96	95	96	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	100
Belgium	108	109	110	110	109	107	106	105	108	110	109	112	111	112	111	110	109	109	110	112	111	113	112	111
Bulgaria	26	28	30	31	34	34	36	39	40	41	42	43	43	45	45	47	48	50	52	55	57	60	61	63
Czechia	66	66	70	72	73	73	75	77	78	78	78	77	79	81	82	83	86	88	90	91	88	85	87	88
Denmark	111	111	110	113	113	114	113	115	115	119	118	118	119	119	118	118	120	119	118	126	127	128	119	121
Germany	109	108	109	110	108	107	108	108	109	112	115	116	117	119	117	117	117	117	115	117	115	112	111	110
Estonia	39	42	46	49	55	59	64	63	58	60	65	69	71	73	72	73	75	77	79	81	81	81	76	76
Ireland	122	127	129	132	133	135	135	122	118	119	121	123	124	130	172	166	175	180	179	196	215	227	209	213
Greece	76	79	83	85	82	86	83	84	85	77	68	65	65	66	64	62	62	62	62	59	61	64	66	67
Spain	86	88	89	89	91	94	94	92	92	88	85	84	83	84	85	86	86	86	86	79	81	84	86	88
France	103	103	100	99	101	99	98	98	99	100	100	99	101	100	99	98	97	97	99	99	96	93	95	94
Croatia	44	46	49	50	51	54	56	58	58	56	56	57	57	56	56	58	59	60	64	63	67	69	72	74
Italy	106	104	104	101	99	99	98	98	98	97	97	95	93	91	90	92	91	91	91	89	91	94	94	94
Cyprus	86	85	86	89	92	91	95	97	96	93	89	84	77	74	76	80	82	84	86	85	87	90	90	91
Latvia	33	35	37	40	44	46	50	52	47	48	49	54	56	57	58	59	60	62	63	66	68	66	68	68
Lithuania	35	38	43	45	48	50	55	58	52	55	60	65	68	69	69	70	73	76	79	83	84	84	83	84
Luxembourg	210	211	213	221	227	240	245	252	247	249	250	254	256	260	260	257	249	243	235	244	251	238	231	232
Hungary	50	53	55	56	56	56	55	57	59	60	61	61	62	64	65	64	64	67	69	71	71	73	74	73
Malta	69	71	74	74	73	71	72	74	76	80	78	81	84	87	92	93	99	100	100	100	104	100	102	104
Netherlands	125	125	122	123	125	126	127	130	128	125	125	125	126	123	123	121	121	122	121	125	126	128	125	128
Austria	111	112	113	114	115	114	113	114	116	115	117	121	121	120	120	119	117	118	117	117	116	117	115	111
Poland	42	43	44	46	46	46	49	51	55	58	60	62	62	63	65	64	65	67	70	75	75	75	74	76
Portugal	73	74	74	73	75	75	74	74	75	75	71	69	71	71	71	72	71	72	73	71	71	74	77	78
Romania	24	26	27	31	32	35	39	47	47	48	50	52	50	51	52	54	58	62	65	69	69	70	74	75
Slovenia	70	72	74	77	78	78	79	82	77	76	76	76	75	76	75	76	79	80	82	84	84	85	88	87
Slovakia	46	48	50	52	54	57	61	65	65	70	70	71	71	72	73	68	66	66	66	71	70	68	71	72
Finland	104	103	103	106	106	105	109	111	108	108	108	107	105	103	102	101	102	103	102	107	104	102	100	99
Sweden	112	112	113	115	113	115	118	116	114	116	118	119	117	116	117	114	111	110	115	114	109	107	108	108

Source: Eurostat, UniCredit Bulbank

Value in the year before the adoption of the euro
 Value 10 years after the adoption of the euro

Value in the year before the adoption of the euro in the CEE countries
 Value 10 years after the adoption of the euro in the CEE countries

TABLE 2: PRICE LEVELS BY COUNTRY, HICP (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	2024
EU	96	96	96	95	96	96	96	96	95	96	95	95	95	95	95	95	95	95	95	94	95	95	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	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	111
Bulgaria	39	39	38	40	41	44	46	49	51	51	50	49	48	47	47	47	49	49	51	52	53	55	56	57
Czechia	51	58	55	55	59	63	64	71	66	70	71	70	67	62	63	65	67	70	71	72	79	85	88	85
Denmark	140	140	140	137	138	136	133	133	133	134	135	136	135	136	135	138	136	134	136	134	133	140	138	137
Germany	107	107	105	103	103	103	102	102	102	101	100	100	101	101	101	101	101	100	101	101	101	103	104	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	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	132
Greece	83	81	83	84	86	87	90	89	91	93	93	91	88	84	84	83	82	82	82	83	83	83	82	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	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	106
Croatia	67	68	66	68	71	72	71	72	71	71	69	68	67	65	64	65	66	67	67	67	66	69	71	73
Italy	99	100	99	101	101	101	100	98	98	97	99	100	100	101	101	99	98	98	96	96	96	95	93	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	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	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	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	127
Hungary	54	59	57	61	63	61	67	68	60	62	60	60	58	57	58	59	62	62	64	62	65	64	71	70
Malta	79	79	72	72	73	76	75	76	77	76	77	77	80	80	79	80	82	82	82	84	87	88	87	88
Netherlands	103	103	105	103	103	102	100	101	103	105	106	106	107	108	108	110	109	108	111	110	109	109	112	111
Austria	106	104	102	101	101	101	101	101	102	102	102	103	103	104	104	104	106	106	107	105	103	103	107	108
Poland	64	60	52	51	60	62	61	66	55	58	56	55	55	55	55	53	56	56	57	56	57	58	64	69
Portugal	81	83	81	81	80	80	82	83	83	83	84	83	81	82	82	83	84	83	83	85	84	83	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	61
Slovenia	75	75	75	74	75	76	78	80	83	83	82	81	81	82	81	82	82	82	82	82	82	84	85	86
Slovakia	43	45	49	53	55	58	64	68	70	68	68	68	67	67	67	74	78	80	81	78	78	81	80	81
Finland	125	125	124	121	121	120	116	115	116	116	117	119	120	120	119	119	119	119	119	119	119	120	119	118
Sweden	117	120	121	118	117	115	112	108	100	114	120	124	128	123	121	124	124	118	116	118	122	116	109	110

Source: Eurostat, UniCredit Bulbank

 Value in the year before the adoption of the euro	 Value in the year before the adoption of the euro in the CEE countries
 Value 10 years after the adoption of the euro	 Value 10 years after the adoption of the euro in the CEE countries

CHAPTER N4

ANALYSIS OF SCENARIOS: THE ALTERNATIVE TO EURO ADOPTION

Maintaining the status quo is associated with a limited number of advantages

The currency board arrangement is well known and broadly accepted by households and firms in Bulgaria. Maintaining the currency board over the coming decade would allow additional time to observe the reforms undertaken by euro area Member States aimed at further strengthening the institutional architecture of the euro area. As this architecture currently remains incomplete, it may represent a source of vulnerability in the event of a severe systemic crisis.

A postponement of euro adoption could also allow further progress in real convergence, notably in terms of price and income levels relative to the euro area. If, during the income convergence process, Bulgaria were to lose competitiveness—owing to stalled reforms aimed at improving institutional quality and raising productivity of the country's economy—the national currency could, in principle, be devalued prior to euro adoption. This could enable the economy to avoid an adjustment episode like that experienced by Greece in 2010, which proved particularly painful as, under a fixed exchange rate regime, adjustment had to take the form of internal (real) devaluation, generally considered more costly and painful than nominal exchange rate adjustment.

The appropriateness of the single monetary policy cannot be assessed solely on the basis of income or price level convergence. What matters more fundamentally is the degree of business cycle synchronisation, the flexibility of product and labour markets, the resilience of the financial sector and the capacity of fiscal policy to act as a stabilisation tool. Differences in income levels across euro area Member States have persisted since the inception of Economic and Monetary Union without precluding the effective conduct of a single monetary policy. Structural heterogeneity is an inherent feature of a monetary union and is managed through market adjustment mechanisms, national fiscal policies and structural reforms.

Delaying euro adoption in anticipation of further institutional reforms at the euro area level entails uncertainty. The institutional architecture of the euro area has evolved significantly since the sovereign debt crisis, including the strengthening of fiscal surveillance, the establishment of common backstops and the development of new instruments aimed at safeguarding financial stability. While further deepening is needed, the current framework has demonstrated a significantly enhanced capacity to respond to shocks, as evidenced during recent crises.

From a broader perspective, maintaining the status quo would preserve monetary arrangements that have functioned effectively, but without granting Bulgaria participation in euro area decision-making processes. Under the currency board arrangement, monetary policy is effectively imported, while representation in the governing structures of the Eurosystem is absent. Euro adoption would formalise Bulgaria's integration into the institutional framework in which monetary policy decisions are taken and would provide access to common financial safety nets.

In this broader context, the strategic choice relates above all to the degree of institutional integration achieved by the country, as well as to the extent to which Bulgaria trusts the other Member States to pursue policies that will not be detrimental to its interests, and, ultimately, whether the country seeks to position itself within the core of the European Union.

The main drawback lies in a misperception regarding the extent of reserve backing

A key vulnerability of maintaining the currency board arrangement lies in the perception on which confidence in the regime is built. Stability and credibility of the currency board arrangement are often associated with the view that all BGN in circulation is fully backed by foreign reserve assets at the legally fixed exchange rate of BGN 1.95583 per euro.

This perception holds strictly only for base money—namely banknotes and coins in circulation, together with commercial bank and government deposits held at the central bank. It does not extend to broader monetary aggregates, including BGN denominated deposits of households and non-financial corporations held with commercial banks. In the event of a severe crisis, the central bank's foreign exchange reserves would, in principle, suffice to convert base money into euro at the fixed rate. However, they would not be sufficient to convert all BGN denominated bank deposits in the banking system into euro simultaneously.

The preservation of the currency board may also entail heightened macro-financial risks. The likelihood of renewed asset price misalignments—particularly in the real estate market, as observed in the period 2005–08—and the risk of banking sector stress episodes could be greater under a continued currency board arrangement than under euro area membership.

While the currency board has functioned effectively in periods of favourable economic conditions, it is subject to important constraints during downturns. In times of crisis, capital—including bank deposits—tends to flow from economies perceived as more vulnerable towards those regarded as safer. Under a currency board, the central bank's capacity to counteract such dynamics by acting as a lender of last resort is significantly constrained. The limited scope for discretionary liquidity provision in crisis conditions represents a structural weakness of the currency board regime.

A further potential cost of maintaining the currency board and postponing euro adoption relates to the risk of gradual isolation from deeper European integration processes. Remaining outside the euro area could imply reduced participation in decision-making, limited access to common stabilisation mechanisms and a slower pace of institutional convergence with the core structures of Economic and Monetary Union.

At first glance, a return to an autonomous monetary policy may appear attractive

Under such a scenario, Bulgaria would regain access to two important adjustment mechanisms that were voluntarily relinquished with the introduction of the currency board arrangement in 1997: the exchange rate mechanism and control over domestic interest rates.

In periods of favourable economic conditions, these two macroeconomic policy instruments typically play a limited role. However, their importance increases markedly during downturns. In particular, exchange rate flexibility and independent interest rate policy may act as important automatic stabilizers. In the event of an economic contraction, currency depreciation and interest rate reductions can support domestic demand by improving price competitiveness and easing financial conditions, thereby mitigating the impact of adverse shocks.

Another perceived advantage is that Bulgaria could make use of exchange rate flexibility while achieving further progress in real convergence—specifically in narrowing the gaps in price and wage levels relative to the euro area—and only subsequently proceed with euro adoption.

A return to an autonomous monetary policy may entail substantial risks

At first glance, exiting the currency board arrangement and restoring central bank control over interest rates and the exchange rate may appear to be an attractive alternative. However, such a course of action would expose the Bulgarian economy to several significant risks.

One such risk relates to potential geopolitical and economic isolation. In today's global environment, countries do not operate in a geopolitical vacuum. If the Bulgarian economy were not to deepen its integration with Europe, this could occur at the expense of increased economic and geopolitical influence by other global actors. In the Balkan region, this may include certain BRICS countries—most notably Russia, but also Turkey and China—which are gradually becoming increasingly assertive in pursuing their strategic and economic aspirations.

Beyond geopolitical considerations, this scenario would also involve macro-financial risks. The likelihood of speculative attacks could increase, particularly during the transition phase. Exchange rate volatility is likely to increase which will have adverse impact on trade and investment. Price formation would become less transparent, and transaction costs would rise, as exchange rate volatility would lead economic agents to convert currencies more frequently and in larger amounts than under the current currency board regime, and especially compared with euro adoption.

A further challenge concerns the practical complexity of the transition itself. While a move towards a more flexible exchange rate regime may appear straightforward in principle, its implementation would be considerably more complex. Such a change would require close consultation with Bulgaria's main trading partners - predominantly European countries, which account for the bulk of trade and capital flows. Bulgaria would need to explain to its European partners why it wants to replace the currency board with a flexible exchange rate regime rather than proceed with euro adoption, to which it is committed under its EU Accession Treaty and which several other countries with similar monetary policy and exchange rate arrangements have already undertaken.

Absent careful coordination and adequate preparation, the transition to a new regime could prove disruptive. The timing of such a shift would be critical and would ideally need to coincide with favourable macroeconomic conditions, including current account surpluses, in order to reduce the risk of speculative pressures against the new currency even before its introduction.

Most importantly, a structural change of this magnitude could succeed only if implemented by a government that enjoys substantial public support. Undertaking such a fundamental transformation in the structure of the economy under conditions of limited political approval - such as those observed in recent years, when government approval ratings have rarely exceeded 30 percent, even at the beginning of mandates - would entail considerable degree of risk.

Even if the technical aspects of the transition were managed well, the absence of broad support from households, businesses and other key stakeholders could render such a move very risky. This consideration is particularly relevant in Bulgaria, where memories of the 1996–97 crisis remain vivid. Any proposal to alter the exchange rate regime could be perceived as an attempt to undermine financial stability or erode household savings, thereby triggering strong public resistance.

Following seven parliamentary elections over the past five years, instability has become a persistent feature of the domestic political environment. In addition, confrontation reached such proportions that reaching agreement even on very basic things proved problematic. Given the degree of societal

polarisation and the high level of public trust required for a major shift in the macroeconomic policy framework to succeed, the risks associated with such a strategy appear substantial.

Proponents of this alternative often refer to the success of countries such as the Czech Republic and Poland in maintaining their own very stable and well-functioning currencies. While experience of these countries may appear appealing, structural differences are significant. Bulgaria does not possess an economy of comparable degree of incomes, accumulated wealth and quality of institutions capable of sustaining a stable and well-functioning national currency. Nor does it currently benefit from the degree of political stability typically considered a prerequisite for the effective functioning of an autonomous monetary policy regime. Most importantly, suspicions that such a move could lead to a repetition of the events of 1996–97 would likely be so strong that it would undermine confidence and block implementation of such a scenario from the very onset.

CHAPTER N5

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 potential disproportionate accumulation of risks, should this be deemed necessary.

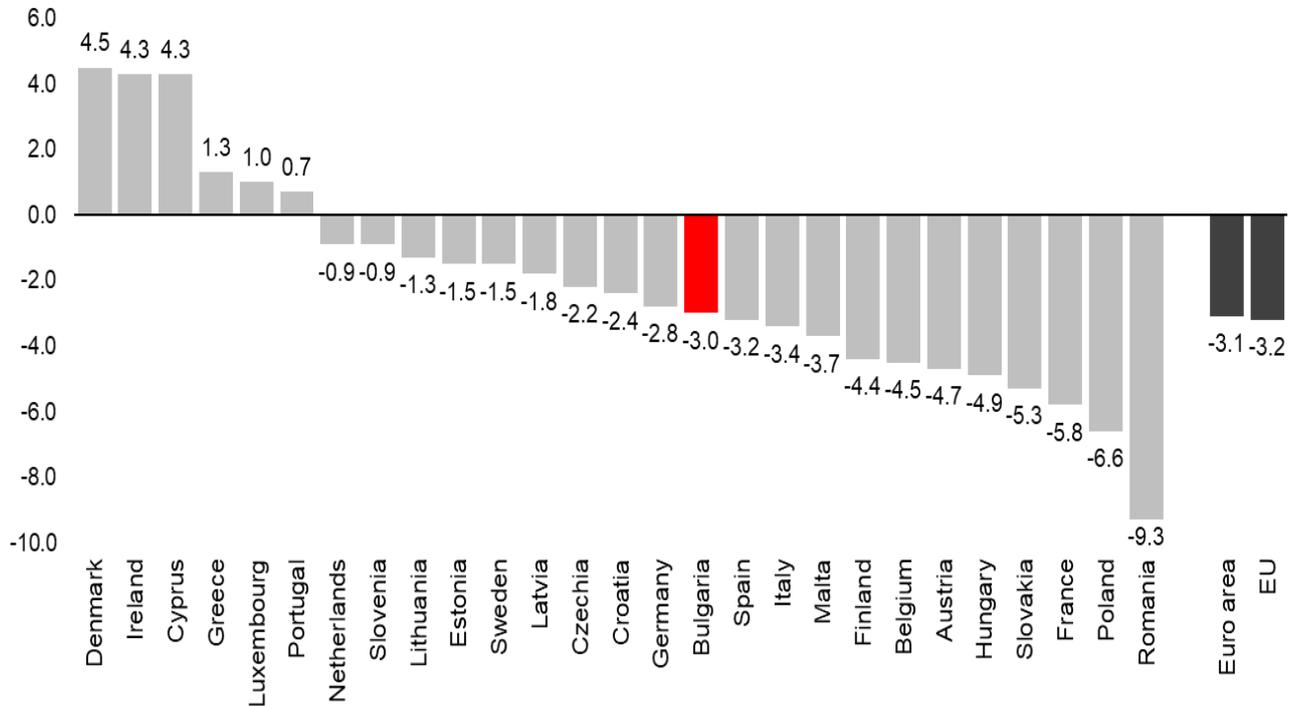
Fiscal policy remains accommodative but in smaller proportions than in many other economies

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 (Chart 2), but real GDP growth remains weak. 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 2: 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 N6

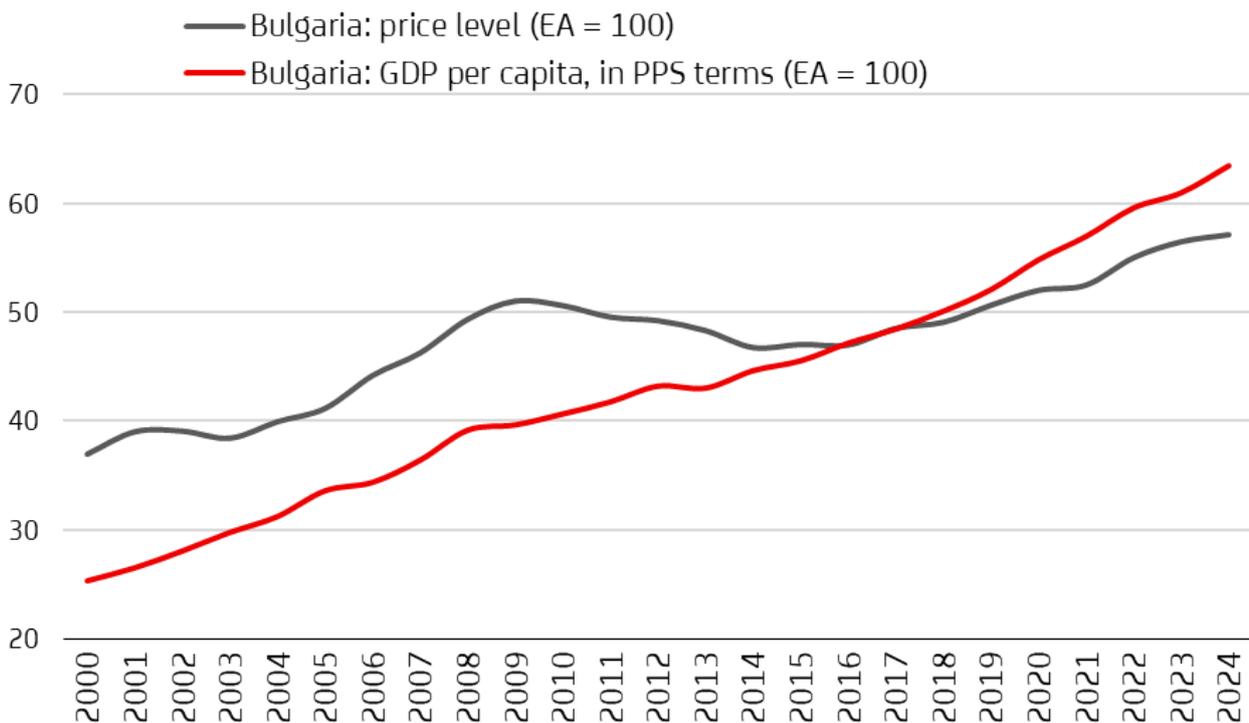
THE NEXT STAGE OF REAL CONVERGENCE WILL BE HARDER

Bulgaria’s progress to date has been substantial

Bulgaria has achieved significant progress in converging towards the standard of living of the most advanced economies following its accession to the European Union in 2007. GDP per capita in Bulgaria increased from approximately 34% of the euro area average in 2006 to 63% in 2024. Over the same period, the overall price level in Bulgaria rose from around 44% of the euro area average in 2006 to 57% in 2024 (Chart 3).

Over the past eighteen years, GDP per capita in Bulgaria has grown at an average annual rate of 3.4%, substantially outpacing the corresponding euro area average of 0.7%. Similarly, prices in Bulgaria increased by 3.4% per year on average over the same eighteen-year period, compared with an average annual increase of 2.1% in the euro area.

CHART 3: 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

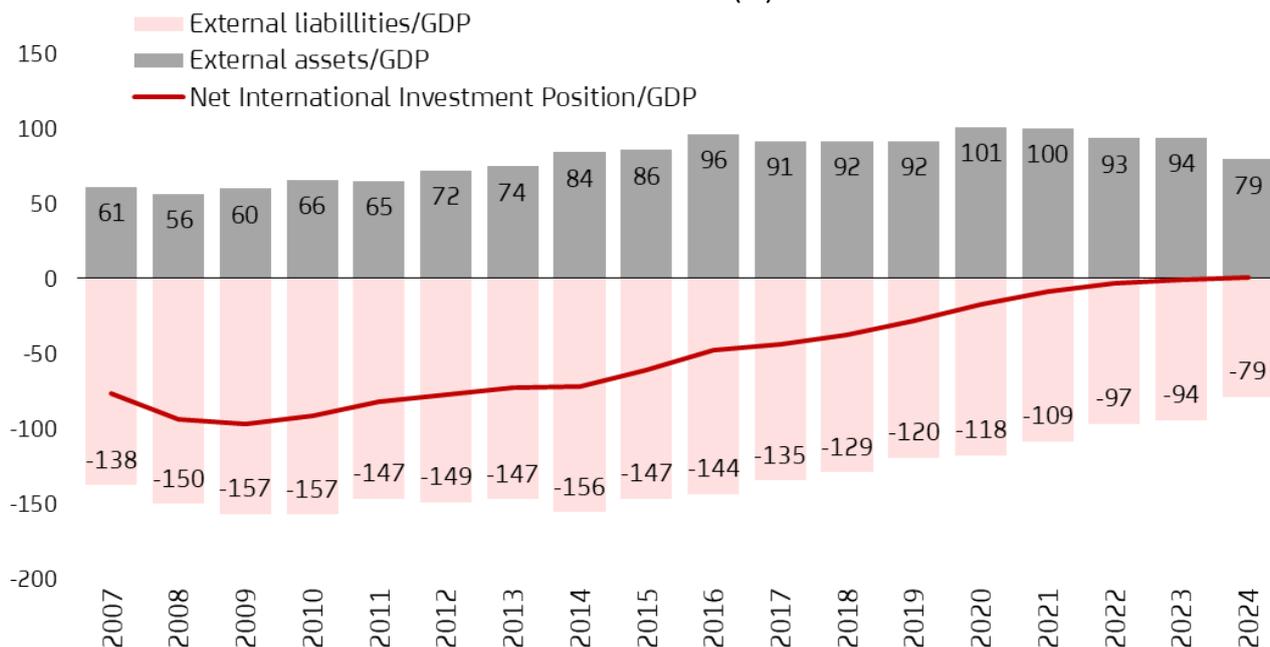
All of this remarkable progress in the convergence of income and price levels in Bulgaria towards those prevailing in the euro area has taken place under a fixed exchange rate regime and without any loss of external competitiveness. On the contrary, competitiveness has improved.

Perhaps the most compelling evidence of this development is the pronounced transformation of the country’s current account balance, which shifted from an unsustainable deficit of whopping 24% of GDP in 2007 to a small and therefore manageable deficit of just 1.4% of GDP in 2024. As a result, Bulgaria’s net international investment position (NIIP) - defined as the balance between the country’s external financial assets and liabilities - improved from a substantial negative balance amounting to 77% of GDP in 2007 to a small surplus of 0.4% of GDP in 2024 (Chart 4).

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 4: PRESERVING COMPETITIVENESS

EXTERNAL FINANCIAL ASSETS AND LIABILITIES AND NIIP (%)



Source: Bulgarian National Bank, UniCredit Bulbank

There is no room for complacency, as the next phase is likely to be more challenging

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 smoothing 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.

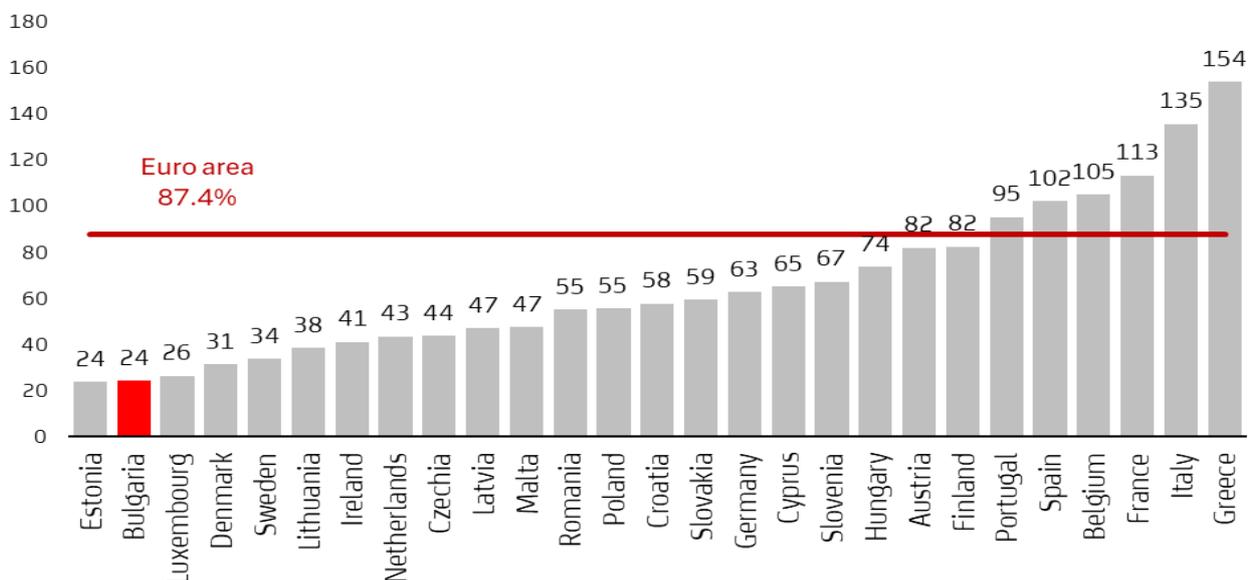
The reforms that lie ahead tend to be harder to implement. These reforms not only focus on fixing past problems, but also on preparing the economy for future challenges. They include structural measures aimed at ensuring long-term sustainability and fulfilling global climate commitments, helping labor 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: 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 (Chart 5) 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.

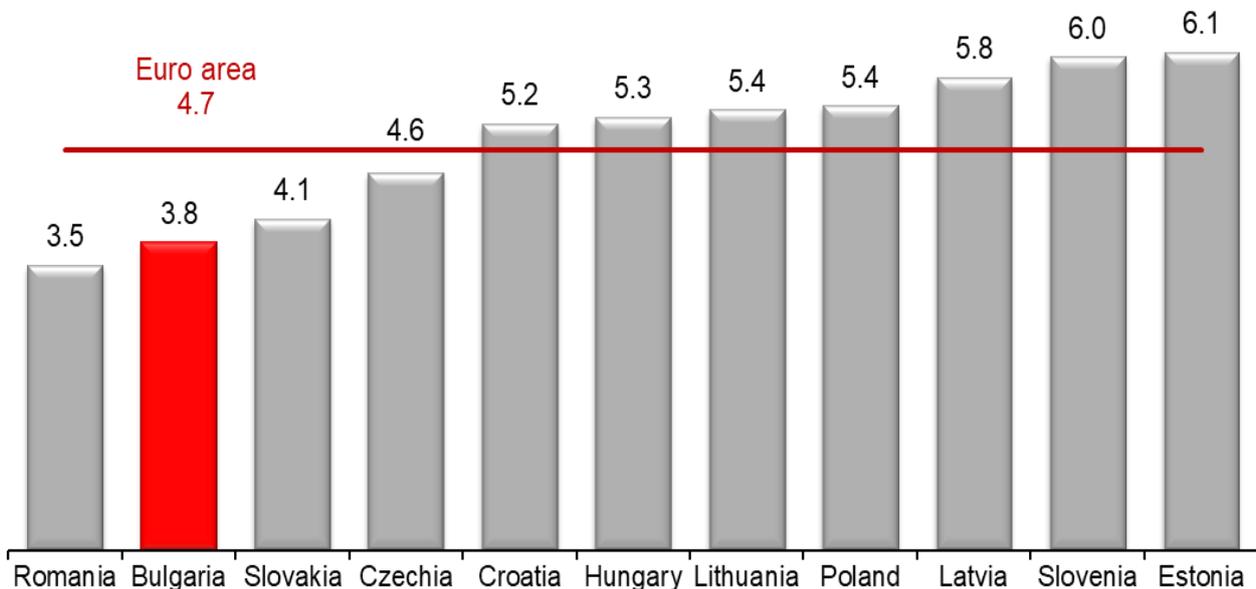
Efforts should focus on reducing inefficiencies and waste in public spending, without using this as a pretext to hinder increases in investment in education, healthcare, and other socially important sectors.

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)

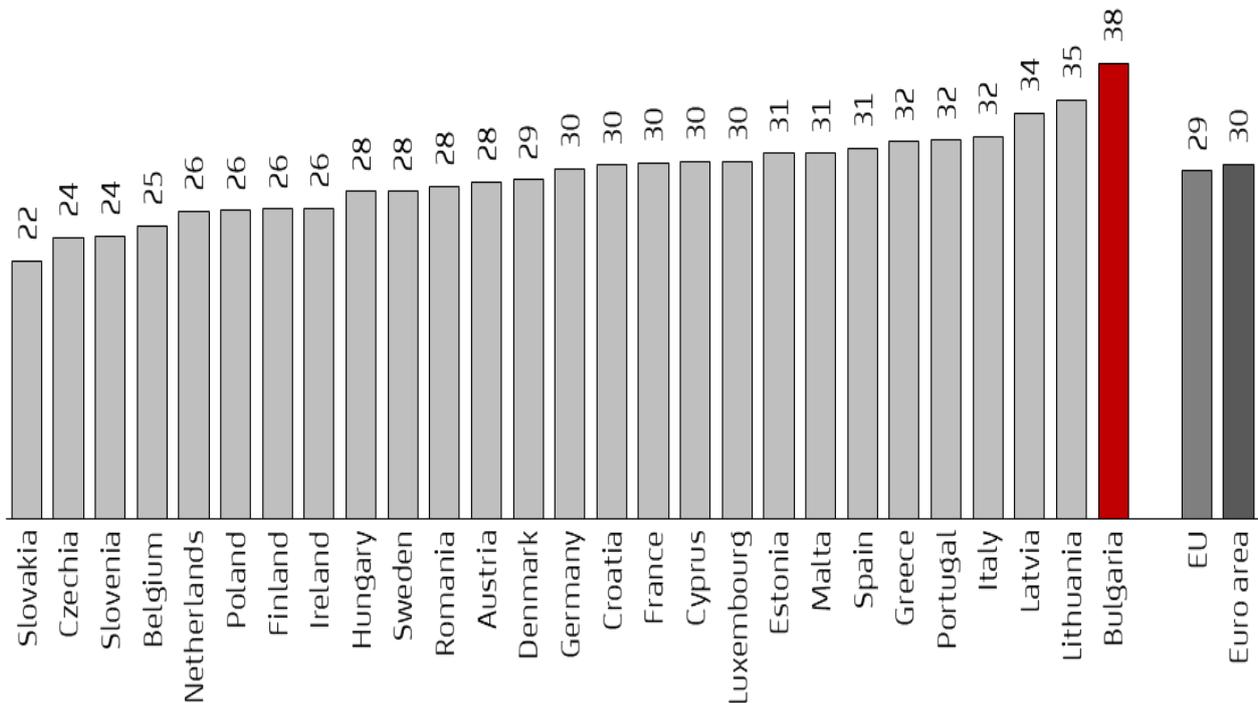


Source: Eurostat, UniCredit Bulbank

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 crucial that there are not too many households who feel left behind and fail to benefit from the income 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 fundamentally important 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



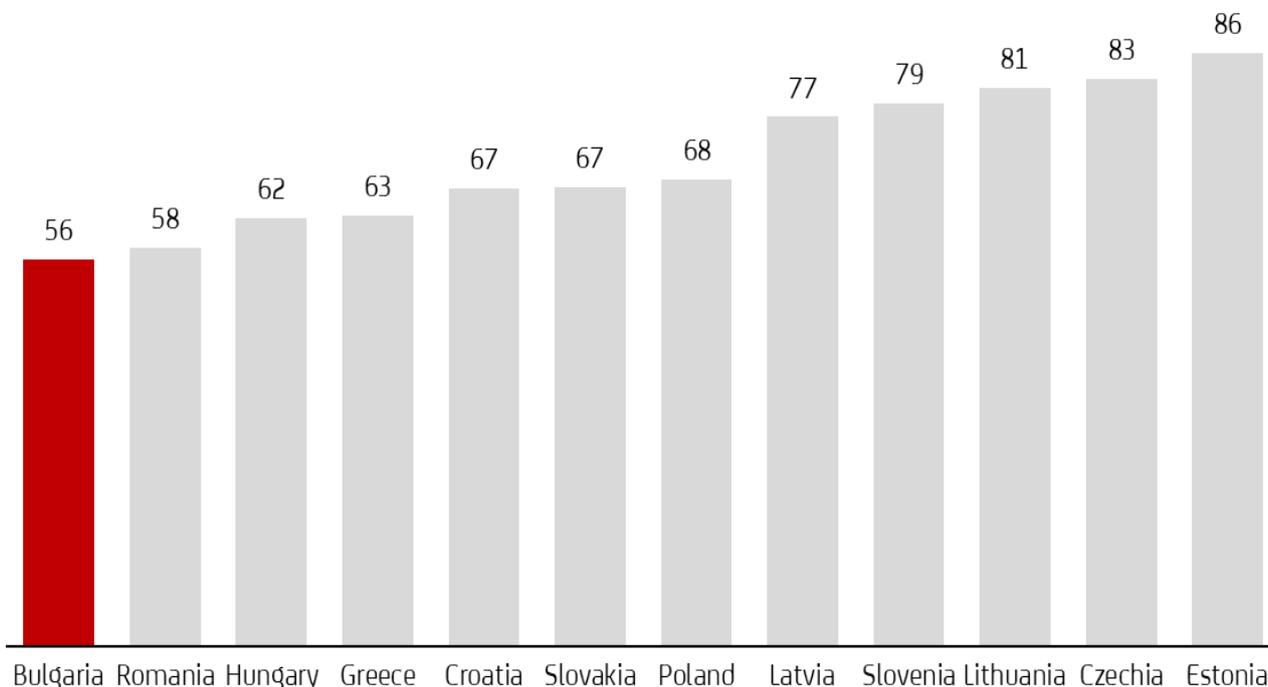
Source: Eurostat, The Investment Institute by UniCredit

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 institutions are what make 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 N7

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 extensive that only the largest economies are able to maintain both sovereignty and effective independence in the conduct of economic policy. In the field of monetary policy in particular, the number of economies that can be regarded as both sovereign and independent is very limited. These include major geopolitical and financial centres such as the United States, the euro area, China and, to a more limited extent, Great Britain and Japan. For most other countries, including Bulgaria, sovereignty and independence in monetary policy do not fully coincide, as policy outcomes are significantly 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 is set to increase

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.

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 – inflation, employment and the exchange rate.

CHAPTER N8

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 2023, the number of Eurozone member states has increased to 20, representing nearly two-thirds of all EU member states. 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 in the globalized world economy.

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 middle-size 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 the bulk 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 very stable and well-functioning 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 see 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% to prevent capital outflows, while the harmonized consumer price inflation reached 25% 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 and well-functioning 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 national 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 economic outlook and from here stability and creditworthiness of the country’s national currency.

INSTEAD OF CONCLUSION:

WITHIN THE HIERARCHY OF THE MOST STABLE CURRENCIES THE EURO RANKS 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 was largely based on the fact that every BGN issued was fully backed by euro-denominated reserves. The exchange rate was 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, were fully covered by these reserves, the deposits of companies and households held at commercial banks were not. Consequently, in a low-probability scenario in which all corporate and household deposits would have needed to be converted into euros and withdrawn simultaneously, the BNB's foreign reserves would have been insufficient.

Although indirectly, prolonged period of political instability during the last several consecutive 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 weighed 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 is set to bring several important benefits to Bulgaria.

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