Enlargement of the euro area toward CESEE: progress and perspectives

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This article reviews the enlargement of the euro area toward CESEE EU Member States since 2010. It covers the Baltic countries' accession to monetary union and summarizes the present state of convergence of non-euro area CESEE EU Member States, with a focus on the economic convergence criteria. Furthermore, it depicts the current views of these countries on future euro area accession. We show how convergence assessments have developed since the onset of the crisis and examine the impact of the deepening of Economic and Monetary Union on the monetary integration process. Looking ahead, the article argues for an even-handed application of the principle of equal treatment in an advancing environment, which combines continuity with a careful and well-grounded integration of the lessons from the past and the institutional reforms that have resulted as a consequence, for the mutual benefit of all stakeholders in the process.

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The euro area will soon complete the second decade of its existence. In hindsight, the first years of monetary union may look like an "easy ride," facilitated by the great moderation and the benevolent economic developments of the time. It was, however, during those years that large imbalances accumulated within the euro area. After a tranquil first decade, the situation changed fundamentally with the onset of the financial crisis. Certainly, these imbalances made it much more difficult to cope with the external shock that hit monetary union in 2008 and thus greatly added to the bumpiness of its ride in the second decade, including a sovereign debt crisis in some euro area countries. Eventually, the euro area weathered this perfect storm, not least thanks to painful adjustment, with the institutional deepening that ensued in response to the crisis still ongoing.

This article deals with the enlargement of the euro area to include CESEE EU Member States. Given the broader context, exploring this topic immediately raises obvious questions: What do the developments within the euro area mean for its enlargement? Put differently, how do the crisis and the resulting deepening impact on the widening of monetary union? Non-euro area EU Member States now face an Economic and Monetary Union (EMU) that is not only "deeper" than before the crisis but is also set to deepen further – a currency union that has been and is being augmented with a banking and capital markets union, with improved surveillance and policy coordination mechanisms and with a permanent firewall for euro area members in financial difficulties (European Stability Mechanism). Not only has the crisis transformed the thinking about the appropriate institutional setup of EMU, especially with a view to its resilience, but it has also sharpened policymakers' views on what it takes for individual countries to participate smoothly in a monetary union.

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The purpose of this paper is to update previous work on the monetary integration of CESEE EU Member States. The focus of this article is on the period since 2010,[2] specifically on economic developments. It should be noted, though, that apart from achieving a high degree of sustainable economic convergence, EU Member States also need to fulfill legal convergence requirements.[3] Convergence in both areas, economic and legal, is regularly assessed in the convergence reports of the European Central Bank (ECB) and the European Commission.

This paper is structured as follows: Section 1 reviews the development of euro area enlargement since 2010 and depicts the present state of convergence, with a focus on the Maastricht criteria.[4] In section 2, we summarize current views of non-euro area Member States on future euro area accession. Section 3 reviews the convergence assessments of the ECB and the European Commission in recent years. Section 4 sheds light on how EMU reform measures have been reflected in the convergence reports. Section 5 concludes.

1 Euro area enlargement from 2010 to 2018

1.1 Accessions to the euro area in the current decade

After two CESEE EU Member States had joined the euro area in the previous decade – Slovenia in 2007 and Slovakia in 2009[5] –, the enlargement of the euro area continued in the 2010s with the accession of the three Baltic countries: Estonia (2011), Latvia (2014) and Lithuania (2015).

The Baltic countries are very small and open economies, two of which – Estonia and Lithuania – had long-standing euro-based currency board arrangements in place before adopting the euro. Latvia, in contrast, followed a tight currency peg, initially to the SDR basket and since 2005 to the euro. After EU accession, they participated in the Exchange Rate Mechanism II (ERM II) while retaining their specific exchange rate arrangements (currency boards and very narrow exchange rate band, respectively) as unilateral commitments, for a period between 6½ years (Estonia) and 10½ years (Lithuania).[6] In all three cases, the exchange rate to the euro remained unchanged upon entry into and during participation in ERM II. This parity also became the conversion rate to the euro when the three countries joined the euro area.

[2] *Developments until mid-2009 are summarized in Backé (2009).*

[3] *For a study on legal convergence in the area of central bank independence, see Dvorsky (2009).*

[4] *A broader review also capturing optimum currency area criteria, including their possible endogeneity, as well as the effectiveness of autonomous monetary and exchange rate policy as an adjustment tool is beyond the scope of this article. For a short review of these aspects, see Backé (2009). Over the last decade, labor and product market flexibility in non-euro area CESEE EU Member States has been rather steady (as measured e.g. by the Global Competitiveness Index of the World Economic Forum), while integration of non-euro area CESEE EU Member States with the euro area has tended to deepen and business cycles have become more synchronized (see e.g. Campos et al., 2017, and Ahlborn and Wortmann, 2018).*

[5] *For a short review of Slovenia's and Slovakia's euro area accession, see e.g. Backé (2009).*

[6] *According to the ECB (2003), countries that operate a euro-based currency board deemed to be sustainable might not be required to go through a double regime shift, i.e. floating the currency within ERM II only to re-peg it to the euro at a later stage. Such countries may therefore participate in ERM II with a currency board as a unilateral commitment, enhancing the discipline within ERM II. However, the ECB has stressed that such arrangements will be assessed on a case-by-case basis and that a common accord on the central parity against the euro will have to be reached.*

Inflation convergence in the Baltics was more gradual, which slowed their compliance with the convergence criteria. It took Latvia and Lithuania[7] somewhat longer than Estonia to get up to par in this respect.

It is noteworthy that Estonia managed to fulfill the convergence criteria at the height of the financial crisis. It was the only CESEE EU Member State in 2009 that kept its budget deficit well below 3% of GDP.[8] A year later, the country returned to the balanced budget policy it had followed since long before the crisis. Latvia and Lithuania needed somewhat more time to rebalance their fiscal position,[9] while their general government gross debt ratios stabilized at about 40% of GDP after the crisis.

For Estonia, long-term interest rate convergence, which is normally measured based on ten-year government bond yields, was assessed using several other indicators, as the country had virtually no long-term public debt outstanding. In Latvia and Lithuania, interest rate convergence was well advanced by 2011/12, with long-term rates moderating further before euro area accession.

Moreover, all three Baltic countries displayed a remarkable degree of labor and product market flexibility and, more generally, economic adjustment capabilities for many years, as evidenced by their adapting to the shock experienced in 2008/09, when the financial crisis hit.[10]

1.2 Economic performance of euro area CESEE Member States in the 2010s

How have the five CESEE economies that are members of the euro area fared in the current decade? More specifically, have the benefits from euro area participation unfolded as expected in these countries, accelerating their catching-up? It is still too early for a rigorous quantitative analysis of this matter given that their accessions to the euro area took place between three and eleven years ago.[11]

Yet, a purely visual inspection of key macroeconomic variables shows that Slovakia and the Baltics have displayed solid growth alongside subdued inflation since 2010. While it is open to question to what extent membership in the euro area has contributed to this performance, the track record of these four countries suggests that in all likelihood their participation in the euro has not had a dampening effect. The Baltic countries' economic adjustment to the crisis was frontloaded and comprehensive, including a massive internal devaluation, which resulted in a V-shaped recovery after a particularly deep recession in GDP in 2008/09. In Slovakia, the contraction in 2009 was less pronounced, followed by a fast return to high growth in 2010, a more measured expansion until 2013 and another acceleration of GDP growth thereafter.

[7] *Lithuania first aimed to join the euro area as early as 2007, together with Slovenia, but missed the numerical fulfillment of the inflation criterion by a small margin in the 2006 convergence assessment (with some concerns about the sustainability of low inflation prevailing at the time).*

[8] *More importantly, Estonia is the only CESEE EU Member State (and one of the three EU Member States overall) that never had an excessive deficit procedure (EDP).*

[9] *Latvia reduced the general government budget deficit to below 3% of GDP in 2012, Lithuania a year later.*

[10] *For a concise survey of convergence in the Baltic states, see Diaz del Hoyo et al. (2017, box 5).*

[11] *A starting point for empirical analysis could be to compare actual convergence, e.g. of per capita income, with the convergence to be expected given the state of economic development. Conducting such a comparative analysis, the Centre for European Policy Studies (CEPS, 2018) reports that the CESEE euro area countries have been converging at a slightly faster rate than one would have expected given their starting levels of income per capita. Likewise, Žúdel and Melioris (2016) find that euro adoption was net positive for Slovakia over the medium term.*

Slovenia, in turn, went through a more extended boom-bust cycle, with a second recession in 2012/13, before embarking on a dynamic growth path more recently.[12] This difference in performance can be attributed to a number of factors. Slovenia had seen a comparatively large reduction in interest rates before and upon euro area accession, which had added to the boom. Moreover, some structural weaknesses (e.g. governance problems in the banking and nonfinancial corporations sectors) and delays in forging a comprehensive policy response to address these frailties exacerbated the subsequent bust in this country. Nevertheless, Slovenia managed to overcome the crisis without recourse to international financial assistance. Moreover, it is far from clear how Slovenia would have weathered the crisis outside rather than within monetary union. In fact, participation in the euro area eliminated the risk of a currency crisis, and access to ECB liquidity during the financial crisis helped the Slovenian banking sector stay afloat.[13]

At the same time, some CESEE countries that had retained their national currencies also performed comparatively or even exceptionally well during the past decade, namely the Czech Republic and Poland – the latter being the only EU Member State that sailed through the financial crisis without experiencing a recession.

1.3 Nominal convergence – state of play

While the 2010 convergence reports of the ECB and the European Commission had clearly shown the fallout from the financial crisis, not least in terms of fiscal developments and long-term interest rates, subsequent convergence reports have documented notable progress of non-euro area EU Member States with respect to nominal convergence. Inflation convergence improved, especially from 2014 onward. Long-term interest rate convergence advanced as well.[14] Moreover, fiscal positions have strengthened, and, since 2017, none of the countries have been subject to an excessive deficit procedure.[15] As a consequence of prior accessions to the euro area, participation in ERM II, a precondition for euro area accession, has been down to one country since 2015, namely Denmark (which, however, has an opt-out from joining the euro area). Thus, no further non-euro area EU Member State has been in the position to meet this element of the convergence criteria since then. In recent years, non-euro area CESEE EU Member States have continued operating diverse exchange rate regimes, encompassing a currency board (Bulgaria), a tightly managed float (Croatia) and more flexible, though not always fully freely floating exchange rate regimes (Czech Republic, Hungary, Poland, Romania). Accordingly, exchange rate trends and volatility have been diverse.

[12] *For an overview on catching-up and convergence in the EU, see e.g. Ridao-Cano and Bodewig (2018).*

[13] *The Slovenian banking sector was mostly domestically owned at the time. Thus, access to parent bank funding (which was stabilized under the Vienna Initiative 1.0 in the year 2009) was limited to a few smaller banks. Hence, ECB refinancing was all the more important during the crisis years.*

[14] *In spite of the progress in overall terms, compliance with the reference values of inflation and long-term interest rates was somewhat less comprehensive in 2018 compared with 2016. In 2018, inflation was – moderately – above the reference value in two countries (2016: one country), and two countries did not meet the interest rate reference value, one of them by a small margin (compared to none in 2016).*

[15] *However, Romania's fiscal position has worsened in recent years, despite buoyant GDP growth, and since mid-2017, the country has been subject to a significant deviation procedure under the preventive arm of the Stability and Growth Pact. In June 2018 (and thus after the release of the 2018 convergence reports), such a procedure was also opened for Hungary.*

Table 1 provides an overview as to the performance of non-euro area CESEE EU Member States regarding the convergence criteria as of spring 2018 (i.e. based on the data underlying the most recent ECB and European Commission convergence assessments).

Table 1

The convergence criteria and the CESEE EU Member States in the 2018 Convergence Reports

	HICP	Long-term interest rates	EDP going on	Fiscal balance		Public debt		ERM II participation
	April 2017 to March 2018 vs. April 2016 to March 2017	April 2017 to March 2018		2016	2017	2016	2017	
	%	%		*% of GDP*		*% of GDP*		
Reference value	1.9	3.2		–3.0	–3.0	60.0	60.0	
Bulgaria	**1.4**	**1.4**	**no**	0.2	0.9	29.0	25.4	no
Croatia	**1.3**	**2.6**	**no**	–0.9	0.8	80.6	78.0	no
Czech Republic	2.2	**1.3**	**no**	0.7	1.6	36.8	34.6	no
Hungary	2.2	**2.7**	**no**	–1.7	–2.0	76.0	73.6	no
Poland	**1.4**	3.3	**no**	–2.3	–1.7	54.2	50.6	no
Romania	**1.9**	4.1	**no**	–3.0	–2.9	37.4	35.0	no
Memo items:								
Euro area	1.4	1.1		–1.5	–0.9	89.0	86.7	

Source: Eurostat.

Note: Bold letters indicate that the citerion was numerically met at the given time. The table does not capture sustainability issues, the full spectrum of exchange rate stability or aspects of legal convergence.

The Treaty on European Union requires a high degree of sustainable economic convergence as a precondition for euro area entry. In other words, countries must meet the convergence criteria on a lasting basis. Therefore, achievements in the area of nominal convergence need to be adequately underpinned by real and institutional conditions as well as by policies that ensure a smooth participation in a currency union.[16]

In its convergence reports, the ECB in particular reviews the sustainability of inflation convergence over the longer term as well as fiscal sustainability risks, the latter based on the European Commission's Debt Sustainability Monitor. In a nutshell, the 2018 report finds risk to inflation convergence to be most pronounced in Bulgaria and Romania,[17] while fiscal sustainability risks are seen to be diverse across countries.

The next enlargement of the euro area is at least a few years away based on current (non)participation in ERM II and the sequence that is implied by the convergence criteria. To achieve a positive convergence assessment, a country must participate in ERM II for at least two years without any devaluation against the euro and without severe tensions. Though not subject to formal preconditions, apart from the need to agree on a central rate of the joining currency vis-à-vis the

[16] *Thus, the economic convergence assessment extends far beyond nominal convergence. For details see ECB (2018), p. 46 and, relatedly, pp. 51ff (section 3.5 on "Other relevant factors").*

[17] *The report notes that the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, unless this is counteracted by an appreciation of the nominal exchange rate.*

euro, ERM II entry is preceded by a consensus-building process of all stakeholders involved to ensure that subsequent participation in the mechanism is smooth.[18] To this end, major policy adjustments need to be undertaken prior to ERM II entry and fiscal policy has to be on a credible consolidation path. Participation in ERM II must be compatible with other elements of the overall policy framework, in particular with monetary, fiscal and structural policies.[19]

Also, the fulfillment of the inflation criterion might become more challenging again in the future. While CESEE EU Member States recorded low and sometimes even negative inflation rates in the last few years, the sustained upswing and increasing energy prices have recently led to a pickup in inflation. Should growth stay buoyant in CESEE EU Member States,[20] with output gaps becoming (more) positive, it remains to be seen how inflation will develop, in particular relative to EU peers and thus relative to the reference value for inflation in the convergence assessment.

2 Views of non-euro area CESEE Member States on euro area accession

In the following, we roughly outline the approaches the authorities in non-euro area CESEE EU Member States have recently taken to future euro area accession. Overall, a rather heterogeneous picture emerges.

Bulgaria and Croatia have expressed their intention to advance toward closer monetary integration with the euro area and ultimately full participation in monetary union. The Bulgarian authorities have declared their firm intention to apply for ERM II entry by July 2019. The ERM II stakeholders, in July 2018, outlined the process that is to lead to Bulgaria's future joining of the exchange rate mechanism (see section 4).[21] The Croatian National Bank, in turn, has presented a euro adoption strategy approved by the government in May 2018.[22] It is noteworthy that the strategy does not include a target date for Croatia's ERM II accession or adoption of the euro. The country's minister of economic affairs stated in May 2018 that the process leading to euro area accession might take five to seven years. Romanian authorities remain committed to joining the euro area at some future point in time, "but the setting of a firm [target] date … implies the realization of in-depth analyses, especially with regard to real, structural and institutional convergence, fields in which important progress is necessary," alongside sustainable fulfillment of the nominal convergence criteria.[23]

The Czech Republic, Hungary and Poland are currently not eager to embark on a closer monetary integration with the euro area. The authorities hold that their countries are, for the time being, well served by monetary autonomy and exchange rate flexibility. The Czech Republic applies an annual review process in which the finance ministry and the central bank jointly assess the country's readiness to join the euro area. According to the most recent review released in late 2017,

[18] *See the European Council (1997).*

[19] *ECB (2003).*

[20] *All major forecasts currently project growth in CESEE EU Member States to remain dynamic, albeit with increasing downside risks (see e.g. the OeNB-BOFIT forecast in Focus on European Economic Integration Q2/2018).*

[21] *Council of the European Union – Eurogroup (2018).*

[22] *Government of the Republic of Croatia and Croatian National Bank (2018).*

[23] *Government of Romania (2018).*

the preparedness of the Czech Republic "to adopt the euro has improved further compared to previous years, although some shortcomings persist, especially as regards incomplete real convergence." At the same time, the document holds that "the economic situation in the euro area cannot be assessed as sufficiently stabilized. Economic alignment across the euro area economies is not adequate either, despite having increased in comparison to last year. Debt and structural problems remain unresolved in a number of countries, regardless of problematic observance and enforceability of the fiscal rules. Another problem facing the EU and the euro area is the increasing uncertainty about their future institutional setup."[24]

Both incomplete "real" convergence at home and unresolved issues in the euro area have also been cited by Hungarian and Polish policymakers, when addressing the issue of euro area accession of their countries.[25] The Hungarian authorities, in particular, have stressed that they regard far-reaching income per capita convergence as well as further progress in other economic areas as preconditions for a smooth participation in the single currency area.[26] Polish authorities have emphasized that they will consider adopting the euro only once euro area reforms have been completed. Moreover, in their view, strong economic arguments – e.g. substantial further advances with "real" convergence of the Polish economy – must support such a decision.[27]

3 How the crisis impacted on convergence assessments

The onset of the financial crisis brought about a number of major and unprecedented developments. As of 2010, new elements were consequently included in the convergence reports. On the one hand, some of the CESEE EU members subject to the convergence reports had to take recourse to IMF or joint EU-IMF balance of payments support facilities and/or some forms of precautionary assistance. On the other hand, practically all EU Member States faced exceptional economic circumstances due to the crisis, which had an impact on the calculation of some reference values. As a case in point, a number of EU Member States recorded negative inflation rates, which produced historically low reference values for the price stability criterion.[28] Against this background, the definition of "outliers" for the

[24] *See the Ministry of Finance of the Czech Republic and Czech National Bank (2017). This position is repeated in the Czech Republic's 2018 Convergence Programme, which also states that against this background the government will not seek to enter ERM II in 2018 (Ministry of Finance Czech Republic, 2018).*

[25] *See e.g. Republic of Poland (2018).*

[26] *See e.g. the interview with MNB Governor Matolcsy in the Frankfurter Allgemeine Zeitung, November 9, 2016, who reckons that full per capita income convergence of Hungary to the euro area average could take 15 to 20 years, linking this explicitly to the timeline for Hungary to join the euro area. Apart from income per capita, Hungarian authorities see wage levels, labor market conditions, productivity, financial integration, business cycle synchronization and the competitive position to be of key relevance for a smooth participation in monetary union. Moreover, they hold that the fiscal position should be stronger than prescribed by the respective convergence criteria (see the speech of MNB Vice Governor Nagy, Budapest Business Journal, September 7, 2017, https://bbj.hu/economy/hungary-needs-new-euro-criteria-says-mnb-deputy-gov_138341).*

[27] *See e.g. Central European Financial Observer, January 4, 2018 (https://financialobserver.eu/recent-news/polands-pm-morawiecki-says-euro-adoption-is-not-under-consideration/) or Emerging Europe, October 13, 2017 (http://emerging-europe.com/in-brief/poland-stays-cool-euro-adoption/). Riedel (2017) notes that official views in Poland on euro adoption have become much more hesitant over time and relates this shift mainly to changes in public opinion about the EU and monetary integration since the crisis.*

[28] *For an overview of inflation reference values in all convergence reports from 1998 to 2018, see European Commission (2018, p. 29).*

calculation of reference values – which originally had been designed for very few exceptional cases – had to be applied more often during the crisis years.[29]

3.1 Balance of payments support and other support measures as reflected in the convergence reports

In its Convergence Report 2010, the ECB for the first time analyzed, under the exchange rate criterion, whether a country had benefitted from balance of payments support or central bank liquidity assistance, and whether this support had helped reduce exchange rate pressures.[30] In this context, a rather comprehensive approach was applied, as all forms of support – bilateral loans and loans from international institutions, and both actual and precautionary assistance – were taken into account, thus including access to precautionary financing, such as the IMF's Flexible Credit Line. In a similar vein, the European Commission took note of balance of payment support programs mentioning them under "additional factors" in the country chapters of its Convergence Report 2010.[31]

In particular, at the time of the 2010 convergence assessment, Hungary, Latvia and Romania had received financial balance of payments support, inter alia, from the IMF and the EU. Hungary, Latvia and Poland had benefitted from different forms of central bank liquidity assistance. Consequently, each country chapter of the ECB Convergence Report 2010 referred to these support programs in the context of the examination of the exchange rate criterion, in particular of the existence of severe tensions.[32]

3.2 Numerical development of reference values and definition of outliers during the crisis

A number of EU Member States registered very low and even negative inflation rates during the crisis, which resulted in historically low reference values for convergence assessments. As a case in point, in 2010, the three best performers in terms of price stability[33] were countries with negative inflation rates. In line with the price stability criterion defined in Article 140(1) of the TFEU, this translated into an unprecedentedly low reference value for HICP inflation. The convergence reports of 2010 and 2016 applied very low reference values for price stability, even though a few outliers had been excluded from the calculation[34].

At the same time, the definition of outliers for calculating the price stability criterion gained a new dimension. In pre-crisis years, namely in 2004, Lithuania

[29] *According to the ECB's convergence reports, an outlier country is defined as follows: "first, its 12-month average inflation rate is significantly below the comparable rates in other Member States and, second, its price developments have been strongly affected by exceptional factors" (ECB, 2010, p. 9).*

[30] *ECB (2010, p. 13).*

[31] *European Commission (2010), e.g. on Latvia (p. 17), on Romania (p. 27), on Hungary (p. 145).*

[32] *For details on Hungary, see ECB (2010), country summary (p. 48) and detailed country chapter (p. 154). On Latvia, see ECB (2010), country summary (p. 45) and detailed country chapter (p. 116). On Romania, see ECB (2010), country summary (p. 51) and detailed country chapter (p. 189) and ECB (2012), country summary (p. 62) and detailed country chapter (p. 182), ECB (2016, p. 128). For Poland, see ECB (2010), country summary (p. 50) and detailed country chapter (p. 171).*

[33] *Clarifying Art. 140(1) of the TFEU (Treaty on the Functioning of the European Union), Protocol No 13 stipulates that "[...] a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability."*

[34] *See the overview table in European Commission (2018, p. 29).*

was the only Member State whose inflation rate was identified as an outlier "due to the accumulation of specific factors." The Lithuanian inflation rate was therefore excluded from the calculation of the reference value for price stability, as "it might otherwise have […] reduced the usefulness of the reference value as an economically meaningful benchmark."[35] By contrast, after the start of crisis, almost every convergence report identified outliers for the calculation of the reference value for price stability.[36]

Outliers were also identified for calculating the criterion of long-term interest rates[37].

4 EMU reform measures as reflected in the convergence reports

In response to the financial crisis, the EU took a wide range of measures to address weaknesses in the EU's economic governance that had been revealed by the crisis with a view to becoming more resilient. In particular, a legislative package to strengthen the Stability and Growth Pact, known as the "Six Pack," entered into force in December 2011. Furthermore, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), formally concluded on March 2, 2012, became applicable on January 1, 2013. These legislative measures strengthened fiscal surveillance for all EU Member States and established a macroeconomic imbalance procedure (MIP).

4.1 Strengthened economic governance in the EU as reflected in the convergence reports

As these strengthened rules were applied to all EU members in the context of the European Semester, they also found their reflection in subsequent convergence reports. Consequently, as of 2012, the ECB as well as the European Commission's Convergence Reports extended their analysis of public finances to these new fiscal rules.[38]

The ECB Convergence Report 2012 for the first time included a presentation of the MIP for all countries covered under "other relevant factors," thereby "ensuring the provision of all available information relevant to the detection of macroeconomic imbalances that may be hampering the achievement of a high degree of sustainable convergence as stipulated by Article 140(1) of the Treaty."[39] The same report also clarified the implications of the MIP for the fulfillment of the convergence criteria: "[…] EU Member States with a derogation that are subject to an excessive imbalance procedure can hardly be considered as having achieved a high degree of sustainable convergence as stipulated by Article 140(1) of the Treaty."[40] This sentence has been repeated in all subsequent ECB Convergence Reports. Similarly, the European Commission's Convergence Report 2012 outlined the key

[35] *ECB (2004, p. 8).*

[36] *Outliers were defined as follows: 2004: Lithuania, 2010: Ireland, 2013: Greece, 2014: Greece, Bulgaria, Cyprus, 2016: Cyprus, Romania.*

[37] *In 2010, Estonia, while being among the three best-performing Member States in terms of price stability, was excluded from the calculation of the interest rate criterion because of the absence of a harmonized long-term interest rate. This was, however, not related to the crisis (see section 1 and ECB, 2010, p. 14). In 2012, Ireland was identified as an outlier for the interest rate criterion for crisis-related reasons.*

[38] *ECB (2012, p. 11ff.) or, for instance, European Commission (2016, p. 30).*

[39] *ECB (2012, p. 18).*

[40] *ECB (2012, p. 18).*

features and results of the then newly established MIP,[41] presenting the individual country results under "additional factors" at the end of the respective country chapters. The European Commission has taken this approach also in its subsequent convergence reports.[42]

4.2 The establishment of the banking union and its reflection in the convergence reports

Another very important response to the financial crisis, and in particular to the euro area sovereign debt crisis, was the creation of the banking union. Its first pillar, the Single Supervisory Mechanism (SSM), entered into force on November 4, 2014, for all euro area countries. As a consequence of the establishment of the SSM, euro area entry has got an additional dimension: New entrants into the euro area automatically become full members of the SSM, with all rights and obligations.[43]

Under the SSM, the ECB, together with the national competent authorities (NCAs), directly supervises all credit institutions classified as significant, around 120 banking groups across the euro area. While Joint Supervisory Teams comprising staff from the respective NCAs and the ECB are responsible for the ongoing supervision of significant institutions, the NCAs continue to directly supervise less significant institutions. Joining the SSM implies thorough preparation and thus considerable lead time both for the national supervisory authorities and for the supervised entities. As a case in point, before the SSM became fully operational, all banks initially identified as significant were subject to a comprehensive assessment by the ECB with close involvement of the national supervisory authorities. This mandatory assessment was conducted for all euro area members from November 2013 to October 2014 and comprised an asset quality review based on year-end 2013 data and a stress test covering the years 2014 to 2016[44].

Consequently, the ECB Convergence Report 2014, and the subsequent 2016 and 2018 reports, emphasize that "It is, therefore, of utmost importance that the necessary preparations are made. In particular, the banking system of any Member State joining the euro area, and therefore the SSM, will be subject to a comprehensive assessment."[45] This was already the case with Lithuania before it joined the euro area. Furthermore, under "other relevant factors," the ECB Convergence Reports 2016 and 2018 state that "financial sector policies should be aimed at ensuring that the financial sector makes a sound contribution to economic growth and price stability in the countries under review, and supervisory policies should be geared towards stabilizing the supervisory framework, which is a precondition for joining the SSM."[46]

[41] *European Commission (2012, p. 41).*

[42] *European Commission (2014, p. 39), European Commission (2016, p. 34) and European Commission (2018, p. 34). The excessive imbalance procedure is an enhanced surveillance mechanism to ensure compliance with the MIP. It can be activated for countries for which excessive imbalances have been identified.*

[43] *Furthermore, Bulgaria will also participate in the Single Resolution Mechanism (SRM), the second pillar of the banking union, upon entry into force of SSM close cooperation (see Council of the European Union – Eurogroup, 2018). The same will eventually also be the case for the European Deposit Insurance Scheme (EDIS).*

[44] *OeNB (2014, p. 31).*

[45] *ECB (2018, p. 4), ECB (2016, p. 4) and, similarly, ECB (2014b, p. 5). In this context, an important distinction has to be made between (1) references to the SSM made in the convergence reports, which are published under Art. 140 TFEU, and (2) the formal process to enter ERM II, which is not based on the Treaty, but on the Resolution of the European Council of 16 June 1997.*

[46] *ECB (2018, p. 54), and ECB (2016, p. 53).*

While SSM membership per se is not a formal criterion for euro adoption, this is simply due to the fact that the SSM had not been in place at the time when the Maastricht criteria were designed. Establishing participation in the SSM requires careful preparations in three dimensions: (1) adopting the relevant legal framework, (2) providing for convergence of supervisory approaches and (3) ensuring that banks are sound by undertaking a comprehensive assessment of the sector. Article 7 of the SSM Regulation provides for the possibility of close cooperation of non-euro area Member States with the SSM. This stepping stone to full SSM membership is the most appropriate framework for a country to timely and comprehensively prepare for full participation in the SSM upon euro adoption. Detailed provisions on the SSM close cooperation are laid down in a decision by the ECB (2014a).

Responding to Bulgaria's intention to join the exchange rate mechanism, which would be the first ERM II entry after the crisis and the ensuing deepening of EMU, the ERM II stakeholders made it more specific in their public statement of July 12, 2018, how ERM II participation and close cooperation interrelate.[47] In particular, they spelled out that a positive assessment on ERM II entry is linked to a positive ECB decision on close cooperation with the SSM. This implies that Bulgaria applies in due time for SSM close cooperation with a view to entering into this cooperation when it starts participating in ERM II. This is to ensure that Bulgaria, including its financial sector and its supervisory authorities, are adequately prepared for full membership in the SSM by the time the country adopts the euro.

The Bulgarian authorities have moreover committed to fulfilling other policy measures before simultaneously entering ERM II and banking union. Apart from close supervisory cooperation with the ECB, these commitments also include strengthening the macroprudential and insolvency frameworks as well as nonbanking supervision, and specific measures to fight money laundering and improve the governance of state-owned enterprises. Improvements are likewise expected in the anti-corruption and judiciary spheres, as part of the Schengen process. Moreover, once it joins ERM II, Bulgaria is expected to take additional commitments aimed at ensuring sustainable economic convergence by the time the country will adopt the euro.

As to the envisaged timeline, the statement of July 12, 2018, reads as follows: "The ECB could be expected to conclude its comprehensive assessment within approximately one year after Bulgaria's formal application for close cooperation, and its decision may make the start date of close cooperation conditional on Bulgaria's progress in implementing the possible measures required in relation to the results of the comprehensive assessment."[48] In other words, should the comprehensive assessment indicate that Bulgaria needs to take follow-up measures, such measures would need to be implemented after completion of the comprehensive assessment and reviewed as well. Only then can a positive decision on Bulgaria's close cooperation with the SSM, and hence also on its participation in ERM II, be taken.

This approach to Bulgaria which was mutually agreed upon by the ERM II stakeholders provides clear guidance for future cases of non euro-area EU Member States intending to enter the exchange rate mechanism and subsequently the euro

[47] *Council of the European Union – Eurogroup (2018).*

[48] *Council of the European Union – Eurogroup (2018). For further reference, see ECB (2014a).*

area: "In the future, we expect to follow a similar approach to Member States wishing to join ERM II, in line with the principle of equal treatment." On the one hand, this approach fully accounts for the relevance of the banking union for future euro area entrants. On the other hand, it considerably improves the prospects for a smooth participation in ERM II, as it minimizes financial stability risks in participating countries early on.

5 Conclusions and outlook

The setting in which monetary integration of CESEE EU Member States is taking place has changed profoundly in the current decade. Experience from the crisis has sharpened policymakers' views in both the incumbent euro area and non-euro area Member States on what it takes for individual countries to participate smoothly in a monetary union. At the same time, lessons drawn from the crisis have substantially transformed the institutional setup of EMU itself, which has affected the euro area accession process and will continue to do so.

A credible and sustainable fulfillment of the economic convergence criteria is crucial for future euro area enlargements. Beyond compliance with the numerical Maastricht criteria, strong emphasis is also put on the "other relevant factors" set out explicitly in the Treaty. Important further aspects are policy discipline, quality of institutions, governance, alignment (both cyclical and structural) and an economy's adjustment capabilities as they support the sustainability of convergence and economic performance in a monetary union. Institutional reform of EMU, in particular the creation of the SSM, has added a new dimension to the euro area enlargement process. Since November 2014, a country's euro adoption automatically implies full membership in the SSM, with all rights and obligations, a step that needs to be thoroughly prepared by all stakeholders and which therefore has considerable lead times.

Looking ahead, the next enlargement of the euro area is at least a few years away given current (non-)participation in ERM II and the sequence implied by the convergence criteria. Moreover, prospective euro area members are subject to new preparatory requirements for participation in the SSM.

Against this background, it will remain key to strike a balance between, on the one hand, lessons drawn from the crisis and, on the other hand, the principle of equal treatment, which applies during the entire process of monetary integration,[49] as was done by the ERM II stakeholders on July 12, 2018. Given that EMU is dynamic in nature, as set out, for example, in Article 3.4 of the Treaty on European Union, the principle of equal treatment needs to take into account the stage of institutional development of EMU at any point in time. The name of the game in an advancing environment is an even-handed application of this principle, which combines continuity with a careful and well-grounded integration of the lessons from the past and the institutional reforms that have resulted as a consequence, for the mutual benefit of all stakeholders in the process.

[49] *ECB (2003).*

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