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A Review of the Conditions of Euro Area Accession*

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Long-term Sustainability and the Euro: How to Rethink the Maastricht Criteria?
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The most recent publication of the Magyar Nemzeti Bank, a book entitled "Long-term Sustainability and the Euro: How to Rethink the Maastricht Criteria?" was presented at the Lámfalussy Lectures Conference held on 20 January 2020.[1] In his welcome speech György Matolcsy, Governor of the Magyar Nemzeti Bank, told the conference that the book was intended to stimulate dialogue in the profession about the future of the euro area and the development of a set of accession criteria facilitating a sustainable convergence process in the Member States introducing the euro. In 1992 Hungary did not have the opportunity to formulate a position on the further progress of European Union integration. Celebrating the 30th anniversary of the Maastricht Treaty two years from now, in 2022, will provide a good opportunity for the MNB to also express its opinion on a subject that is fundamental to our common future and highly important for achieving a strong Europe built on internal cohesion. The authors intend this volume to be their contribution to the ongoing debate about how to improve the functioning of the euro.

Twenty years after the introduction of the euro, it is worth taking stock of how well the single currency of the euro area has worked in practice; after all, the euro has been the most ambitious project in the entire economic history of Europe. Besides, a well-functioning euro is also highly important for Hungary, which made a commitment when joining the European Union in 2004 that it would introduce the euro at some later date, once it will comply with the relevant conditions, i.e. the Maastricht criteria. Significant changes have taken place in the last two decades as the global economy has become multi-polar; this crisis-laden period

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* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

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[1] The online version of the book is available at the following link: https://www.mnb.hu/letoltes/longtermsustainabilityandtheeuro-1.pdf

has highlighted problems concerning the functioning of the economies and the financial systems of the euro area. It is clear that the introduction of the euro was not merely a financial matter; there were primary political and of course economic motivations behind that decision. The introduction of the single currency was the outcome of attempts and adjustments to fix exchange rates, combined with the institutional ideas prevalent in economic thought at the time. The book evaluates these lessons and examines the underlying doctrine to understand the euro and the institutional and economic frameworks behind it, with a special focus on Hungary's euro maturity.

In Chapter 1 of the book (*'From birth to the present - the first twenty years of the Euro'*), the MNB authors describe the Maastricht criteria, the underlying assumptions and conditions, and the performance of the euro area in light of the criteria and beyond. One practical objective for the monetary union was to eliminate exchange rate risk and achieve monetary stability. However, since the Maastricht criteria for accession formulate their objectives as nominal variables, they cannot measure real economic convergence directly or guarantee financial stability by themselves. A further problem is that the budget deficit criterion fails to take the initial deficit figure into account and that few have recognised the lasting impact of fiscal policy in boosting demand; as a result, no central fiscal instrument was created to smooth the economic cycles across the euro area. Member States mostly complied with the inflation rate criterion when the euro was introduced; non-compliance subsequently increased but has been falling again in recent years. Long-term interest rates have dispersed over a wider range following the global financial crisis, but currently all the euro area Member States satisfy the long-term interest rate criterion. Yet whether the date of accession fell into a period of boom or recession is highlighted by the authors as relevant for compliance with accession criteria.

Chapter 2 discusses the *Lessons from the Global Financial Crisis of 2007–2009*, highlighting the *shortcomings of the Maastricht criteria and the directions of institutional development of the euro area*. The global financial crisis uncovered the shortcomings of the criteria and the rules, and demonstrated that it was possible for significant imbalances to develop in spite of fiscal discipline rules being in place. The problem with fiscal criteria is that they disregard the processes that occur in the private sector: high private debt was accumulated in the peripheral countries, which often led to overheating and significant imbalances as well. Crisis management was made harder by the absence of joint fiscal capacities, and therefore fiscal stimulus was left to the national governments, which were significantly hampered in this by their obligation to adhere to the fiscal criteria. Problems were further aggravated by the slow and inadequate crisis management on the part of European decision-makers. The euro area was only saved from a protracted contraction in the Member State economies and a collapse of bond markets in certain peripheral countries through the fast intervention, rate cuts and unconventional steps of the European Central Bank.

In response to the crisis, the European Union renewed its institutional structure: the European Financial Stability Mechanism was created in 2010, followed two years later by the European Stability Mechanism based on this and operating as a permanent crisis management institution. The European System of Financial Supervision was also set up; among other things, it is tasked with micro- and macro-prudential supervision performed in cooperation with Member State authorities. Major steps were also taken in the area of the banking union: the Single Rulebook providing a single set of harmonised prudential rules was created and the Single Resolution Mechanism was introduced to ensure the orderly resolution of failing banks and minimise the adverse impacts on the real economy, the financial system and the public finances of Member States. However, the final element of a banking union, the European deposit insurance scheme, did not materialise due to opposition from several Member States. This and the overall slow progress of establishing an optimal institutional framework is attributable to the fear in certain well-functioning Member States that a number of less disciplined Member States would benefit from unilateral income redistribution at the expense of 'the good ones'. As regards institutional development, the need for a continued deepening of capital market integration is also worth mentioning.

Chapter 3 presents *the experience of specific euro area Member States*. The chapter discusses two main questions: how the *cost/benefit balance of euro introduction* has changed over time and what the *experience of new accession countries* was*, for and against*. The euro has improved the efficiency of trade within the euro area and simplified and reduced the cost of financial clearing. The convergence of yields has been only partial, however. Against all expectations, the resilience of the eurozone was not consistent across the Member States, and the mere fact of membership was not able to offset the country-specific factors. Without independent monetary policy, the absence of real economic convergence in the euro area led to imbalances due to the long-term presence of excessively low real interest rates. Experience has been mixed regarding the success of the euro introduction. Whereas the southern countries were faced with a number of negative impacts, the experience of the Baltic states tended to be positive. Slovakia was well-prepared for accession and its introduction of the euro was unambiguously positive. By contrast, the experience of Slovenia, a country that had previously been seen as highly successful, was negative due to the emergence of imbalances similar to those in Southern Europe. From the experience of euro area Member States, we can draw the conclusion that new accession countries must pay special attention to ensuring that they remain on a sustainable and balanced path of growth even after the euro is introduced.

Finally, perhaps the most important chapter of this book formulates the *necessary criteria for joining a successful euro area*; it is therefore worth discussing that section in greater detail here. Its starting point is that the euro area is not an optimal currency area at the moment; in contrast to the stated objectives, the Member States have not yet converged in practice. The original set of criteria is therefore in need of significant revision. In terms of institutional structure, the most important future steps would be to implement the fiscal and capital market union and the missing component of the banking union. It is clear that reaching the appropriate level of real economic development and the presence of continued convergence are among the most important criteria. In addition, a suitably high degree of harmonisation between business and financial cycles must also be a high priority. A further important matter concerns the continued improvement of the productivity and the competitiveness of market participants, especially small and medium-sized businesses, whose productivity is typically lower than at large corporates.

The book proposes the creation of a set of criteria that retains some of the original conditions, introduces changes to others and also formulates new criteria. The proposed revised criteria are the followings:

- the inflation rates of the three EU members with the lowest but still positive rates of inflation to be used as a basis for the price stability criterion,
- similarly, the benchmark for the yield criterion to be the long-term yields of the three Member States with the lowest but still positive rates of inflation,
- for the fiscal criterion, to consider certain country-specific factors such as, for example, the debt ratio and the cyclical position of the particular Member State,
- the concrete deficit target to be tied to the amount of government debt and a structural balance to provide some room to manoeuvre,
- to prove exchange-rate stability, 3 to 5 years rather than the current 2 years of ERM II membership is recommended in addition to the original Maastricht criteria,

Recommendations for specific new criteria:

- per-capita GDP and wage levels to be at least ninety per cent of the corresponding values in the euro area,
- synchronised business and financial cycles,
- small- and medium-sized enterprises to have labour productivity higher than 50 per cent of that of large corporations and a wide range of high-added-value products and export arrangements,

- the economies of the countries wishing to join to be near full employment and
- have a stable and competitive banking sector,
- the convergence of the financial sector's depth to reach at least 90 per cent of the corresponding value of the euro area,
- macro- and microprudential policy instruments to minimise the risk of asymmetric shocks and adequate resolution tools to be available,
- the structural balance dependent on government debt to range between 0 and –2 per cent of GDP and the debt target to be 50 per cent.

The next section discusses *Hungary's euro maturity* in the light of the foregoing. In spite of a balanced process of convergence, the Hungarian economy does not comply with the price stability and exchange rate stability criteria, although it has achieved interest rate convergence. While it meets the government deficit criterion, shedding previously accumulated government debt is a time-consuming process. This means that Hungary is not yet mature enough to introduce the euro under the original criteria. Although the set of criteria recommended by the MNB captures the optimal accession conditions better, we can conclude that, in spite of the numerous significant advances made in recent years, Hungary meets only some of these.

The most important question for Hungary (and all other Central and Eastern European countries still to introduce the euro) is under what conditions and based on what timing should they introduce the European single currency so that our region can continue on its path of economic convergence after it joins the euro area. Hungary's convergence and sustainable development in the next few years will be possible only if the euro area functions successfully. The most important message of this book for Hungary is that we must understand our convergence opportunities clearly before joining the euro area: accession is recommended if the euro area we are to join is functioning in a healthy and successful way, because to withdraw later would be counterproductive.

The most important added value of this publication is that it makes objective, substantiated and concrete recommendations with clarity and is thus highly important for decision-makers and the wider professional public alike; after all, it is important to give the countries of this region the opportunity to explain their position regarding a decision as momentous for our shared future as the introduction of the euro. The introduction of the euro is not an endpoint, but a key milestone on the long road towards sustainable convergence.