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It is not about Croatia and Bulgaria: it is about the fundamentals of membership of the euro area

Abstract

This article was invited from the author in response to the June 2022 Bruegel.com blog post by Zsolt Darvas – and see the separate article in this issue – about the decision to let Croatia into the euro area while keeping Bulgaria out; and intended to elicit a view from Bulgaria. The author believes that Darvas is essentially right in his approach; and that, furthermore, the applications of Croatia and Bulgaria for entry to the euro area are a perfect example of why the whole framework needs a thorough re-consideration. The founding fathers of the euro area constructed it on the basis of fundamental principles of macroeconomic stability and the equal treatment of applicants. Consequently, most of the criteria for adopting the euro, the so-called Maastricht criteria, have numerical expressions: clear and transparent criteria do not open any room for interpretations and compromises with macroeconomic stability. In the last decade, however, the author argues that the flexible interpretation of these criteria has led to changes making the accession process more discretionary and euro area membership less attractive.

Keywords*: euro area, ERM II, convergence criteria, TFEU, inflation, public debt, public policy, Stability and Growth Pact*

Changing the essence of ERM II

The only non-numerical criterion for euro area admission (namely, participation of the national currency in ERM II for at least two years) has been fundamentally revised in the last three years. Although the European legislation had not so far provided for criteria and restrictions on the access of national currencies to ERM II, in 2020 the two countries with strong aspirations for membership of the euro area – Bulgaria and Croatia – were requested to accept really rather severe conditions in order to fulfil this convergence criterion. The conditions set before the two countries have no precedent in the functioning of the euro area.

It is important to note from the outset that the changes in the conditions and procedures for accession to ERM II are carried out in the form of letters, decisions of the parties responsible for the ERM II process, and others. This creates both legal ambiguity and, therefore, instability. The European Central Bank (ECB) and the European Commission calls these new conditions 'prior commitments', although they basically act as restrictions on, or conditions for, access to the mechanism. These new conditions and procedures evidently put the countries that are about to join the euro area at a disadvantage compared to those that are already in it.

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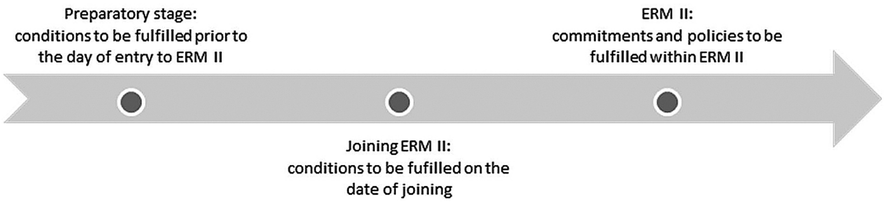
Joining the currency mechanism has now become a lengthy process and consists of three stages with various conditions set at each stage (Figure 1).

Figure 1 – Three-stage admission to ERM II



Source: European Central Bank

First stage

The first stage constitutes preparation for the accession of the national currency to ERM II. Unlike prior examples of the accession of national currencies to the mechanism, with requirements set for the policy which needs to be followed after joining, the authorities' new approach sets conditions that need to be fulfilled before joining. The two countries with currencies that joined ERM II in 2020 – the Bulgarian lev and the Croatian kuna – had to fulfil many conditions in various areas – economic, legal and technical.

The fulfilment of these conditions was subject to ongoing reports and a final assessment by the ECB and the Commission. In the cases of Bulgaria and Croatia, the commitments referred to areas such as, among others:

a) supervision of the non-banking sector
b) bankruptcy framework
c) framework for anti-money laundering measures
d) the management of state-owned enterprises.

An essential part of the preliminary stage of preparation is the asset quality review (AQR) of banks selected by the ECB and conducted by it in line with its own methodology. The process itself may put the system at risk insofar as revealing weaknesses in some of the assessed banks may raise doubts about their stability. In the case of Bulgaria, the result of the AQR led to a request for the capitalisation of a private bank with public funds; in the case of Croatia, mergers and acquisitions appeared within the banking system.

Second stage

The second stage represents the actual accession of the national currency to ERM II. Previous practice saw it as sufficient that a country had declared its intention to join the mechanism; refusals and rejections were not foreseen. The discretion of the decision making bodies is limited to determining, at the date of accession and together with the candidate country, the central rate of the national currency against the eu-

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ro; the rate at which the respective currency enters the mechanism; and the range of deviation from the central rate.

According to the new procedure for ERM II entry, on the date of accession the Commission and the ECB assess whether the preconditions have been met. The second condition, in addition to the fulfilment of the so-called 'preconditions', is the mandatory accession of the country to the Banking Union in the form of 'close cooperation'.

At this stage, ECB selects the banks it will supervise directly. The loss of supervision and control over a country's own banking system as a condition for joining ERM II is a significant loss of national sovereignty that countries with a derogation have to accept if they wish to enter the euro area.

Third stage

The third and final stage is participation in both ERM II and the Banking Union in the form of close cooperation. Up to now, it has been standard practice that the press release on the admission of the new currency to ERM II includes the setting out of some policy commitments. These are the obligations that countries will honour in the future so as to ensure the stability of the currency alongside its commitments not to erode the stability of its own currency nor that of the mechanism itself. The relevant press releases indicate the new post-entry commitments that each country had agreed to follow after the inclusion of its national currency in the mechanism.

The current impact of change

No matter how one interprets change in the entire process of accession to ERM II, it can be said that it definitely violates the principle of equal treatment. The other problem is that the new conditions, particularly that of participation in 'close cooperation', are essentially directly related neither to the currency mechanism itself nor to the maintenance of currency stability within the permitted 15 per cent deviation either side from the exchange rate to the euro. In this sense, the currency mechanism is no longer a pure currency mechanism. On the other hand, data for the last fifteen years on countries with a derogation from membership[1] show that the fluctuation of their currencies is persistently within the ERM II fluctuation band, even though they are not formally included in the mechanism.

The recent changes in ERM II were inspired by the extension of the ECB's functions to banking supervision within the Banking Union, alongside the ambition to extend those supervisory functions to subsidiaries of banking groups in countries with a derogation. The aim is to test the stability of each country's banking system before entry to ERM II and before entry to the euro area. For this purpose, the currency mechanism is being used not only as a 'front door' to the currency area but also acts as a front door to the banking systems of those countries which have a derogation. Nine years after the establishment of the Banking Union, this 'close cooperation'

1 It being a requirement that members of the EU join ERM II; those that do not have a derogation but are expected to join where they meet the criteria.

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form of participation remains unattractive to countries outside the euro area. The requirement to enter the Banking Union before entering the euro area creates a risk for countries since they do not have access to the European Stability Mechanism – the instrument which provides financial assistance to euro area countries threatened by severe financing problems – as well as that their banks have no access to ECB financing.

Obviously, the Maastricht criteria for ERM II participation have now become completely discretionary even prior to accession itself; and this makes the process of application for membership of the euro area both more risky and less attractive to applicant countries.

The numerical convergence criteria are no longer numerical

We remember with nostalgia the case of Lithuania when, in 2006, the country's request to adopt the euro was rejected because its inflation rate exceeded the reference rate by a mere 0.1 percentage points. At that time, the reference rate for inflation was calculated based on the average of the three best performers; and there was no possibility of excluding so-called 'outliers' from the calculation of the benchmark. If this option had been available then, Lithuania would by now have been in the euro area for more than 15 years.

Things have changed a lot since 2010. As Zsolt Darvas rightly emphasises, the choice of the ECB and the Commission to exclude countries from the inflation reference rate calculation gives them a tool to define different values for that rate. In doing so, the automatism in the assessment of the inflation criteria has already been replaced with discretion. The flexibility inherent in defining the reference rate for the inflation criterion, especially in the most recent assessment carried out in 2022, is subject to serious criticism. The process itself seems to be a manageable one but doubts about what happens in practice have arisen with the 2022 convergence report.

If the principle enshrined in the Treaty and prior practice before the implementation of the new concept, which did not exclude countries regarded as 'statistically atypical in the calculation of the reference value', had been applied in 2022, then Croatia would not have met the inflation criterion. As Darvas (see separate article, this issue) writes:

> The three countries with the lowest all-items inflation rates were Malta (2.1 per cent), Portugal (2.6 per cent) and France (3.3 per cent), giving an average of 2.6 per cent.
>
> …
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> But the Commission and ECB chose to exclude Malta and Portugal from the calculation, referring instead to France (3.2 per cent), Finland (3.3 per cent) and Greece (3.6 per cent) as the best performers. This resulted in a reference value of 4.9 per cent (average of 3.4 per cent + 1.5 [the leeway]), meaning that Croatia [inflation rate of 4.7 per cent] squeezed in.

The overly vague criteria for excluding low inflation countries from the reference group gives a reason to doubt the appropriateness of the decision of the ECB and the Commission as to whether countries can be excluded from the calculations and, if so, thereafter which ones. This discredits the entire assessment process. Discretion in the

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inflation criterion can certainly also be exercised by the candidate country: to suppress inflation, short-term measures can be taken – for example, maintaining fixed prices, tax changes and others.

The problem is not so much that some countries could benefit from the concept of outliers and thus enter the euro area. The real problem is that the euro area wants countries with high inflation. The data prove that, following 2010, the inflation reference rate is much higher than that calculated from the three best performers, being higher than the average inflation rate in the EU, and that in only four of the ten convergence reports is inflation below the ECB's target level of two per cent. In the last decade, the euro area has gradually departed from its main benchmark – low inflation.

Although the Treaty states that applicant countries need to fulfil the criteria sustainably, most of the latter are calculated on the basis of a one-year period. This is a very short time in which both random factors and targeted policies can suppress inflation to a level which falls within the reference value. This weakness in the criterion, together with its flexible interpretation, gives access to the euro area to countries with the potential for high inflation.

Greater tolerance for high debt and fiscal deficits among candidate countries

Croatia is a country that has entered the euro area with a large level of public debt and an unsustainable fiscal policy. This has happened due to the flexible interpretation of Maastricht's fiscal and debt criteria. The criterion for the state budget position is fulfilled when there is no excessive deficit, determined not so much by data on the size of the deficit, but by a Council Decision on the presence of an excessive budget deficit or lack thereof.[2] The regulatory framework allows a country's deficit to be assessed as not 'excessive' when:

> … the deficit ratio has declined substantially and continuously and reached a level that comes close to the reference value… [or alternatively] the excess of the deficit ratio over the reference value is only exceptional and temporary and … the ratio remains close to the reference value. (European Commission 2012: 9)

During the financial crisis, in all the countries with a derogation except Sweden, the budget deficit exceeded the reference value of three per cent. Then, however, no relaxations and exemptions from the fiscal criteria were introduced. In 2021 and 2022, the exclusion clause was activated and some countries formally fulfilled the criterion. Its exceptionally high deficit in 2020, amounting to 7.3 per cent of GDP, enabled Croatia to refrain from major public spending in the benchmark year of 2021, thereby achieving fulfilment of the criterion. Sustainability of public finance, however, remains a problem.

2 12008M/PRO/12 'Consolidated text of the Treaty on the Functioning of the European Union – PROTOCOLS – Protocol (№ 12) on the excessive deficit procedure' *Official Gazette* No. 115, 09/05/2008, pp. 0279-0280, accessed 12 December 2022 at: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008M/PRO/12&from=EL.

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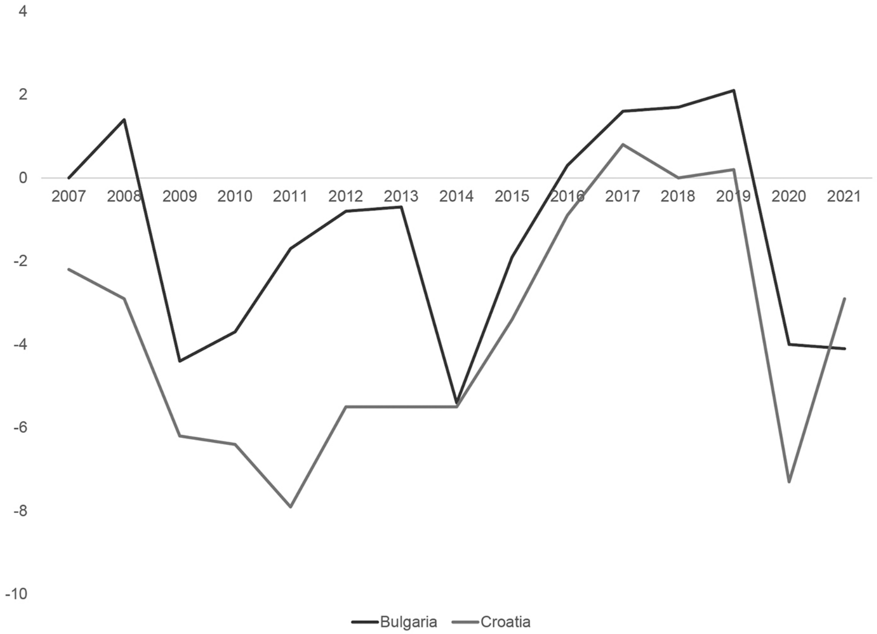
A member state does not fulfil the debt criteria if public debt is above 60 per cent of GDP. But exceptions from the rule can be had when this ratio is decreasing 'at a satisfactory pace'. Croatia's general government debt ratio fell to 79.8 per cent of GDP in 2021 but the ECB and the Commission produced a relatively favourable report (European Commission 2020: 5) on the grounds of the scale of the decline in the ratio from its peak value, of 87.3 per cent of GDP, in 2020. The ECB expects that both the debt ratio and the budget balance will both be below the reference rates in 2022. This remains to be seen.

Bulgaria conducts a prudent fiscal policy and is one of the most fiscally stable countries in the EU. The country has fulfilled the fiscal criterion in two out of three of the last fifteen years. It is also a country with large and durable fiscal surpluses.

Figure 2 – Fiscal balance to GDP, %



Source: Eurostat

Regarding the public debt criterion, Bulgaria has fulfilled the requirement for a figure that is below 60 per cent of GDP, with no exception or interpretation, in the last twenty years. In contrast, Croatia has not kept its public debt below 60 per cent in the last decade.

As these concrete examples show, the debt criterion loses its meaning when there is an excessive number of ways of avoiding it. At the same time, the indicator can be easily managed by candidate countries for euro area membership, including through one-off measures which reduce the value of this indicator.

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One of the main arguments of those who advocate against euro area membership is that the euro area tolerates the indebtedness of countries. The ineffectiveness of the Stability and Growth Pact and the entire macroeconomic surveillance mechanism is evident by following the dynamics of debt within the euro area, which has been over 85 per cent of GDP throughout the last fifteen years. This tolerance of high debt levels is expanding to candidate countries.

Sustainability in achieving the nominal convergence criteria is a Treaty requirement. However, since most of the indicators are calculated for a single year they are therefore subject to countries seeking to influence their values by engaging in particular policies. As far as the sustainability of Bulgaria's criteria is concerned, it has:

- the most stable exchange rate between 1997 and late 2022, i.e. without any fluctuation for a period of 25 years
- public debt has always below the reference rate
- prudent fiscal policy (only once, and for a short time, was it in the excessive deficit procedure)
- the inflation criteria has been met six times according to the last ten convergence reports.

Apparently, however, numbers do not matter anymore. And yet this is not about Bulgaria.

The two recent crises in countries with a derogation are a kind of test of the sustainability of their economies and of their macroeconomic stability in the context of nominal convergence criteria. Due to the prevailing level of flexibility in the assessment of the criteria, their achievement largely depends on the intentions of the countries concerned to adopt the euro as well as of those in the euro area to welcome them. Even so, the change in the entire entry mechanism to the euro area creates doubts among countries outside the area who are looking to join. The criteria have been created to ensure the stability of the core of the EU – the euro area – but their loosening at the point of entry and once inside makes it increasingly unstable and a less attractive place to those outside it.

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