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Bulgaria: Economic Impacts of ERM II and Banking Union Participation

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Abstract

The purpose of this article is to identify the benefits, costs, and risks of Bulgaria's accession to the Exchange Rate Mechanism II and the European Banking Union. A descriptive approach is applied. The main findings are that there are costs and risks that are not thoroughly discussed or are underestimated implying that the net impact on Bulgaria's economy is not definitely positive. Identifying the effects of ERM II and European Banking Union participation is a specific task determined by the procedure for euro area accession applied especially for Bulgaria and Croatia. On the other hand, Bulgaria has been operating a currency board arrangement for the whole period of existence of the euro with a fixed exchange rate of the lev. A descriptive and comparative analysis is made where effects are qualitatively rather than quantitatively assessed. Three degrees of probability are assigned to risks which are author's judgement based on the publicly available information.

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INTRODUCTION

Bulgaria has been a member of the European Union since 2007 with derogation concerning the obligation to adopt the euro as a legal tender. According to the treaties with the EU it must be done but there is not explicit deadline for it. After some informal unsuccessful queries, in 2018 the Bulgarian government and the central bank declared their intention to further deepen the EU integration by participating in the European Economic and Monetary Union (EMU). Some requirements assigned by the European Commission and the European Central Bank had to be met to give consent. They were in areas of banking and non-banking financial supervision, macroprudential framework, governance of state-owned enterprises, money laundering and insolvency framework. At the same time additional requirement was set to Bulgaria to join the European Banking Union simultaneously to ERM II before becoming a member of the euro area.

Meeting the latter required implementation of asset quality review and stress test of part of Bulgaria's banking system by affirmed by ECB methodology. Six banks were selected and reviewed. For two of them stress test showed capital deficiencies applying the worst-case scenario. This imposed raising additional capital for both banks. The process was completed in the beginning of July 2020. Thus, on July 10th, 2020 ministers of finance of the euro area countries plus Denmark together with the Presidents of the ECB and the Danish Central Bank decided that Bulgaria meet all the requirements.

Since July 13th, 2020 Bulgarian lev has been participating in the Exchange Rate Mechanism II with central parity of 1.95583 lev per euro. The compulsory intervention rates have been agreed with upper limit of 2.24920 levs per euro and lower limit of 1.66246 levs per euro. Bulgaria preserves its currency board arrangement and unilaterally commits to maintain its fixed exchange rate of 1.95583 levs per euro without commitment for this by the ECB. Apart from this starting from October 1st, 2020 Bulgaria joins the European Banking Union by close cooperation. Until then an assessment of significant credit institutions will be made to identify banks that will be under ECB's direct supervision.

There is a great number of studies about the benefits and costs of countries' participation in the euro area. For example, Hristozov (2019) explores the problem of possible change in the rate of inflation. However, there are not such estimations about the preparatory phase. The purpose of this paper is to identify the main economic impacts including risks of Bulgaria's participation in the ERM II and the European Banking Union. In Bulgaria, such discussion hasn't been carried out and thus risks have been neglected and underestimated.

REVIEW OF LITERATURE

The impact of EMU participation has been broadly studied. This analysis includes all phases – preparatory, period at the ERM II, and the actual euro area membership. The preparatory and ERM II phases themselves are not usual subjects for a separate research. (Backe et. al 2004) points out that the countries that aim the introducing the euro in the medium term issues related to the ERM II participation could be quite different than the issues concerning countries with more distant prospect. Their analysis reviews the considerations underlying the ERM II participation.

ERM II has been often perceived as a "waiting room" that offers at best little value-added and may even entail certain risks (Backe et. al 2004). Most countries' plan the minimum possible duration (2-3 years), with relatively narrow limits of exchange rate variation and a central rate that eventually will be the conversion rate. ERM II is seen as a mechanism that does not necessarily provide discipline, credibility, adjustability, and multilateralism. They see little disciplinary effect from ERM II membership. It is considered as an intermediate exchange rate regime with increased risk of speculative attacks. The standard interval of +/-15% is perceived as too broad implying large exchange rate fluctuations. There is also uncertainty about the involvement of the ECB in the coordinated intra-marginal interventions. According to the Pre-accession Economic Program 2003 of the Czech Republic the participation of the currency at the ERM II does not eliminate monetary turbulence.

The Eurosystem position is that countries should join the mechanism when they have achieved a sufficient level of nominal and real convergence and have economic policies and structures consistent with this regime. It also can help manage the expectations and consolidate economic policies for promoting stability and convergence. ERM II is a voluntary arrangement of fixed but adjustable central parities. It also leaves some room to accommodative policies. It is also multilateral meaning that decisions are taken on a case-by-case basis on a mutual agreement of all the parties involved. If national policies are inconsistent with the sustainability of the central parity, the first option for parties involved is to try making the country's authorities change these policies. The other option is to change the central parity.

ERM II is a medium of preserving and even intensifying the convergence process until the sustainable achievement of the Maastricht criteria. ERM II participation does not need to be limited to only two years which is the minimum. It could last longer and the exchange rate may be used as a policy variable in order economy to be adjusted to catch-up quicker.

European Banking Union has been developing since the Great Recession. Since it is still evolving there are a great number of studies related to this topic. (Elliot 2012), (Millar 2012), (Beck 2012) among others describe the essence of the banking union, its interconnections to the fiscal union by the framework for deposit guarantee. It also requires changes in bank regulations, supervision, and resolution. However, it is much easier to describe the features of the banking union than it is to design or implement it. There are some key issues regarding this topic: the trade-off of economic growth and financial stability, centralized versus local supervision, single regulator or multiple specialized regulators, independence from political interference or accountability. Choices that must be made are subjective and the theory is not sufficiently developed to have a well-grounded answer.

RESULTS AND DISCUSSION

What are the benefits?

It is a crucial step of the further and deeper integration of Bulgaria to the European Union. It is an expression of trust of European institutions like the Commission and the ECB and the governments of the euro area countries. This is considered as a success by the credit rating agencies as it is a stabilizing mechanism. Fitch Ratings announced that: "all things being equal, we would upgrade Bulgaria's long-term foreign currency IDR by two notches between admission to the ERM II and joining the euro."

Given the situation of COVID-19 pandemic probably this upgrade will be applied later. Still, the period at the ERM II is hard to be determined so eventually this statement could be confirmed by Fitch Ratings. The other two major credit rating agencies are expected to upgrade Bulgaria's rating as well. As a result, the cost of financing government and private sector would decrease. Hence, foreign debt servicing costs would be lower reducing the interest expenses in the state budget. In a short term, the probability of upgrading Bulgaria is low. Since the adoption of the currency board arrangement in Bulgaria there have always been discussed whether the exchange rate between Bulgarian lev and the Deutsche mark and later the euro is correct. With the accession to the ERM II the rate of 1.95583 levs per euro is confirmed to be the sustainable one by the European institutions and especially by the ECB.

Benefits related to the membership at the Banking Union are:

Delinking sovereigns and banks are the primary reason for the establishment of the Banking Union. It is aimed at preventing sovereign problems to spread to banks as it happened in Greece as well as preventing banking problems to spread to sovereigns as in Ireland or Cyprus. Bailing-out banks by national governments increases borrowing costs for them but simultaneously driving up banks' financing costs. The Banking Union should prevent this.

A single European supervisor is aimed at rebuilding depositors' confidence. It should not allow banks to hide bad assets. This implies that the available information about the asset valuation would be more reliable which means more precise data about the capital adequacy ratios. It should also eliminate national biases and the associated supervisory forbearance. On national level supervision is often indulgent towards local banks due to pressures and interests. European supervisor should be able to assess independently financial situation of specific banks in a systemic context.

As a part of the preparation for the ERM II and the Banking Union accession two of Bulgarian banks had to raise additional capital. Previous crisis showed that this step is very important to preserve the sustainability of the banking system and the public finances. The sooner it is done, the lower are the funding costs. Initially the COVID-19 pandemic negatively affected the economy, but it is expected that financial and banking sector will be hurt as well.

Improvement of the legal framework about the governance of the state-owned enterprises is another benefit of the preparation process. It was a requirement of the EU institutions towards Bulgarian authorities. The other steps concerned the supervision on non-banking financial institutions and the legislation about the money laundering.

Costs and risks

As Bulgarian lev participates in the ERM II an amendment of Law on the Bulgarian National Bank was made. It is according to the EU legislation and states that the exchange rate between the lev and the euro could be changed during this period. According to art. 29 (3):

"As from the date of participation of the Republic of Bulgaria in the Exchange Rate Mechanism II, the official exchange rate of the lev to the euro shall be equal to the central rate between the euro and the lev, as agreed under the paragraph 2.3 of the Resolution of the European Council on the establishment of the exchange rate mechanism in the third stage of economic and monetary union Amsterdam, 16 June 1997 and Article 1.1 and 17.1 of the Agreement of 16

March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union."

According to the provisions the exchange rate could be changed by unanimous decision by the ministers of finance and governors of central banks including Bulgaria's. This operation no longer requires approval by the Bulgarian Parliament as it is given by the amendment of the law. Exchange rate risk increases compared to the previous provisions. However, the short-term probability of materializing this risk is low. The impact of this risk on funding costs for the government and the private sector could be negative.

Another risk is related to the insufficient extent of nominal and real convergence at the start of the accession. According to the latest convergence reports by the ECB and the European Commission Bulgaria does not meet the criterion on the price stability. According to the Eurostat data as of the end of 2019 Bulgaria is still the poorest EU country. The Gross Domestic Product per capita in purchasing power standard in Bulgaria is only 53% of the EU average. (For comparison, the second poorest country is Croatia with 65% of the EU average). Moreover, the price level in Bulgaria is 52.8% of the EU average.

There is no formal requirement about the GDP per capita in PPS but unofficially this ratio should be at least 70% of the EU average at the time of accession to the EMU. As it is evident Croatia is much closer to this threshold while Bulgaria will need much more time to reach it. This means that Bulgaria's stay at the ERM II could last very long to achieve more sustainable levels of convergence. Apart from this the convergence of price level would lead to higher rates of inflation which could be an obstacle to meeting the price stability criterion in sustainable way.

Bulgaria and Croatia will be the two countries participating in the Banking Union and outside the EMU. The mechanism of close cooperation means that the ECB will supervise directly significant banks and any other bank considered important for the stability of the national banking system. For the rest of the banks ECB will issue instructions. In such circumstances an asymmetry will emerge because the ECB will have the power while the BNB will be liable. The ECB will make decisions and the BNB will implement them and will be responsible for eventual errors.

Initially, there will be uncertainty which banks will be supervised directly by the ECB. Banking legislation and rules in Bulgaria should quickly be synchronized to these in the euro area. At present, there are differences in terms of requirement about the capital adequacy and liquidity (minimum reserve requirements). In Bulgaria, they are higher. For example, the MRR ratio in Bulgaria is 10% while it is 1% in the euro area. It is not appropriate Bulgarian banks to be treated differently depending on the supervising institution.

The MRR ratio is much higher than in the euro area on purpose. As in Bulgaria a lender of last resort function of the central bank is absent due to the currency board arrangement, banks should acquire liquidity on the interbank money market. So, it is of their own interest to have enough reserves in case of deposit withdrawals.

Apart from this a gradual decrease of minimum reserve requirement ratio should be implemented by the BNB. Banks should change their liquidity management and should hold more excess reserves to avoid liquidity shortages and sudden increases of overnight interest rates.

A major risk is that subsidiaries of euro area banks might transform them into branches which are not separate legal persons registered in Bulgaria. Eventually over EUR 2.5 billion is expected to outflow from Bulgaria's economy. It is a policy of the ECB to create champion banks to be competitive on global markets. So, the management of the banking supervision at the ECB promotes bank consolidation and withdrawal of capital from subsidiaries. In Bulgaria some of the largest banks are owned by banks from the euro area and probability of transforming their subsidiaries to branches is high. This is a win-win situation for banks as capital adequacy ratio is lower in the euro area than in Bulgaria. So, they will be able to raise additional capital for mother banks and continue running their business in Bulgaria at lower administrative costs.

The European banking supervision will also encourage consolidation of banks of the local market. As a result, the concentration of the market will decrease the competition and ultimately affect the customers. Profitability ratios will probably rise on the account of bank clients.

For the depositors, such operation will mean that they become customers of foreign based banks and their deposits will be insured at other institution abroad. Hence, part of the contributions of these banks at the local deposit insurance fund and in resolution fund will be transferred to the respective foreign funds. As a result, a major capital outflow is possible from Bulgaria to the euro area countries because of the change of the banks' legal form from subsidiaries to branches. Direct consequence of this is the drop of foreign direct investment in the banking sector and that could worsen the financial account of the balance of payments and decrease the foreign investors' confidence. This, along with the political uncertainty and rather unfavorable business environment could jeopardize the inflow of foreign investment in the country.

Yet, the negative effect on the investment is expected to be small.

Capital outflows will have another negative impact in terms of lowering official foreign exchange reserves. As they cover the monetary base it eventually will contract leading to higher interest rates. On the other hand, lower minimum reserve requirement ratio will counteract so the overall effect is hard to be determined. In period of economic restructuring a rise in interest rates might result in more severe and more protracted recovery with greater social cost in terms of higher rate of unemployment, lower incomes and purchasing power and even social unrests.

As banks become branches their investment portfolio could shift from securities issued by the Bulgarian government to these of euro area countries. The latter are eligible as a collateral for loans by the ECB while the former will not be eligible until Bulgaria joins the EMU. According to the author's calculations based on Ministry of Finance data banks on the Bulgarian market hold at least 40% of issued government securities. As the largest banks will be supervised by the ECB and eventually change their securities holdings the demand on the local market for government securities will decrease. This might increase the funding costs for the government. As a result, a crowding-out effect could arise for the private investment.

Accession to the Banking Union is risky because the union itself is far from completed. A common guarantee scheme for deposits is necessary which implies an agreement for a fiscal union which will regulate fiscal transfers on EU level. Such an agreement still looks distant as there are many different opinions of governments. The so-called frugal countries like Austria, Netherlands, Denmark, and Sweden do not agree with large grants to not so disciplined countries and require implementation of reforms as a precondition. The latter countries consider these requirements as excessive international control over their national policies. Still, there is no agreement between the parties.

The euro area is already excessively indebted as the government debt to gross domestic product ratio is close to 100%. Many European governments depend on the ECB's negative interest rate policy to service their debts and the not so precise assessment of the risks by the market participants. The lack of structural reforms aimed at increasing efficiency of the public costs and the rising government intervention on the markets do not promote faster economic development.

Capital markets union is the other element of the euro area that should be built to have a genuine economic and monetary union. Hence, the European single currency union is still under construction and is not sustainable enough

CONCLUSION

Accession to the ERM II and the Banking Union is an important step towards adoption of the euro as a legal tender in Bulgaria. However, the assessment of the period at the ERM II showed that there are many issues that should be addressed but they are not even discussed. For example, an accord between the Bulgarian authorities and the foreign owned banks could be made to preventing them to withdraw their capital from the banking system in the country until it joins the euro area.

This article describes some of the effects, but a complete impact analysis is necessary to compare benefits to costs and risks and to generate measures to mitigate these risks. Underestimating risks or even neglecting them is not a responsible reaction by the authorities and they should prepare such analysis as quickly as possible. It is possible that costs and risks outweigh benefits.

Because of the current level of convergence, the price level, and the real income per capita are about 53% of the EU average Bulgaria is not ready for a short period at the ERM II. The price stability criterion is a challenge. Due to the COVID-19 crisis meeting the budget deficit and stability of interest rates criteria could be a challenge as well.

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