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Bulgaria's Lesson for Euro-Skeptics

Sofia maintains its fixed exchange rate to the euro.

The Bulgarian government has announced that it is suspending its plans to adopt the euro, which had been scheduled for sometime after 2015. "The momentum has shifted in our thinking and among the public," Finance Minister Simeon Djankov told the Journal. "Right now, I don't see any benefits of entering the euro zone, only costs."

This, supposedly, amounts to the latest proof of the single currency's necessary and certain doom. The popular British website HousePriceCrash.co.uk heralded the spectacle of Europe's poorest country telling the currency club to "get stuffed." Russia Today, the Kremlin's English-language mouthpiece, was called up a "financial expert" who characterized Bulgaria's stance as "we don't want your euro because your grand design is deeply flawed, it's built on sand, it's a catastrophe."

Except that's not what Bulgaria said. As Mr. Djankov told the Journal, "the public rightly wants to know who would we have to bail out when we join? It's too risky for us and it's also not certain what the rules are and what are they likely to be in one year or two."

It's difficult to argue with those concerns. But they hardly condemn the notion that disparate economies can share a single currency. Sofia's position reflects recent developments in Europe, which have seen euro leaders use Mediterranean spending crises as a reason to shred the single currency's founding agreements, most notably its no-bailout provision, and shuffle toward a fiscal union to go with the monetary union.


Bloomberg/Angelov Velko

If this seems like a distinction without a difference, consider that while Sofia's news this week means it's opting against joining the official European Exchange Rate Mechanism, it is maintaining its fixed exchange rate to the euro.

Why? Because it has worked. Bulgaria adopted a fixed exchange rate in 1997—originally fixing the lev to the German mark—after the central bank had responded to the collapse of the Soviet Union and the Bulgarian banking system with a series of devaluations. Inflation was in triple digits, and in 1996 alone the lev fell by 560%. By the end of that year, the average Bulgarian income was less than $30 per month—not enough for a new pair of Levis, let alone the household basics.

Every lev in circulation has since been backed 100% by foreign exchange reserves at the national bank—first the mark, and since 1999 the euro. This arrangement is known as a currency board and is much stronger than a mere currency peg. That's because in principle under a currency board the central bank could meet any speculative attack on the lev by accepting levs in exchange for the euros the bank holds in reserve.

Average real wages have increased more than 1000% since Bulgaria established the currency board, to more than $400 per month today. Economic reforms have allowed and encouraged real productivity gains, not inflation, which has been limited to single digits almost every year since 1997.

Bulgaria's currency board has also forced its government to control spending, as the central bank is not free to print money to support government borrowing. Bulgaria today would not only meet the Maastricht Treaty's criteria for joining the euro zone—it would be one of its star members, with public debt less than 20% of GDP. Maastricht signatories agreed to similar fiscal constraints but flouted them from the start. Bulgaria's fixed rate with the euro and its internal reserve requirements eliminated that choice.

Johns Hopkins economist Steve Hanke, who designed the currency board in Bulgaria and in several other east European countries in the 1990s, says he has recommended for months that Sofia stay out of the euro. But "it has nothing to do with the euro being in jeopardy," Mr. Hanke told us. "They are part of what I'd call the unified euro zone," which means they get the advantages of Europe's monetary union without having to join the euro club's current agonizing about political or fiscal union.

"The lev is a clone of the euro," Mr. Hanke adds. "It's the same as the euro. This is not a no-confidence vote on the euro, it's a reaffirmation of their own sovereignty to control their own monetary regime." Just so.