

Discretion lets Croatia in the euro area in 2023, but leaves Bulgaria out*

Abstract

This article – written originally as a blog post for the think tank Bruegel – reviews the decisions made in June 2022 to allow Croatia into the euro zone but, in contrast, to make no change in the status of Bulgaria which, nominally, thus remains an EU Member State with a derogation from introducing the euro but one subject to complying with the requirements to allow it to do so. The author notes that, while the Bulgarian legislation on central bank independence remains an outstanding issue, there are other aspects of the decision to allow Croatia in but to refuse Bulgaria which cause disquiet. In reviewing price stability statistics on the basis of different measures, the author concludes that these indicate a level of decision-making discretion, creating a grey area in the criterion, as well as uncertainty over how comparative inflation performance is judged and a level of dubiety. He concludes that a rethink is necessary on how to interpret 'best performers' and that the time is right to fix the flaws in the existing criterion by switching to comparators which are closest to the average for the euro area as a whole.

Keywords: euro area, Croatia, Bulgaria, European Commission, European Central Bank, price stability

Introduction

On 17 June 2022, the euro area's finance ministers endorsed Croatia's euro membership, based on assessments by the European Commission (2022) and the European Central Bank (ECB) (2022). Both institutions concluded that Croatia had fulfilled the conditions for the adoption of the euro. They also judged that another candidate, Bulgaria, had not.

To join the euro, countries should meet criteria on price stability, having sound and sustainable public finances, low long-term interest rates and exchange rate stability. Their laws should also provide for central bank independence. While Croatia was considered to have met the necessary conditions, Bulgaria fell short on price stability and incompatible central bank legislation. But Croatia would also have fallen

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short on price stability without a discretionary adjustment – related to the choice of comparison countries – being made to the assessment.

It should be noted that, from the perspective of macroeconomic development and adjustment capacity under a fixed exchange rate, both countries are ready to enter the euro area.

Bulgaria's performance has been especially stunning: under a fixed exchange rate, the country corrected its current account deficit of close to 22 per cent of GDP in 2008 to a close-to-balance position by 2010. Between then and 2021, a small surplus was maintained on average. The global financial crisis of 2007-08 was followed by robust economic growth and Bulgaria's export performance was similar or even better than floating-rate Czechia, Hungary and Poland, all of which benefited from substantial exchange rate depreciation after 2008. Bulgaria's gross public debt was 25 per cent of GDP in 2021, the third-lowest value in the EU after Estonia and Luxembourg.

Croatia, meanwhile, had a harder time adjusting after the global financial and euro crises but ultimately did so under a tightly managed exchange rate regime. This is encouraging for the country's performance inside the euro area.

Before joining the exchange rate mechanism (ERM II), both Bulgaria and Croatia had to fulfil various requirements, including governance reforms, and both the European Commission and the ECB assessed that Bulgaria and Croatia had properly implemented these reforms. Both countries have integrated into the Single Supervisory Mechanism since their entry in 2020 and their banking systems are strong.

One might welcome the decisions of the European Commission and the ECB to exploit the grey area in the interpretation of the price stability criterion to allow Croatia to join in 2023. But this should not have been done in a way that prevented Bulgaria from joining (conditional on fixing its central bank legislation issues). This episode highlights again the need to re-think the interpretation of the price stability criterion so that it can be applied consistently without the need for discretionary adjustments.

In this article, I review the Commission's and the ECB's justification for excluding two countries from the calculation of the price stability criterion and examine what the consequences of the alternative choices would have been.

How did Croatia benefit and Bulgaria lose out?

Article 140(1) of the Treaty on the Functioning of the EU (TFEU) requires price stability to be measured by comparing the inflation rate in the euro candidate country with that in 'the three best performing Member States in terms of price stability'. For Croatia and Bulgaria, the Commission and ECB dropped two of the comparison countries that would normally be considered best performers, replacing them with countries with higher inflation rates.

TFEU does not define the concept of 'best performing Member States in terms of price stability', leaving room for interpretation. The Commission and the ECB define this concept as those countries with the lowest inflation rates, with occasional discretionary adjustments. Neither the Commission nor the ECB provide any justification for this choice.

For the ECB, considering the lowest inflation countries as the best performers is highly problematic. The ECB defines price stability as an inflation rate of two per cent for its monetary policy framework. It thus uses a different definition of price stability for its monetary policy objective (two per cent) to that used for assessing suitability for euro membership (lowest inflation rates). The ECB only states that:

The price stability criterion thus takes into account the fact that common shocks (stemming, for example, from global commodity prices) can temporarily drive inflation rates away from central banks' targets. (European Central Bank 2022: 7)

This leaves the definition of price stability for euro membership assessment rather unclear.

Two questions emerge:

- do the lowest inflation rates correspond to 'best' performance?
- on what basis are discretionary adjustments made?

A level of inflation that is too low entails risks. Since price stability is the ECB's primary objective, and the ECB has quantified this concept as an inflation rate of two per cent, it is hard to argue that the countries with the lowest inflation rates are the best performers in terms of price stability. Instead, considering the best performers to be the three countries with inflation closest to the ECB's two per cent target would be an unambiguous definition in line with the provisions of the Treaty.

An alternative would be to measure euro area candidates against the three countries with inflation rates which are closest to the euro area average. The euro area average is what the ECB is able to achieve when pursuing its price stability mandate, under the specific economic circumstances of the time. Euro aspirant countries have close economic ties with the euro area and are influenced by macroeconomic developments in the euro area, including inflation. Again, this definition would be unambiguous, not necessitating any ad hoc adjustment.

Discretionary adjustments to the selection of best performers

The April 2022 inflation data, used for the Commission's and the ECB's assessment, indicated that the three countries with the lowest all-items inflation rates were Malta (2.1 per cent), Portugal (2.6 per cent) and France (3.2 per cent) (Table 1), giving an average of 2.6 per cent.

In assessing price stability, the EU Treaty gives a leeway of 1.5 percentage points by which inflation rates in euro candidate countries can exceed the average rate of the best performers. So the application of the previous practice of the Commission and the ECB would have resulted in an inflation reference value of 4.1 per cent (i.e. $2.6 + 1.5$). This would have stopped both Croatia (4.7 per cent) and Bulgaria (5.9 per cent) from joining the euro area in 2023.

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), meaning Croatia squeezed in.

Table 1 – The ten EU countries with the lowest inflation rates, plus Bulgaria, Croatia and the average for the euro area, April 2022 (12-month moving average rate of change, %)

Country	All-items index
Malta	2.1
Portugal	2.6
France	3.2
Finland	3.3
Greece	3.6
Denmark	3.6
Italy	3.7
Sweden	3.7
Austria	4.2
Slovenia	4.2
Euro area	4.4
Croatia	4.7
Bulgaria	5.9

Source (for all tables in this article): Bruegel, based on Eurostat's HCIP monthly data (12-month moving average rate of change) [prc_hicp_mv12r] dataset

Malta and Portugal were excluded because they were considered outliers. The Commission and the ECB used almost the same words for this decision, so I quote the Commission's report. The Commission said that the inflation rates of Malta and Portugal were 'substantially below the euro area average' and there were 'country-specific factors that cannot be seen as representative of the process driving inflation in the euro area' (European Commission 2022: 4). For Malta, the country-specific factor was the absence of energy-price inflation, which was a result of government measures. For Portugal, the country-specific factors were:

comparatively low energy inflation and the weaker cyclical position of the country compared with most other EU Member States. (European Commission 2022: 4)

The slow recovery from the Covid-19 crisis:

reflects mainly Portugal's large exposure to tourism and particularly aviation-based tourism, which has been heavily and durably hit by the pandemic. (European Commission 2022: 4)

This raises three issues.

First, the exclusion of any country from the calculation is based on a discretionary decision, because TFEU does not provide any guidance on excluding certain countries.

Second, the Commission's justification refers on multiple occasions to average inflation in the euro area and also refers to a comparison with other Member States. This undermines the rationale for considering the three countries with the lowest inflation rates as the best performers in terms of price stability. Instead, the Commission's justification would actually be consistent with treating as the best performers those three countries in which inflation is closest to the average for the euro area. For the current exercise, that would be Cyprus (4.4 per cent), Ireland (4.5 per cent) and either Austria or Slovenia (both 4.2 per cent), resulting in a reference value of 5.9 per cent, which would have allowed Bulgaria to join the euro area from 2023 (again, provided that central bank law issues had been fixed).

Third, the justifications used to exclude Malta and Portugal could have been used to exclude Finland, France and Greece – the countries that were used – as well (indeed, arguments could also be made for other countries). We explore this issue in detail in the rest of this section, with reference to different measures of price rises.

1. Energy prices grew 13.7 per cent in Portugal, 18.3 per cent in Finland and 18.8 per cent in France, while the euro area average was 24.7 per cent (Table 2). Thus, there was also a sizeable gap between the euro area average and Finland and France. In Croatia, Czechia, Hungary, Malta and Slovakia, energy prices increased less than in Portugal, so the Portuguese energy price increase is not really an outlier.

Table 2 – The ten EU countries with the lowest energy inflation rates, plus the average for the euro area, April 2022 (12-month moving average rate of change, %)

Country	Energy index
Malta	-0.4
Slovakia	6.8
Czechia	12.1
Hungary	13.2
Croatia	13.5
Portugal	13.7
Slovenia	17.8
Poland	18.2
Finland	18.3
France	18.8
Bulgaria	20.4
Euro area	24.7

2. since an important concern was too-low energy price inflation, the overall index excluding energy could have been used (Table 3), leading to Greece and Italy (both 1.3 per cent) and either France or Portugal (both 1.7 per cent) being seen as the three best performers, giving a reference value therefore of 2.9 per cent. In this case, neither Croatia (3.4 per cent) nor Bulgaria (3.9 per cent) would have qualified to enter the euro area.

Table 3 – The ten EU countries with the lowest non-energy inflation rates, plus Bulgaria, Croatia and the average for the euro area, April 2022 (12-month moving average rate of change, %)

Country	All-items index excluding energy
Greece	1.3
Italy	1.3
France	1.7
Portugal	1.7
Denmark	1.9
Finland	1.9
Spain	2.0
Sweden	2.0
Belgium	2.1
Euro area	2.2
Luxembourg	2.2
Netherlands	2.2
Croatia	3.4
Bulgaria	3.9

3. the third lowest increase in food prices among EU countries was France (1.4 per cent) and the fourth lowest increase was in Finland (2.0 per cent) while the euro area average was 2.9 per cent (Table 4). Thus, one could argue here that unusually low growth in food prices could have justified the exclusion of France and Finland.

Table 4 – The ten EU countries with the lowest food price inflation, plus Bulgaria, Croatia and the average for the euro area, April 2022 (12-month moving average rate of change, %)

Country	Food and non-alcoholic beverages index
Belgium	1.0
Ireland	1.2
France	1.4
Finland	2.0
Luxembourg	2.0
Netherlands	2.0
Sweden	2.0
Italy	2.3
Slovenia	2.3
Denmark	2.5
Euro area	2.9
Croatia	5.6
Bulgaria	7.7

4. the price stability criterion could reasonably have been assessed based on the overall index excluding energy, food, alcohol and tobacco – in other words, core inflation (Table 5). By excluding these volatile items, core inflation better reflects underlying price developments. The three countries with the lowest core inflation rates were Greece (0.4 per cent), Italy (1.1 per cent) and Portugal (1.4 per cent), with an average of one per cent, leading to a reference value of 2.5 per cent. Here, Croatia (2.5 per cent) would have just qualified to enter the euro area while Bulgaria (2.6 per cent) would have missed it by a sliver. But, if both Greece and Portugal were excluded because of their weak cyclical positions (see next point), then both Croatia and Bulgaria would have qualified for the euro by a good margin. Moreover, if the three countries with inflation rates closest to the euro area average (2.1 per cent) were the best performers, then both Bulgaria and Croatia would be in, again by a large margin.

Table 5 – The ten EU countries with the lowest non-volatile inflation rates, plus Bulgaria, Croatia and the average for the euro area, April 2022 (12-month moving average rate of change, %)

Country	All-items index excluding energy, food, alcohol and tobacco
Greece	0.4
Italy	1.1
Portugal	1.4
Spain	1.5
Denmark	1.6
Finland	1.6
France	1.8
Belgium	2.0
Malta	2.0
Euro area	2.1
Sweden	2.1
Croatia	2.5
Bulgaria	2.6

- in terms of the weak recovery argument for Portugal, the latest Commission estimate puts the output gap at -3.3 per cent in 2021 and +0.3 per cent in 2022. But Greek output gap estimates are much lower: -5.3 per cent in 2021 and -2.4 per cent in 2022. Thus, the weak recovery argument would have applied more strongly to Greece than to Portugal yet, while Portugal was excluded from the calculations, Greece was included as among the three best performers on price stability.

Gaming the system?

The inflation criterion is assessed over a one-year period. Euro candidate countries might be tempted to resort to techniques such as freezing administered prices or reducing consumption taxes to squeeze in under the reference value: what has been called ‘weighing-in syndrome’ (Szapáry 2001: 12ff). This could be followed with a reversal of such measures after a country has joined the euro. Of the first eleven countries that joined the euro area in 1999, all met the inflation criterion in 1997 and 1998, but six failed to meet it in 2000. Similarly large violations occurred in later years.

Whether the intention was to help energy consumers or to foster euro introduction, Croatia has also resorted to such techniques. The ECB noted that:

The rise in HICP inflation was mitigated by fiscal measures (some temporary), such as reduced VAT rates for gas, electricity and basic groceries, cuts in fuel excise duties and the freezing of margins on petroleum products. (European Central Bank 2022: 103)

However, neither the ECB nor the Commission measured the impact of such techniques. The energy price increase in Croatia (13.5 per cent) was lower than in excluded Portugal (13.7 per cent) (Table 2); while administered energy prices increased by 7.1 per cent in Croatia, the sixth lowest value in the EU and well below the euro area average of 19.5 per cent (Table 6).

Table 6 – The ten EU countries with the lowest rise in administered energy prices, plus the average for the euro area, April 2022 (12-month moving average rate of change, %)

Country	Administered energy prices
Malta	-0.4
Hungary	0.2
Slovakia	1.3
Sweden	1.6
Czechia	4.6
Croatia	7.1
Poland	8.2
Finland	9.3
Bulgaria	9.6
Romania	10.4
Spain	12.1
France	13.1
Euro area	19.5

The assessments could have considered the overall index excluding administered prices for the price stability criterion (Table 7), since government intervention in energy markets was the sole concern over the inclusion of Malta and was also an issue for Portugal. In this case, both Croatia and Bulgaria would have missed the price stability criterion if the countries with the lowest inflation rates are considered as the best performers, irrespective of whether Malta and Portugal were excluded from the calculation or not.

Table 7 – The ten EU countries with the lowest overall inflation excluding administered prices, plus Bulgaria, Croatia and the average for the euro area, April 2022 (12-month moving average rate of change, %)

Country	All-items index excluding administered prices
Malta	2.4
Portugal	2.8
Greece	2.9
France	2.9
Italy	3.0
Finland	3.2
Netherlands	3.8
Denmark	4.0
Cyprus	4.0
Slovenia	4.1
Euro area	4.3
Croatia	5.1
Bulgaria	6.4

Missing convergence report forecast in the first month

The Commission's assessment predicted that inflation in Croatia would remain below the forecast reference value by the end of 2022. This turned out to be already wrong in the first month after it was made. The ECB assessment was more cautious by not presenting a specific forecast for Croatian inflation relative to the reference value, noting instead that:

Looking ahead, there are concerns about the sustainability of inflation convergence in Croatia over the longer term. (European Central Bank 2022: 67)

The assessments used April 2022 inflation data. On 17 June 2022, one day after the Eurogroup's endorsement of Croatia's euro membership, Eurostat published detailed inflation indicators for May 2022. The countries with the lowest overall inflation rates were (again, on the basis of a 12-month moving average rate of change): Malta (2.6 per cent); Portugal (3.3 per cent); France (3.5 per cent); Finland (3.7 per cent); Sweden (4.1 per cent); Denmark and Italy (both 4.2 per cent); and Greece (4.6 per cent). The euro area average was 4.9 per cent while Croatian inflation was 5.4 per cent and Bulgarian inflation 6.8 per cent. By excluding Malta and Portugal, the reference value would have been 5.3 per cent, preventing Croatia from joining the euro area in 2023.

Croatia would thus have missed the inflation criterion by a mere 0.1 of a percentage point on the basis of the May 2022 data; yet in 2006 Lithuania's entry to the euro was rejected on the basis of the same 0.1 percentage point gap against a reference value of 2.6 per cent, drawn from inflation rates in Sweden, Finland and Poland (European Commission 2006: 8, 12). Then, Lithuania's 2.7 per cent inflation rate was close to the euro area average of 2.2 per cent. In 2006, there was a good reason to exclude Poland and Sweden from the calculation: energy price increases in Poland (6.0 per cent) and Sweden (6.9 per cent) were significantly below the euro area average (11.2 per cent); furthermore, the Polish zloty had appreciated against the euro by 8.5 per cent over the same period, which could have contributed to low inflation in general and to low energy price increases in particular. But no such exclusions were made. Not excluding even non-euro area countries with low energy price increases in 2006, but excluding two countries with low energy price increases in 2022, underlines the arbitrariness of whether a discretionary adjustment is made to the price stability reference value.

Summing up

This all shows that different adjustments – supported by arguments – could have been made to reach any of three outcomes:

1. neither Croatia nor Bulgaria had met the price stability criterion
2. only Croatia had met the criterion
3. both countries had met the criterion.

It is undesirable that the crucial decision of whether a country can join the euro area depends on such dubious discretionary decisions. It is time to rethink the interpretation of best performers as either those countries that are the closest to the ECB's two per cent inflation target or to the euro area average. The latter option would also fix some of the well-known flaws of this criterion (Darvas 2010).

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