

CHALLENGES FOR BULGARIA AND CROATIA IN JOINING THE EURO AREA

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Abstract: *The main objective of the report is to examine the challenges facing Bulgaria and Croatia before the adoption of the euro. Croatia is already part of the euro area and managed to overtake Bulgaria for years to achieve this goal. The subject of study is the single European currency, and the subject of adoption in Bulgaria and Croatia and the challenges that arise from it. Economic indicators will be examined in the moment before Croatia's accession and Bulgaria's expected accession.*

Keywords: euro, eurozone, monetary policy, Bulgaria, Croatia

JEL: E31, E40, E50

Introduction

1. Literature Review

There are numerous publications on the subject in the scientific literature, many of which are relevant and have been published in recent years in connection with the adoption of the euro in Croatia. Gechev, Beev & Hristozov (2020) tried to make a forecast of the euro adoption in Bulgaria. The sustainability of the nominal convergence criteria depends on a high level of real convergence and on sound macroeconomic indicators that would not generate macroeconomic imbalance (Vasiloiu, 2019). In his research (Walko, 2022) reveals the potential benefits and risks of euro adoption for Croatia and Bulgaria, and his opinion is that it is expedient to review their past performance in terms of convergence and compare that with the performance of current euro area (EA) countries. (Cuaresma, Fidrmuc, & Silgoner, 2008) are analyzing the link between macroeconomic fundamentals and exchange rate dynamics in two new and two potential EU member states: Bulgaria, Romania, Croatia, and Turkey. Important for the theory and practice is the research of (Aleksejevska, 2020) about the financial crisis after 2020 that has forced the central banks of many countries to use new monetary policy methods. Similar to the topic is the research of (Dan, 2019) regarding the real and structural convergence in Romania, Bulgaria and Croatia. An interesting reading on the subject is made in the study "With or without you? Are central European countries ready for the euro? (Darvas, 2019), which deals with the cases of Bulgaria, Romania and Croatia.

2. Background

Bulgaria has been a member of the European Union since 1 January 2007 and has committed to adopt the euro when it fulfills the necessary conditions under the Maastricht

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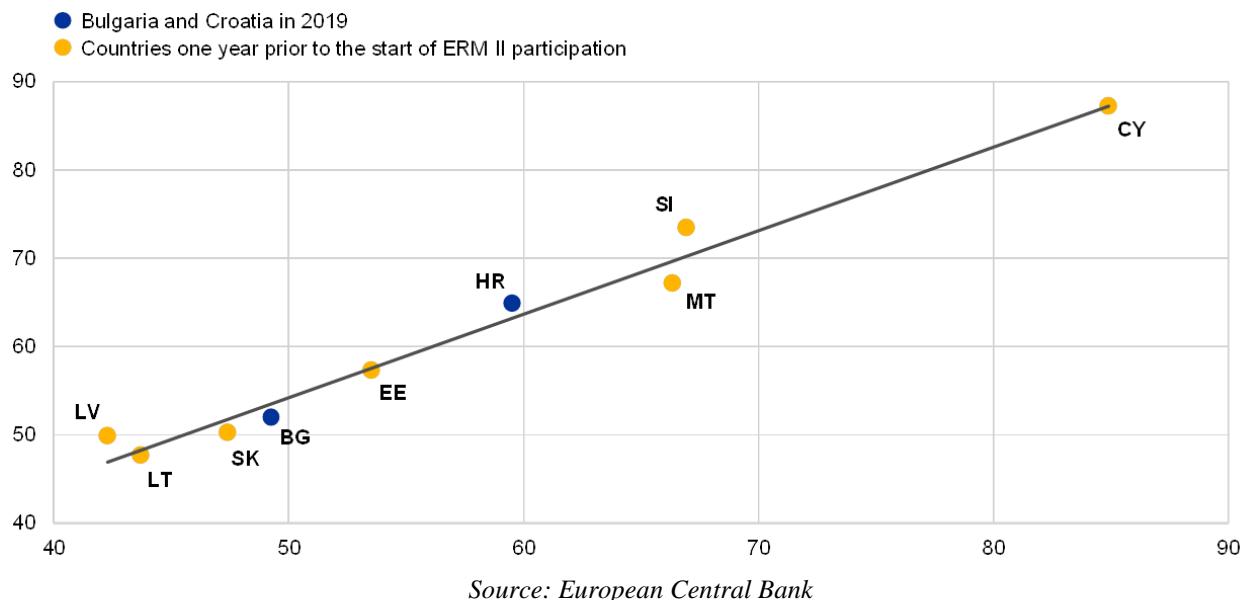
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Treaty. Croatia has been in the EU since 1 July 2013 and is part of Schengen and the euro area since 1 January 2023. Bulgaria has become part of full Schengen by air, sea and land since 1 January 2025, after controls at air and sea borders have been lifted as of 31 March 2024. To fully complete its European integration, Bulgaria must also be part of the euro area. Croatia is 20 countries that have joined the euro area since 2015. Lithuania was the nineteenth member and Bulgaria is expected to be the 21st.

Bulgaria and Croatia joined together the Single Exchange Rate Mechanism ERM II and established close cooperation with the European Central Bank by becoming part of the Banking Union on 10 July 2020, although Bulgaria started this process a year before Croatia and at the beginning paved the way (ECB, 2020). On the day of Bulgaria's accession to ERM II, however, protests against political governance began and political instability has been a fact for more than 3 years.

Experience to date has shown that countries that join ERM II at comparable or even less advanced stages of convergence can subsequently introduce the euro in a successful way. In this respect, a more important prerequisite for successful participation in ERM II is price levels that are commensurate with income levels (as shown in the graph below) and, more generally, with the country's economic fundamentals.

Figure 1.



The difference compared to Bulgaria is, that as a result of a strong political demarche led by Prime Minister of Croatia Andrej Plenković, the process of joining the euro area has already been successfully finalised. In the years leading up to Croatia's accession to the euro area, Croatia's politicians and central bankers defined accession to the euro area as a crucial step towards the country's integration into the core of the European Union and ensuring future economic development and the accession process became official state policy because it was

not only an expert but above all a political issue. Although in 2022, according to a Eurobarometer survey, 49% of Croats are worried that the euro will have a negative impact on their nation, while only 45% believe it will have a beneficial impact overall.

Bulgaria has not adopted the euro since 1 January 2023 due to the political instability in the last few years in the country and the failure to meet the criterion on price stability, the level of inflation. As of the end of November 2024, inflation in Bulgaria continues to fall, narrowing the gap between the average annual inflation in the country and that of the three best performing EU Member States. Both the regular reports of the ECB and the European Commission of summer 2024 found that Bulgaria fulfilled all the criteria, including full legal convergence, with the exception of the criterion on price stability. This criterion is also expected to be met at the end of December 2024 or at the latest in January 2025. According to Fitch, this will happen at the beginning of 2025, depending on the evolution of inflation in the EU. After the fulfilment of the last criterion, the country will send a request for the preparation of extraordinary convergence reports by the European Commission and the European Central Bank, on the basis of which the date for our country's membership in the euro area should be determined. This is a commitment by the Bulgarian executive on the basis of a decision taken by the National Assembly of the Republic of Bulgaria in the summer of 2024. Moreover, at this stage, Bulgaria is the only country that is a member of the Banking Union and participates in the Single Supervisory Mechanism within the framework of the close cooperation established with the ECB as part of the country's commitment to join both the Banking Union and the Exchange Rate Mechanism (ERM II). The framework for close cooperation with the Bulgarian National Bank entered into force on 1 October 2020, following the fulfilment of the necessary supervisory and legislative requirements.

The importance of Bulgaria's accession to the euro area is also emphasized by all rating agencies. In practice, the country has reached the highest possible level as a credit rating at this stage, and only admission to the euro area can increase it. In October 2024, the credit agency Fitch Ratings confirmed Bulgaria's 'BBB' rating with a positive outlook, with "a positive outlook reflecting the country's prospects for euro area membership, which would lead to further improvements in the country's external position indicators" (Fitch Ratings, MF, 2024). And an increase in the country's credit rating would also affect banks' and businesses' higher ratings. While not joining the euro area would have a negative effect on the country's rating. According to Fitch Ratings, there is a broad political commitment at national and European level to adopt the euro. Moreover, despite the political instability in the last 3 years, the preparations for the introduction of the euro at the level of the banking sector, central bank, business continue to this day, with investments in this direction for the preparation of the sector by commercial banks alone amounting to over BGN 500 million, excluding the funds invested by the Central Bank.

The adoption of the euro and the accession of our country to the euro area is the most successful way out of the current currency board regime for more than 27 years, during which the central bank cannot lend to the government, refinance commercial banks, but it helps to impose fiscal and financial discipline by committing to exchange local currency for a chosen reserve currency at the fixed exchange rate upon request. Moreover, the lev has been pegged to the euro since the very beginning of the existence of the euro.

Bulgaria, which, according to the regular convergence reports of summer 2024, does not meet the criterion on price stability, the challenge for Croatia on its path towards the euro area is the management of public finances, the higher level of debt than allowed under the criteria. It should be noted, however, that the general exception clause in the EU's Stability and Growth Pact was activated between 2020 and 2023. This allowed countries to take the necessary coordination measures under the Policy Pact in the context of the pandemic and Russia's invasion of Ukraine. In particular, this allowed for a departure from the budgetary requirements that would normally have been applied. A reformed Stability and Growth Pact entered into force in April 2024, modifying the rules for opening a debt-based excessive deficit procedure.

Following the European Council's endorsement of Croatia's entry into the monetary union at its meeting at the end of June 2022, euro area finance ministers gave their formal approval on 12 July 2022. The exchange rate for the kuna to the euro was set at 7,53450 to 1 and the date of formal adoption was set for 1 January 2023. Bulgaria is expected to stand at 1.95583 to one euro, as is currently the case for the fixing of the lev to the euro.

Since its inception in 1994, Croatia's currency, the kuna, has used the German mark and then the euro as a benchmark. At the same time, most of the deposits of individuals and companies are in euros, as well as over two-thirds of the debt, as well as the prices of real estate, cars and hotel accommodation (and one-fifth of Croatia's GDP comes from tourism). Therefore, it is no coincidence that it is the tourism sector that is the biggest supporter of the adoption of the euro in Croatia. Both are small and open economies, well integrated with euro area countries with trade and financial relations. But they are direct competitors in terms of tourism. In various studies related to tourism, usually between 30 and 40% of respondents indicate that the euro saves bank charges for tourism and between 74 and 80% that the euro makes it easier to compare the prices of tourism and other services in countries because price transparency is seen as the most important effect of the common currency on tourism. Before the pandemic, tourism accounted for around 10% of GDP and 9% of employment in the European Union each year, while international tourism accounted for 6% of total EU exports. And in the case of Bulgaria, EU countries are the most important market for inbound international tourism with a relative share of about 60%, with pre-pandemic revenues of over EUR 3.7 billion per year. In Croatia, tourism revenues amounted to around 19% of GDP in 2019, and for Croatia, too, the euro area countries are the most important trading and financing partner. In addition, the introduction of the euro significantly reduces transaction costs, since it is no longer necessary to exchange the kuna for the euro and vice versa. This further boosts Croatia's trade and financial integration into the euro area and makes Croatia more attractive for investment, and it is also expected that the euro will make the economy more resilient to shocks and financial crises.

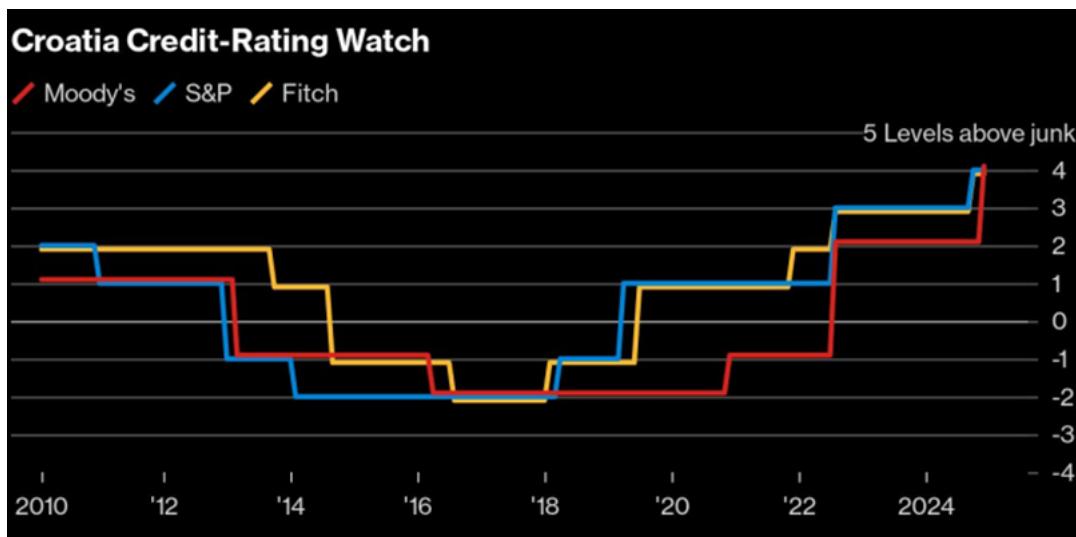
3. Croatia's connection to the euro area as a trade and financial partner

The goal set by Croatia on the path of joining the euro area is the elimination of currency risk as one of the main expected positive effects of the introduction of the euro. And this goal was fully achieved a year later after the adoption of the euro. Another challenge is the debt of

different economic sectors in foreign currency. Today, the debt of all sectors in foreign currency is less than 1% of the total debt, as opposed to about 70% before the adoption of the euro. This is major progress for Croatia, which helps to reduce the country's risk premium and also limits the transfer of higher global interest rates to the domestic financial system.

Last but not least is the change in the rating of Croatia. In 2017, Croatia's rating was BB, two notches below investment grade. In the following years, credit rating agencies increased the rating and outlook for the Croatian economy. In 2019, Croatia reached the minimum investment grade rating (BBB-) and in 2022, against the background of the EU Council's decision on the adoption of the euro by Croatia, the credit rating was upgraded to BBB+ (by two grades), approaching the Investment grade rating. Since the adoption of the euro, Croatia has received a much higher rating from all credit agencies and the outlook has changed from positive to stable. Standard & Poor's raised the country's credit rating from BBB+ with a positive outlook to A- with a positive outlook in September 2024. This is the highest credit rating in Croatia's history. Moody's Ratings raised Croatia's long-term credit rating by two levels, citing the prospects for strong economic growth and sustainable fiscal policy and shifting the sovereign rating of A3 from Baa2. Croatia has reduced its budget deficit to less than 3% of GDP and expects to bring the level of government debt below 60% of GDP by the end of 2024.

Figure 2.



Source: Bloomberg

Both employers and the government and the citizens of the country themselves, as a result of the changed credit rating, expect lower interest rates when taking out loans and better market conditions. Thanks to the increased credit rating, "Citizens, companies and companies can expect lower borrowing rates and better market conditions," Croatian Prime Minister Andrej Plenković commented on this occasion.

Even after the decision on Croatia's accession was taken and before this actually happened, two credit rating agencies raised its credit rating by two grades. Thus, the credit rating of Croatia, which before the decision was one degree lower than that of Bulgaria, months before the actual adoption of the euro is one degree higher than that of Bulgaria.

A challenge for Croatia is also the expectations for inflation growth with the introduction of the euro. According to the analysis of the Central Bank of Croatia (and that of the ECB), the impact of the euro on prices is 0.4 percentage points, while Eurostat's analysis shows that this impact is at most 0.2 percentage points. This level of impact of the euro on prices is within expectations and fully in line with the experience of other countries that introduced the euro before Croatia, despite the circumstances of historically high global inflation in which Croatia introduced the euro. In fact, inflation in Croatia at that time was lower than countries that had not adopted the euro, such as Hungary, the Czech Republic and Poland.

4. Economic Indicators

The following table presents some of the economic indicators of the two countries, compared with the euro area. The authors take a closer look at the current economic situation in Bulgaria.

Table 1.

	European Union	Euro area	Bulgaria	Croatia
People at risk of poverty or social exclusion (as percentage of the population)	21.6% (2022)	21.8% (2022)	32.2% (2022)	19.9% (2022)
Inflation rate (percentage change compared to previous year)	6.4% (2023)	5.4% (2023)	8.6% (2023)	8.4% (2023)
Unemployment rate (as percentage of the labour force aged 15 - 74 years)	6.1% (2023)	6.6% (2023)	4.3% (2023)	6.1% (2023)
GDP per capita (Euro per inhabitant)	29 280€ (2023)	32 150€ (2023)	7 900€ (2023)	15 020€ (2023)
Government gross debt (as percentage of GDP)	80.8% (2023)	87.4% (2023)	22.9% (2023)	61.8% (2023)
Government deficit / surplus (as percentage of GDP)	-3.5% (2023)	-3.6% (2023)	-2.0% (2023)	-0.9% (2023)
Renewable energy (as percentage in gross final energy consumption)	23.1% (2022)	21.8% (2022)	19.0% (2022)	28.1% (2022)
Electricity prices (Euro per MWh, incl. taxes)	285.0€ (2023-S2)	305.4€ (2023-S2)	119.4€ (2023-S2)	154.3€ (2023-S2)

Source: Eurostat

Annual HICP inflation stood at 2.8% in June 2024, with administratively priced services and goods and services contributing the most positively. In the domestic macroeconomic environment, pro-inflationary pressures continued to exert high rates of growth in unit labour costs and continued strong private consumption. Fiscal policy also continued to be a pro-inflationary factor. HICP inflation stood at 0.6% in October compared with the previous month, mainly reflecting seasonal fluctuations in the components of underlying inflation. The highest positive contribution was made by higher prices for clothing and footwear by an average of 7.9% (+0.32 percentage point), followed by those for package holidays by 16%. The annual inflation rate accelerated to 2.0% in October, from 1.5% in the previous month. This was mainly due to a higher contribution from the components of underlying inflation, which accelerated to 2.9% year-on-year. According to the BNB projections, inflation will amount to 1.9% at the end of 2024 (compared to 5.0% at the end of 2023), while average annual inflation is expected to be 2.5% (compared to 8.6% in 2023). A key factor behind the moderation in inflation was the downward dynamics in international oil prices and in some imported industrial goods. And according to the autumn macroeconomic forecast of the Ministry of Finance, the average annual inflation is expected to reach 2.6%, and in 2025 to slow down to 2.4%.

Bulgaria's real GDP growth is expected to accelerate from 1.9% in 2023 to 2.2% in 2024, driven by higher private consumption growth, the return of goods exports to growth in 2024, as well as the formation of a low positive contribution of inventories versus a negative one in 2023. At the same time, the projected decline in fixed investment and the expected acceleration in import growth will limit the growth of economic activity this year. And Fitch forecasts average annual inflation at 3% in 2024, 3.5% in 2025 and 3.1% in 2026. At the end of the first half of 2024, the CFP budget balance is negative, with a deficit of BGN 596 million. The fiscal deposit reserve funds decreased by BGN 1,736 million compared to the end of 2023 and amounted to BGN 9,143 million (4.8% of GDP), of which BGN 8,369 million represented BNB deposit funds.

While Fitch projects the general government deficit to increase to 2.8% of GDP in 2024 from 1.9% for 2023, reflecting higher compensation and social expenditure.

Bulgaria has a GDP per capita of €24,200, which is below the EU average (€37,600), with the country's share of total EU GDP being 0.6%. Croatia has a GDP per capita of €28,700, below the EU average (€37,600) and its share of total EU GDP is 0.4%. At the same time, for the period 2003-2023, Bulgaria converged by an average of 1.5% per year and ranked third relative to the countries of Central and Eastern Europe (GDP per capita in PPS compared to the average for EU). But for Bulgaria as a small and open economy, it is of utmost importance that the exchange rate to the main trading partners is fixed, especially since after joining ERMII and the Banking Union in 2020, the best strategy is to join the euro area as soon as possible (BNB, 2024).

Conclusion

And if Croatia is already presenting itself as a success story for the introduction of the euro in the country, Bulgaria still has to complete the path of joining the euro area in order to become a success story for the euro, in order to provide cheaper and more affordable

financing for the government, banks and the private sector, as well as increasing aggregate demand and production. Because even now the Bulgarian economy is highly prepared for the adoption of the euro and for successful functioning as a member of the euro area. According to the only official analysis of the effect of the introduction of the euro in Bulgaria, prepared by the widest platform of employers, trade unions and consumers, the Economic and Social Council, as a result of the introduction of the euro will be a higher potential GDP and average annual real growth rate, higher productivity and potential for accelerated development and convergence towards average levels of productivity and income in the more advanced Eastern European countries, the EU and the euro area.

An improvement of the investment environment, a significant impulse and enabling conditions for activation of domestic and foreign investment is expected, respectively to a sustainable growth of the share of gross capital formation in GDP to levels permanently exceeding 21-23%, an increase in export orientation and unlocking statistically significant positive direct and indirect effects on export-oriented sectors and on net exports of goods and services, an improvement of the fiscal base, an opportunity to reformat national strategic management, long-term budgeting and efficiency of public spending and investment programs, as well as a more efficient labour market, employment, high levels of economic activity and labour integration and income, improved adaptive capacity and, in the longer term, to address demographic challenges, ageing of the workforce and negative net external migration.

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