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DG INTERNAL POLICIES OF THE UNION
- Directorate A **-**
ECONOMIC AND SCIENTIFIC POLICY
POLICY DEPARTMENT

MONETARY DIALOGUE JUNE 2007
Summary of Monetary Experts' Panel Briefing Papers

The following summary presents the respective topics of the briefing papers followed by brief points on the main messages and answers of the experts to the questions asked:

1. Treaty reform: consequences for monetary policy

The new prospective treaty should practically include most of the provisions in economic and monetary policy which were already present in the (failed) constitutional treaty. These provide for some subtle institutional changes as well as some strengthening elements to EMU governance structures (e.g. Euro-Ecofin-Council, SGP, BEPG, widened enhanced cooperation). However recently, in the first draft of the text of 23 July 2007, there were two notable deviations from the last constitution draft. Firstly, the ECB was grouped under EU institutions (and not under "other institutions") and secondly, the National Central Banks and the European System of Central Banks (ESCB) were no longer mentioned in the treaty. Both points are of great importance to the ECB as evidenced by the letter of President Trichet to the Presidency.[1] The debate on these points is ongoing.

The experts were asked to discuss the prospective reform treaty, and in particular, whether the changes will make euro area governance more efficient and/or whether the treaty potentially jeopardized the independence of monetary policy decisions in the EU. They were also asked to discuss whether additional coordination is in general necessary in the euro area. Four experts, Sylvester Eijffinger, Gustav Horn, Leon Podkaminer and Norbert Walter addressed this topic.

All contributions had in common the general notion that not too much should *substantially* change with the reformed treaty. The "formalization" of the Eurogroup and the additional mandate given to it was welcomed by all experts as a strengthening element in EMU governance. Also, the changes in the SGP and the BEPGs where the Commission will have more direct powers were welcomed. The international role of EMU is also strengthened, a development generally welcomed. There, however, remain some reservations as regards the potential implications for exchange rate policy where competences remain sub-optimal.

While some experts did not accept that any danger is posed to ECB independence by the foreseen changes (Horn, Podkaminer), for others the devil could lie in details and the dangers could be introduced indirectly and through the "back-door" (Eijffinger, Walter).

The following briefly sums up some (selected) main points of the respective experts[2]:

Sylvester EIJFFINGER - Current attempts to limit ECB independence will only backfire

The ECB's concerns on the institutional status are not only legitimate, but bear an additional danger. There exists a trade-off between the "conservativeness" and the "independence" of a central bank.

[1] Letter of the president of the ECB to Manuel Lobo Antunes, President of the Council of the European Union, dated from August 2, 2007, ECB web site, http://www.ecb.int/pub/pdf/other/jct1080en.pdf
[2] For the complete arguments, see the respective contributions.

If the independence is endangered, the central bank will have to increase its "inflation aversion" in order to maintain same levels of inflation (conservativeness).[3] Therefore all that results from (verbally or legally) endangering independence is higher interest rates and a higher cost to keep inflation down. The result would be exactly the opposite of what was intended by those attempting to limit the independence.

Leon PODKAMINER - Treaty includes helpful elements but does not solve real challenges

The treaty leaves essential issues unaffected. Nevertheless, there are some gradually improving elements (such as the SGP) as "people learn by doing". However, the much-used magic word "coordination" remains empty of concrete content.

Three main challenges remain in the EMU: First, real inflation rates differ considerably across the euro area and the "one-size-fits-all" monetary policy is increasingly becoming "one size does not fit anyone". Second, beggar-thy-neighbour policies remain possible even in a monetary union (as currently exercised by Germany), and they are dangerous. Third, the ECB does not have all necessary powers of a true lender-of-last-resort and crisis manager.

Gustav HORN - We are still far from an optimal and European governance structure for EMU

A truly European form of governance is needed. Real and substantial fiscal policy coordination in EMU is necessary together with some degree of wage policy coordination.

Treating the ECB as an EU institution would not per se undermine its independence. Independence in its monetary policy decisions does not imply that the ECB cannot be politically accountable for what it is doing. The ECB should not be setting its own targets.

Norbert WALTER - The treaty introduces some strengthening elements for EMU governance

The ECB's demands in respect to changes to the draft treaty are fully legitimate (see above). In addition, the omission of competition policy as a target should be taken seriously, as competition has direct linkages to price levels and thus monetary policy. Currently, harmful tendencies toward state interventionism and economic patriotism are on the rise again.

Positive changes in the treaty, in addition to those mentioned above, include the strengthening of the voting procedures in SGP (as offenders will not be able to vote anymore) and the majority vote on the ECB Executive Board Members. The agenda to strengthen EMU's international voice may be a source of conflicting interest, especially due to the unclear competences in exchange rate matters. Political will is essential for a common position and the continuity of policy.

2. Criteria for Monetary Union Accession

The Maastricht Criteria for joining EMU are from time to time subject to debate. With the new Member States gradually joining the euro zone, this discussion is once again given more attention by policy-makers and academics alike. It has also taken on a new quality as the economic reality surrounding the entrance of new members into the euro zone is profoundly different from the situation that prevailed at the time of the formulation of the criteria.

The experts were therefore asked to explain why the criteria take the current form and what the economic reasoning is behind them. They should then, from their point of view, devise a set of criteria for monetary union accession.

[3] Conservativeness relates to the "strength" of the relative lower inflation preference of the central bank (relative to the government), i.e. roughly at what "cost" will a low inflation policy be implemented by the central bank.

Seven experts, Guillermo de la Dehesa, Jean-Paul Fitoussi, Jörg Krämer, Jean-Pierre Patat, Pedro Schwartz, Anne Sibert and Charles Wyplosz addressed this topic.

With regard to the fiscal criteria, most experts agree that sound fiscal policies are a necessary prerequisite to monetary union membership. The differences in opinion lie in the qualification of the fiscal criteria. Some experts call for longer observation periods and a tightening of the limits, others reflect on a better consideration of the quality of public expenditure in candidate countries, some look at the possibility of considering a "golden rule" similar to the UK strategy.

Looking at the monetary criteria, most experts show the theoretical background to a potential conflict in simultaneously fulfilling all three criteria under full capital mobility. There is a consensus that the interest rate criterion is self-fulfilling and therefore does not make much sense as an entry criterion. A second major discussion is that of the inflation criterion: some experts argue that it is too severe with an unhelpful benchmark definition. Others call for a prolonged observation of adherence while leaving the criterion itself unchanged.

While some suggestions on handling the criteria merely modify the interpretation of current criteria, others refer to changes in the benchmark. Some experts propose entirely new criteria looking at e.g. current account deficits, the soundness of banking systems and supervision, corporate tax rates.

Finally, most experts also allude to the fact that current EMU members are not the best examples of adherence of the criteria and hence call for the criteria not just to be fulfilled in the reference year for accession but also thereafter.

Guillermo DE LA DEHESA – Critiques of the criteria have no chance ever to be implemented

The criteria for nominal convergence were originally introduced because most Member States had achieved a reasonable degree of real convergence towards the EU average levels of GDP per capita, but this had been reached in spite of a persistent nominal divergence. Thus, it made sense to choose nominal convergence as the main requisite for joining EMU. Now, for the new Member States the problem is exactly the contrary. Their real convergence is still a far away, while their nominal convergence is even closer today than that achieved by some euro zone members when preparing to join EMU.

The main challenge for the new Member States joining EMU is how to achieve nominal convergence starting with a rather low real convergence when there is a conflict between real and nominal convergence and mainly between catching up and inflation.

Jean-Paul FITOUSSI - An ambitious approach would abandon the Maastricht framework

The Maastricht Treaty and the institutions for the economic governance of Europe are children of the new classical doctrine that prevailed in the 1990ies. An ambitious approach would abandon this framework in favour of a series of criteria based on the preservation of the European social model.

Some realistic modifications: allowing for a higher inflation rate; a higher deficit ceiling for current expenditure; application of the golden rule of public finance to allow for infrastructure building.

More radical reform proposals avoiding a race to the bottom in search of competitiveness: 1) The corporate tax rate of the candidate should not be lower than the lowest rate of the union; 2) The ratio of social expenditure over GDP should not be lower than the lowest ratio among existing members.

Jörg KRÄMER - Bond yield criterion doesn't make much sense and should no longer be used

Some criteria should not only be met in the 12 months prior to EMU entry: the deficit criterion should be met for 3 consecutive years as should the inflation target. The qualification that a country with a debt-to-GDP ratio above 60% could join EMU if the ratio is "sufficiently diminishing and approaching the reference value at a satisfactory pace" should be dropped.

The 3% deficit-to-GDP ratio has become too loose as this value is based on a too optimistic assumption of 5% annual nominal GDP growth. Assuming 4 instead of 5% requires the deficit to be below 3% to prevent the debt-to-GDP ratio from rising. Hence the limit should be lowered to 2.5%.

Jean-Pierre PATAT –Simple concepts should not be exchanged for more complex ones

Minor and technical changes could be implemented in the inflation and interest rates criteria. Concerning fiscal and public debt criteria one can find a lot of technical and apparently logical arguments for modifying their definition. But one must ask about the consequences of introducing complexity. The risk is to replace a perhaps global but simple concept by a perhaps technically better but incomprehensible concept, which would be suspected to enable discrete wangling (e.g. replacement of HICP for measuring inflation, cyclically adjusted deficits instead of global deficits).

Adding new criteria: In cases of current account imbalances, any discretion could be refused to a country with a CA deficit in evaluating its compliance with the budget ratio or a lower deficit limit (e.g. 2% for countries with twin deficits) could be imposed. Furthermore, the soundness of the banking system and the supervision arrangements could be re-examined for EMU candidate countries.

Pedro SCHWARTZ - Properly designed convergence criteria afford an opportunity to follow sound and sustainable economic policies

Before accession, low inflation is more important while after accession, a sustainable fiscal policy is crucial. Stable and low interest rates are a symptom of good behaviour in the field of prices and deficits rather than a condition for a smooth transition to the euro. And keeping the exchange rate within the ERM "tram lines" may prove near impossible as foreign investment piles into the country.

Price stability: The countries taken into account for the benchmark should be those in the euro zone. It would be advisable to set the 1.5% margin over the average of the whole of euro zone.

Fiscal discipline: Candidates should be required to achieve fiscal balance or surplus as a medium term fiscal target. The criterion could be bettered if the budget deficit were analysed together with the performance of public investment (similar to the UK fiscal strategy). If the *golden rule* was adopted as a fiscal criterion, candidates should aim at a yoy zero deficit in current terms and a lower debt ratio.

Anne SIBERT – The monetary criteria are unreasonable

Problems with the fiscal criteria: The benchmark values may have been based on a 5% annual nominal GDP growth assumption while this is significantly higher in the new Member States. Off-budget and contingent assets and liabilities present accounting problems. Collecting statistics is difficult. Current EMU members extravagantly flout the rules. Nevertheless, applying the fiscal criteria would make a reasonable distinction between countries that are ready for monetary union and countries that are not.

The monetary criteria are unreasonable, the major theoretical objection being that it is only possible for a central bank with a single policy instrument to target a single nominal variable. The inflation target is too severe, the definition of the benchmark problematic with the operationalisation of "best performing" being at odds with the ECB's own target for price stability.

Improvements: Allowing to pick between either joining ERM or satisfying the inflation criterion. The inflation target should be made less restrictive (e.g. adding 1.5% to the ECB inflation target).

Charles WYPLOSZ – The best, if most radical, approach would be to eliminate the criteria

Weaknesses of the criteria: As entry conditions, they do not provide any guarantee that, once admitted, members will behave as they are expected to. Furthermore, they are based on arbitrary rules that invite efforts at circumvention.

As a particular aspect of the catch-up process, prices must rise faster than in the euro area. With an exchange rate within ERM, inflation must be higher than in the euro area. Catch-up also requires heavy public spending in infrastructures; and productive investments can be safely financed through borrowing. Hence budget deficits early on in the catch-up period are not only acceptable but desirable. The new Member States were required to fully liberalize capital movements. This required that they either let their exchange rate float or forego monetary policy.

The most radical way to adapt the admission conditions would be to ignore the Maastricht criteria. The view that euro area membership does not require nominal convergence, just proper institutions, is finally (almost) recognised by the ECB President himself[4]. A less radical approach would be to recognize the specificities of the new Member States in interpreting the criteria (e.g. ignore the inflation criterion for the Baltic states, pay attention to the quality of public expenditure in deficit countries, disregard the interest rate criterion as it is self-fulfilling).

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[4] This alludes to a presentation by the ECB President at the 9th ECB Watchers Conference in Frankfurt, 7 September 2007, where he stated: „Recent ECB research […] identifies the launch of EMU and the establishment of a clearly defined nominal anchor as the defining event that changed the very nature of the inflationary process in the euro area. This institutional break has eradicated the "intrinsic" component of the inflation formation mechanism, namely the extent to which economic agents – in re-setting prices or negotiating wages – look at the past history of inflation, rather than into the eyes of the central bank. To be sure, this phenomenon is not confined to the euro area."

Treaty Reform: Consequences for Monetary Policy

TREATY REFORM: CONSEQUENCES FOR MONETARY POLICY

Briefing Paper for the Monetary Dialogue of October 2007 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

October 2007

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(CentER Tilburg University, RSM Erasmus University and CEPR)

Executive Summary

The purpose of this Briefing Paper is to discuss the issue of Treaty reform and its consequences for monetary policy. Inter alia, the changes include that the institutional set-up will be subtly changed and the European Central Bank (ECB) will be grouped in the first part of the Treaty as one of the "other institutions and advisory bodies". Possibly more importantly, the euro area as such will be in the position to act legally as itself within the European Union (EU) legal structures. The Eurogroup also will be officially recognized ("Euro-Ecofin-Council"). The rules for enhanced cooperation have also been further facilitated from the Treaty of Nice, also applying for the area of economic governance (e.g. euro area coordination, tax policy, exchange rates). What should we think of these reforms? Will they make euro area governance more efficient and/or could they potentially jeopardize the independence of European monetary policy and the European Central Bank (ECB)? From a theoretical point of view it can be argued that an independent central bank may reduce the inflationary bias of monetary policy making. A substantial amount of empirical research supports the inverse relationship between central bank independence and the level of inflation. The negative relationship between indicators of central bank independence and inflation in OECD countries is quite robust, also if various control variables are included in the regression. President Jean-Claude Trichet's concern about the status of the ECB under the new Treaty and fear that by including the bank in a list of EU institutions there is a risk that EU member states could formulate policy recommendations to the ECB is not only true, but may also lead to more central bank conservativeness with the ECB. Politicians, such as President Sarkozy, should realize that their attempts to downgrade ECB's independence legally and verbally will only *increase* its conservativeness in order to maintain the *same* inflationary bias and limit the ECB's degrees of freedom with respect to its interest rate policy. The consequences of these attempts are relative *higher* interest rates in the eurozone, being exactly the opposite of what they wish to achieve. Sometimes it is better to tie yourself, like Odysseus, to the mast to resist the siren voice.

Introduction[5]

The purpose of this Briefing Paper is to discuss the issue of Treaty reform and its consequences for monetary policy. Inter alia, the changes include that the institutional set-up will be subtly changed and the European Central Bank (ECB) will be grouped in the first part of the Treaty as one of the "other institutions and advisory bodies". Possibly more importantly, the euro area as such will be in the position to act legally as itself within the European Union (EU) legal structures. The Eurogroup also will be officially recognized ("Euro-Ecofin-Council"). The rules for enhanced cooperation have also been further facilitated from the Treaty of Nice, also applying for the area of economic governance (e.g. euro area coordination, tax policy, exchange rates). What should we think of these reforms? Will they make euro area governance more efficient and/or could they potentially jeopardize the ECB's independence and European monetary policy?

The reform of the Treaty

In essence, the content of the new proposed reform treaty is very similar to that of the Treaty establishing a Constitution for Europe (OpenEurope.org.uk/research/guide.pdf). It has just been modified and rephrased, as many heads of the different EU governments have already confirmed. In July 2007, an Inter Governmental Conference (IGC) has been held to discuss the "new" Treaty and to seek political support for all the amendments to the original treaties that are in the reform of the Treaty. The major proposed changes include the removal of the three-pillar structure of the EU, more democracy, change of the institutional setup of the Union, improvement of the solidarity and security within the Union and enhancement of the position of the EU on the global stage (European Commission, July 10, 2007). The three-pillar structure will be abolished, as to simplify the structure of the EU. The structure will be reorganized, with more emphasis on foreign and security policy and justice and home affairs. More democracy is realized by giving national parliaments and the European Parliament (EP) a bigger say, while the power of the European Commission (EC) will decrease. The EP will be on equal footing with the Council of Ministers in many areas in terms of decision making. Also, a withdrawal option will be included, as to state that member states are part of the EU by their own choosing. Also, there will be some opt-out options in the area of police and criminal law, as urged for by the United Kingdom and the Czech Republic. The change in the institutional set-up of the ECB will be most important for the working of monetary policy and the status of the ECB. The latter effects will be singled out later in the text and treated in more detail. Furthermore, decision making will be made more swiftly and more commonly supported by the system of *qualified majority voting*, which will be introduced in more than forty new areas. This is also going to apply to economic governance. These measures include the giving up of veto power in many areas (including the ECB's powers over financial regulation), the appointment of a permanent President of the European Council, and a reinforcement of the Commission's authority. Also, as will be clear later on, it is easier to amend the treaty in the new form, by means of co-decision and qualified majority voting, so that a new IGC will not be necessary. This also includes amending the articles concerning the ECB and its independence, as we will see in the next section.

[5] The author gratefully acknowledges the helpful comments of Drs. Edin Mujagic, MSc and the excellent research assistance of Mr. Rob Nijskens, BSc.

Consequences for European monetary policy and the European Central Bank[6]

Article 107 (formerly III-187 of the Constitution) states that a number of Articles in the Statute of the European System of Central Banks can, for the first time, be amended by qualified majority voting, on a proposal from the Commission:

"Articles 5.1, 5.2, 5.3, 17, 18, 19.1, 22, 23, 24, 26, 32.2, 32.3, 32.4, 32.6, 33.1(a) and 36 of the Statute of the ESCB may be amended by the European Parliament and the Council, acting in accordance with the ordinary legislative procedure."

These articles include significant ECB powers such as: the power to set minimum reserve requirements for banks and the power to fine financial institutions; the power to conduct foreign exchange operations and make international agreements for currency coordination; the power to set up and regulate clearing systems; and arrangements for sharing the profits of the ECB. The ultimate consequence of these changes may imply that ECB's interest rate policy could be neutralized by other EU institutions, like the EP and the Ecofin council. The Ecofin council could e.g. push the ECB to use more frequently (sterilized) exchange rate interventions influencing ECB's monetary policy.

This will give the EP and the Ecofin council more power and may affect the ECB's independence and monetary policy. It has to be noted that these amendments have to take place by co-decision and qualified majority voting. Quality majority voting implies that not all countries have to be on board and *relative* stronger voting position of the larger countries. The possible *collusion* between the larger countries (compare the collusion of France, Germany and Italy regarding the non-enforcement of the Stability and Growth Pact in recent years) may undermine the supranational character of policy decision making and increase the tensions within the eurozone between the larger and smaller countries.

Article 114 of the new Treaty (which was Article III-194 of the original Constitution) will make the Eurogroup – the informal meetings of finance ministers from eurozone countries – into a formal body with its own President, elected for two and a half years. This President may represent the eurozone in international financial organisations like the International Monetary Fund (IMF). The Eurogroup also gains the right to send recommendations to eurozone countries that are in breach of EU rules, and the power to decide (by majority voting) whether a non-eurozone country is ready to enter the euro area.

Article 115a (ex-111(4)) (137)(III-196)

1. In order to secure the euro's place in the international monetary system, the Council, on a proposal from the Commission, shall adopt a decision establishing common positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences. The Council shall act after consulting the European Central Bank.

2. The Council, on a proposal from the Commission, may adopt appropriate measures to ensure unified representation within the international financial institutions and conferences. The Council shall act after consulting the European Central Bank.

3. For the measures referred to in paragraphs 1 and 2, only members of the

Council representing Member States whose currency is the euro shall take part in the vote.

These powers were already defined in the old Treaty, although this new article is wider in scope. The actions following from this article are subject to the new qualified majority voting procedure described in Article 205 (3)(a). It should be emphasized that this article, certainly

[6] The following part draws on the research of Open Europe at www.OpenEurope.org.uk/research/guide.pdf,

the first part, is so vague ('of particular interest for economic and monetary union') that it may be easily misinterpreted and misused by the Council and other EU institutions. I would strongly advise to revise this article to secure ECB's independence.

Article 117 (ex-121(1), 122(2) and 123(5)) (139)

(…) "The Council shall act having received a recommendation of a qualified majority of those among its members representing Member States whose currency is the euro. These members shall act within six months of the Council receiving the Commission's proposal." The only substantive change here is the power of the eurozone countries to give a recommendation, separately from the rest of the Council, on whether a candidate for the eurozone is qualified to join it.

The independence of the European Central Bank

Although *Article 108* of the Treaty still states that "neither the *European Central Bank,* nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from *Union* institutions or bodies, from any government of a Member State or from any other body", the fact that the ECB will be grouped with institutions such as the EC and the EP makes that its special status may or will be affected. This may have consequences for the functioning of the ECB in conducting effective monetary policy. The grouping of the ECB with other EU institutions will affect its independence and must be considered as an extremely dangerous development. President Jean-Claude Trichet (Agence France Presse, August 13, 2007) emphasized rightfully that only the ECB's independence makes its monetary and exchange rate policies credible and effective. Lorenzo Bini Smaghi, Executive Board Member of the ECB, also mentioned the importance of central bank independence for credible and effective monetary policy (Speech, July 5, 2007). French President Nicolas Sarkozy (The Daily Telegraph, August 11, 2007) seems to want to downgrade the independence of the ECB, as to give the Council of Ministers (and therefore the Ecofin council) more power over monetary policy within the eurozone. In the Table 1 an overview of opinions by central bankers, politicians and other opinion leaders is given.

Table 1. An overview of opinions by central bankers, politicians and other opinion leaders

The independence of the European Central Bank

<table>
<tr>
<td rowspan="5">French President Nicholas Sarkozy

He has publicly criticized the position of independence of the ECB and tried to give the Council of Ministers more control over monetary policy. Sarkozy wants to see the policies of the bank oriented towards promoting growth and jobs in the eurozone, rather than simply being focused on controlling inflation. (The Daily Telegraph, August 17, 2007)

“Mr Sarkozy’s criticism: politicians, not central bankers, should be in charge of exchange rate policy, as is the case in the US and most other countries, including Germany before 1999, and the euro’s exchange rate should be actively managed to be competitive.” (Wolfgang Münchau, Financial Times website, July 1, 2007)</td>
<td>German Chancellor Angela Merkel

She has supported the independence of the ECB after Sarkozy attacked it.

"Of course one can talk, but ECB decisions are a matter for the bank's governing body alone," (Agence France Presse, July 19, 2007)</td>
</tr>
<tr>
<td>Wolfgang Münchau, The Financial Times

“Sarkozy jeopardises the future of the euro area” Mr. Münchau criticizes Sarkozy for wanting to touch the independence of the central bank in conducting monetary policy, for wanting to control the exchange rate of the euro and for increasing the French government deficit instead of decreasing it.

(Financial Times website, July 1, 2007)</td>
</tr>
<tr>
<td>Joaquin Almunia, EU Economic and Monetary Affairs Commissioner.

"Everyone has a right to his opinion on monetary policy and on interest rates but nobody should put pressure on the (central) bank," (Agence France Presse, September 4, 2007)</td>
</tr>
<tr>
<td>Several EU Ministers of Finance.

They support the ECB’s independence and have clearly expressed their concerns about Sarkozy’s statements (Europa Nu, May 9, 2007).</td>
</tr>
<tr>
<td>Lorenzo Bini Smaghi, ECB Executive Board Member

His critique is that the in negotiating the new treaty, there are still governments that want to “rebalance” economic powers (Speech, July 5, 2007).</td>
</tr>
</table>

Treaty reform with respect to European Central Bank and the Eurogroup

French President Nicholas Sarkozy He seeks to increase the Council's power over monetary policy, and mainly the French government's power. This is made easier by the new draft Treaty. (The Daily Telegraph, August 17, 2007)	*ECB President Jean-Claude Trichet* He is concerned about the status of the ECB under the new Treaty and is afraid that by including the bank in a list of EU institutions there is a risk that EU member states could formulate policy recommendations to the ECB, an ECB spokesman explained.
UK Labour Government Criticises the new Treaty for allowing the Eurogroup more power, while it does want the Council (and thus the UK) to have more power over euro area matters. This will of course jeopardize the position of the UK vis-à-vis eurozone countries. (Open Europe Guide to the Treaty, August 16, 2007)	*Open Europe Vice-Chairman Derek Scott* "France has always sought political control of the ECB: the new Treaty entrenches it." (Open Europe Press Release, August 16, 2007)
	Joaquin Almunia, EU Economic and Monetary Affairs Commissioner. "A central bank with an independent statute which feels under pressure would be liable to show that it is independent." (Agence France Presse, September 4, 2007)
	Pietro De Matteis, Founder 'United For Europe' Lowering ECB independence may lead to less credible monetary policy, and even to political pressure making the monetary policy only fit the policies of the big EU countries, leading to asymmetries. (TheNewFederalist.eu, August 15, 2007)

Competition versus protectionism

French President Nicholas Sarkozy He managed to remove the reference to "free and undistorted competition" from the draft Treaty, as he does not see this as a target (EurActiv.com, July 2, 2007)	*Open Europe Vice-Chairman Derek Scott* He opposed the change of the phrase "free and undistorted competition" and criticized Gordon Brown of being outmanoeuvred by Sarkozy in negotiations. (The Daily Telegraph, August 11, 2007)
German Chancellor Angela Merkel "It has been restructured, it hasn't been devalued," Merkel said. "Since the free market is mentioned and the internal market is mentioned throughout this mandate." (EurActiv.com, July 2, 2007)	*Daniel Gros, Director of the Centre for European Policy Studies (CEPS)* "(…) important is that, in the eurozone, competition is increasing, reaching markets that were previously protected, in large countries such as France, and this is what is upsetting a number of politicians." (EurActiv.com, July 2, 2007)

The trade-off between central bank independence and conservativeness

The Maastricht Treaty has made the ECB very independent. Nowadays is it widely believed that a high level of central bank independence and an explicit mandate for the bank to restrain inflation are important institutional devices to assure price stability? It is thought that an independent central bank can give full priority to low levels of inflation. In countries with a more dependent central bank other considerations (notably, re-election perspectives of politicians and a low level of unemployment) may interfere with the objective of price stability. In that context the German central bank is often mentioned as an example.

The Deutsche Bundesbank was relatively autonomous; at the same time, Germany had one of the best post-Second World War inflation records among the OECD countries. Indeed, the statutes of the ECB are largely modeled after the law governing the Bundesbank. Why would central bank independence, ceteris paribus, yield lower rates of inflation? The theoretical reasoning in this field stresses the *time inconsistency problem* (Kydland and Prescott, 1977; Barro and Gordon, 1983). The basic idea behind the time-inconsistency problem can be explained as follows. Suppose, the policy maker announces a certain inflation rate that (s)he considers optimal. If private sector agents take this announced inflation rate into account in their behaviour, it becomes at that time optimal for the government to renege and to create a higher than announced inflation rate. The reason for this is that a burst of unexpected inflation yields certain benefits. For instance, unexpected inflation reduces real wages, thereby increasing employment.

Of course, this is only part of the story. The next step is to add rational expectations. Under rational expectations economic agents know government's incentive to create unexpected inflation and take this into account in forming their expectations. Government has no other choice than to vindicate these. It is clear that the inflation rate will be higher than under the situation in which government would stick to its promise. No matter which factors exactly cause the dynamic inconsistency problem; in all cases the resulting rate of inflation is sub-optimal. So in the literature devices have been suggested to reduce this so-called *inflationary bias*. Rogoff (1985) has proposed to delegate monetary policy to an independent and 'conservative' central banker. *Conservative* means that the central banker is *more averse to inflation* than the government, in the sense that (s)he places a greater weight on price stability than the government does.

Why would a central banker be more inflation averse than the government? Two main differences have been pointed out in the literature between preferences of the government and those of the central bank (Cukierman, 1992). One relates to possible differences in the time preference of political authorities and that of central banks. For various reasons, central banks tend to take a longer view of the policy process than do politicians. The other difference concerns the subjective weights in the objective function of the central bank and that of government officials. It is often assumed that central bankers are relatively more concerned about inflation than about other policy goals such as achieving high employment levels and adequate government revenues.

If monetary policy is set at the discretion of a 'conservative' and independent central banker, a lower average time-consistent inflation rate will result. The central insights of this literature can be explained as follows. It is assumed that policy-makers seek to minimize the following loss function (L), which represents the preferences of the society:

$$L^G = \frac{1}{2}\pi_t^2 + \frac{\chi}{2}(y_t - y_t^*)^2 \qquad (1)$$

where y_t is output, y^* denotes desired output and χ is government's weight on output stabilization ($\chi > 0$). Output is driven by a simplified Lucas supply function:

$$y_t = (\pi_t - \pi_t^e) + u_t \tag{2}$$

where π is actual inflation, π^e is expected inflation, and u_t is a random shock. Policymakers minimize (1) on a period by period basis, taking the inflation expectations as given. With rational expectations, inflation turns out to be:

$$\pi_t = \chi y_t^* - \frac{\chi}{\chi + 1} u_t \tag{3}$$

The first term at the right hand side of equation (3) is the inflationary bias. A country with a high inflationary bias has a credibility problem, as economic subjects realize government's incentives for surprise inflation. The second term in equation (3) reflects the degree to which stabilization of output shocks influence inflation. Suppose now that a 'conservative' central banker is put in charge of monetary policy. Conservative means that the central banker is more inflation averse than government. The loss function of the central banker can therefore be written as:

$$L^{cb} = \frac{1+\varepsilon}{2}\pi_t^2 + \frac{\chi}{2}(y_t - y_t^*)^2 \tag{4}$$

where ε denotes the additional inflation aversion of the central banker. The preferences of the central banker do not matter, unless (s)he is able to determine monetary policy. In other words, the central bank should be able to pursue monetary policy without (much) government interference. This can simply be modeled as follows (Eijffinger and Hoeberichts, 1998):

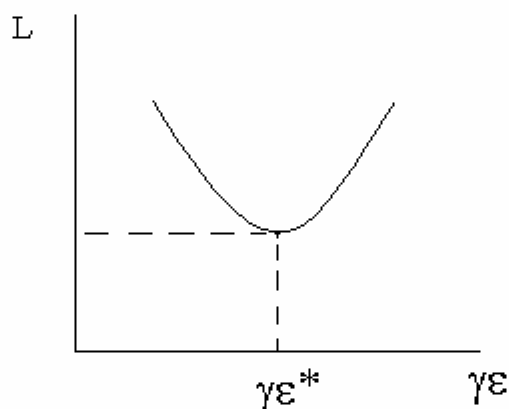
$$M_t = \gamma L^{cb} + (1-\gamma)L^G \tag{5}$$

here γ denotes the degree of *central bank independence*, i.e. to which extent the central banker's loss function affects monetary policy making.. If $\gamma = 1$, the central bank fully determines monetary policy *M*. With rational expectations and minimizing government's loss function, inflation will be:

$$\pi_t = \frac{\chi}{1+\gamma\varepsilon} y_t^* - \frac{\chi}{1+\gamma\varepsilon+\chi} u_t \tag{6}$$

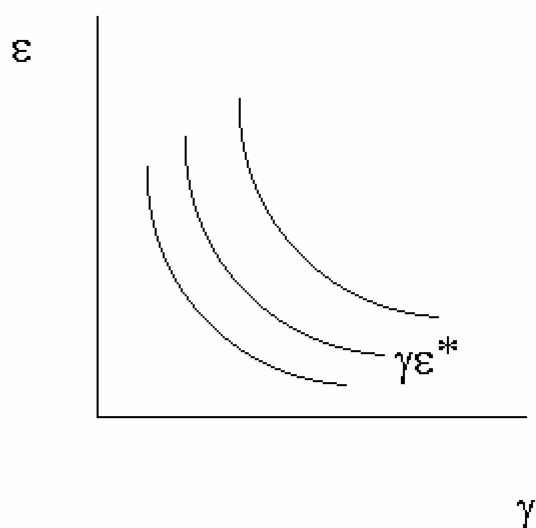
Comparing equations (3) and (6), one can immediately see that the inflationary bias (the first term at the right hand of the equations) is lower for positive values of γ and ε. In other words, delegating monetary policy to an independent and 'conservative' central bank will yield a lower level of inflation. There is an optimal level of independence cum conservativeness ($\gamma\varepsilon^*$). Under certain assumptions, this is shown graphically in Figure 1. Optimal means that the loss function of the society (eq. 1) is minimized. This optimum is not necessarily one with zero inflation, as it also depends on output stabilization.

Figure 1. The optimal level of central bank independence and conservativeness



It also follows from equation (6) that both independence and the inflation aversion of the central bank matter. If the central banker would have the same inflation aversion as government (i.e. $\varepsilon = 0$), the independence does not matter. And similarly, if the central bank is fully under the spell of government (i.e. $\gamma = 0$), the conservativeness of the central bank does not matter. There are various combinations of γ and ε that may yield the same outcome, including the optimal one. We can illustrate this in Figure 2.

Fig. 2. Trade-off between conservativeness and independence of a central bank



From a practical point the concept of a 'conservative' central banker seems, however, void, if only since the preferences of possible candidates for positions in the governing board of a central bank are generally not very easy to identify and may change after they have been appointed. So, it is hard to find some real world example of a 'conservative' central banker. Still, one could argue that the statute of the central bank could be relevant here, especially with respect to the question of whether or not it defines price stability as the primary goal of monetary policy. Whether or not the statute of a central bank defines price stability as the primary policy goal, can be considered as a proxy for the 'conservative bias' of the central bank as embodied in the law (Cukierman, 1992).

Conclusion

So from a theoretical point of view it can be argued that an independent central bank may reduce the inflationary bias of monetary policy making. What about the empirical evidence? A substantial amount of empirical research supports the inverse relationship between central bank independence and the level of inflation (see Eijffinger and De Haan, 1996 for a review). The negative relationship between indicators of central bank independence and inflation in OECD countries is quite robust, also if various control variables are included in the regression. Still, it should be noted that a negative correlation does not necessarily imply causation. The correlation between both variables could be explained by a third factor, e.g. the culture and tradition of monetary stability in a country. However, sometimes central bank independence is a *condition sine qua non* to establish the culture and tradition of monetary stability in a country (e.g. in France).

President Jean-Claude Trichet's concern about the status of the ECB under the new Treaty and fear that by including the bank in a list of EU institutions there is a risk that EU member states could formulate policy recommendations to the ECB is not only true, but may also lead to more conservativeness (inflation aversion) with the ECB. Central bankers are like whipping cream: the more politicians stir them, the stiffer they become!

Politicians, such as President Sarkozy, should realize that their attempts to downgrade ECB's independence legally and verbally will only *increase* its conservativeness in order to maintain the *same* inflationary bias and limit the ECB's degrees of freedom with respect to its interest rate policy. The consequences of these attempts are relative *higher* interest rates in the eurozone, being exactly the opposite of what they wish to achieve.

Sometimes it is better to tie yourself, like Odysseus, to the mast to resist the siren voice.

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TREATY REFORM: CONSEQUENCES FOR MONETARY POLICY

Briefing paper for the Economic and Monetary Committee of the EU Parliament

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Executive Summary

Treaty Reform: Consequences for Monetary Policy

The reformed treaty as far as it is known has met stiff resistance by the ECB and many scholars of monetary policy. The subtle change of the institutional setting that enumerates the ECB among "other institutions and advisory bodies" is seen as an attack on the independence of the central bank. Moreover, the implicit demand for more cooperation within the euro area has also been received sceptically. In the following a different view will be outlined. Basically the reforms of the treaty point into the right direction. Present information on the reformed treaty indicates that the governance structure will be improved after its adoption. However, much remains to be done until the euro area in particular achieves an optimal governance structure. The main problem is that national interests still dominate. Given that the internal market is now of *European* nature, this framework does not fit any more. What is needed is a truly European form of governance.

Introduction

The reformed treaty as far as it is known has met stiff resistance by the ECB and many scholars of monetary policy. The subtle change of the institutional setting that enumerates the ECB among "other institutions and advisory bodies" is seen as an attack on the independence of the central bank. Moreover, the implicit demand for more cooperation within the euro area also has been received sceptically.

In the following a different view will be outlined. Basically the reforms of the treaty as far as known point into the right direction, although – in terms of clarity – it would have been preferable if a lot fewer issues had been tackled in the treaty. The basic idea is to strengthen the political institutions of the EU, which seems to be achieved. However, both the EU and the euro area are still far away from an optimal setting. Much remains to be done in this respect.

The next section deals with the role of the ECB in the reformed treaty. The subsequent one is devoted to the euro group, followed by section on euro area coordination issues. Finally conclusions will be drawn.

1. Is the ECB Treated Correctly?

Some scholars and observers interpreted the inclusion of the ECB into the group of other EU institutions as a degradation of the central bank. This would be correct, if one saw the ECB as an institution that must be superior to all other agencies and have no political accountability whatsoever. But this is a mistaken perception of a central bank. Needless to say, a central bank should be independent. This means it should have full freedom to conduct its monetary policy in order to meet the monetary targets. No political interference should be permitted. In such a setting inflationary pressures originating from governmental pressure on the ECB should not become effective. Thus, any attempt to create high inflation by printing money to bail out excessively indebted governments is inconceivable. But this important point had already been taken care of in the old draft. It is also included in the reformed one.

Apart from its general independence there is no need to treat the ECB differently from any other institution. Independence as defined above does not mean that the ECB should not be held politically accountable for what it is doing. This is expressed, although in a very incomplete manner, by the fact that the ECB president has to report to a quarterly meeting of the Monetary Committee of the European Parliament. The expression "meeting" suggests that here is no hierarchy, but this is wrong. The parliament is the representative of the people in the EU as are the different governments in the Council of Ministers and it is therefore in charge of the political control of all EU bodies and agencies. It is a mistake of the treaty not to put more emphasis on the democratic legitimation of EU institutions

Only if this fundamental aspect is ignored, it may seem that the ECB is inappropriately treated in the same way as any other EU institution. However, as far as political accountability is concerned this treatment is correct and fully corresponds to the present institutional framework.

It is also correct from an economic point of view. The ECB is responsible for the conduct of monetary policy. Its success is measured against its target, which is primarily to preserve price stability. It is not the ECB's responsibility to define targets, although it tends to do so by setting its own inflation target. Rather, it is the task of political institutions to set the target. Otherwise the ECB could easily evade any sound judgement on its performance by changing targets. Consequently, the ECB should be listed among other bodies that are also being held politically responsible to the European Parliament and the Council. In this context it is remarkable and unwise that the reformed treaty – like its predecessor – narrows the

ECB's target to price stability. Political preferences as well as the academic assessment may change and lead to a broader set of targets. Under the present treaty, these changes seem to be impossible, even if politically desired or economically optimal. All in all the reformed treaty does not provide optimal provisions for the ECB, but the given ones are in line with existing economic and political settings.

2. The Institutional Emergence of the Euro Area

Although the existence of an internal European market is considered a matter of course, its consequences are still incompletely taken into account. The same applies to the division of the EU between members of the euro area and non–members. First of all it is simply logical that only members of the euro area should deal with most monetary issues. The inclusion of all EU members in the monetary decisions for the euro area is based on the somewhat unrealistic assumption that all members will join the euro area sooner or later. Given the present situation and a realistic outlook, a clearer stance on this issue is advisable. A two-tier EU with members of different status already exists. Insofar the definition of a euro Ecofin group is logical against the backdrop that some countries like the UK, Sweden or Denmark will not join the euro area for the time being. In this setting only those countries should be involved in decision making on the euro that are affected by these decisions.

This is necessary since the euro area has its own economic developments that are different from those in the rest of the EU. The main characteristic is the absence of an exchange rate mechanism between the individual economies. That ties the economies closer together since trade relationships become much more intensive. At the same time trade imbalances can no longer be corrected by exchange rate adjustments. Therefore differences in competitiveness affect the respective economies to a much larger extent than economies with an exchange rate.

Furthermore, there is a common interest of all members to meet the inflation target. All these are issues that do not directly affect the non-members of the euro area. In addition, they are able to react to these decisions by adjusting their exchange rate against the euro. Therefore they should not be involved in decisions that only affect the euro area. The risk of this strategy is that it may prove politically divisive, since the ideal of a uniform EU membership is given up. However, from an economic point of view, governance is improved by the existence of a euro Ecofin group.

3. Economic Policy Coordination in the EU

Currently, economic policy coordination exists only for monetary policy and – in a looser manner – for fiscal policy. In the case of monetary policy coordination is perfect, since there is only one policy maker, i.e. the ECB. Fiscal policy is basically still conducted at the national level. However, the Stability and Growth Pact (SGP) requires budgets that show surpluses or are at least balanced in the longer run. For most member states such a rule implies a fiscal policy path that tends to be restrictive not for national but for European reasons. In the case of wage policy European coordination is completely non-existent. This is sub-optimal governance with respect to a stable macroeconomic development in the euro area. The reason is that economic policy in the present setting for the euro area is not able to respond optimally to economic shocks especially if they are of adverse nature, and to internal imbalances.

If the euro area is hit by a positive shock triggering buoyant growth, high employment and the danger of overheating, monetary policy can pull the brakes and raise interest rates to cool the economy down. Inflation can thus be avoided. But monetary policy works only slowly and the impact will be felt only after some time. The danger is that by then expectations will

already have adjusted to a higher inflation path and an additional cooling down is required. The cooling down could occur faster if fiscal policy could be supportively restrictive at the European level. However, since fiscal policy is of national responsibility, this is by no means guaranteed. Only if national fiscal policy makers behave optimally with respect to their national cycle, one would get an appropriate euro area fiscal policy stance. Then fiscal policy would be restrictive in those member countries, where growth is particularly buoyant, and less so in countries, where this is not the case. On an aggregate level the result would be optimal .But if national policy makers think more in terms of a beggar-my-neighbour policy, things turn out to be different. Then national fiscal policy makers may try to avoid a restrictive course hoping that other countries will be restrictive enough to stabilise the euro area economy. In this case fiscal policy will be too expansionary from a euro area perspective. If the ECB expects such a kind of behaviour, monetary policy is forced to adopt a more restrictive stance right from the beginning.

In case of an adverse shock the outcome may be even more problematic. Again monetary policy can act as necessary. But an expansionary monetary policy takes even more time to become effective than a restrictive one. The support of fiscal policy would therefore be particularly helpful. However, the support of fiscal policy is unfortunately more doubtful than in the reverse case. Apart from the beggar-my-neighbour lines of reasoning mentioned above, the SGP limits the leeway for an expansionary fiscal policy. There is the threshold of 3 % and the debt ratio of 60 % as well as the general requirement of balanced budgets. Therefore, an additional wage coordination would also help. If inflationary pressures result form excessive wage increases, a coordinated wage policy would help to fight inflation fast. In other words, a macroeconomic dialogue on a tripartite level between ECB, Ecofin and the social partners would be a useful tool to stabilise the euro area. There are already forms of such a macro dialogue. But the ECB in particular has not acknowledged its importance so far. Therefore the economic policy governance of the euro area still is in a particularly bad shape for times of recession and economic slack.

More fiscal flexibility and more fiscal coordination would help. In principle the SGP has provided more flexibility since its reform. It would be helpful, if at times of economic slack the Ecofin could decide on an expansionary fiscal policy stance for the euro area as a whole to support the ECB in its stabilisation efforts. The macro dialogue would be equally effective in a situation of overheating. This kind of coordination would enhance growth and employment in the euro area, while keeping inflationary pressures at bay. So the proposed changes in the reformed treaty should be welcomed as a step towards the right direction. However, it is not sufficient to overcome the existing severe internal trade imbalances.

For this purpose either wage coordination or fiscal policy coordination would have to be implemented. The first option would address diverging competitiveness directly. If wage increases in all member countries more or less followed national productivity paths, inflation rates would converge. Real exchange rates and consequently the relative competitiveness of member states would be stabilised. In order to reverse the existing divergences, higher wage rises in Germany and Austria and lower ones in Italy and Spain would be necessary. Currently there is no institutional structure that ensures such a kind of wage convergence. Hence it seems highly unlikely that such a process can be achieved in the short run.

For this reason an indirect method of fiscal policy coordination is advisable for the time being. In those countries facing a significant wage restraint like in Germany a looser fiscal stance is recommended than in those member countries where higher wage increases prevail. As a result growth and employment expansion should be stronger in the former leading in the end to the desired wage dynamics. This indirect method would definitely take longer and may lead to a conflict with the requirements of the SGP. This shows that there is not yet any sound solution for the coordination problem in the euro area. Any institutional framework that facilitates such cooperation would enhance stability in the euro area.

4. Conclusion

Currently available information on the reformed treaty indicates that the governance structure will be improved after its adoption. However, much remains to be done until the euro area in particular achieves optimal governance. The main problem is that national interests still dominate. However, a truly European internal market calls for truly European policies. Therefore the institutional framework which the EU has had up to now does not fit any more. A European Monetary Union can only be economically successful, if there are truly European governance structures. That would also help to stabilise the national economies.

THE REFORM TREATY: MONETARY AND ECONOMIC POLICIES UNAFFECTED

Briefing paper for the Economic and Monetary Committee of the EU Parliament

October 2007

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Summary

The new treaty, should it become reality, is likely to include the monetary/economic policy provisions already present in the constitutional treaty. Moreover it would not entail any changes to the *substance* of the present provisions (e.g. from the EC Treaty) and therefore would leave the tasks, mandate and legal status of the ECB unchanged. Finally, the new treaty is unlikely to substantially affect the actual conduct of monetary (and much of the overall economic) policy in the EU.

'Coordination' (of economic policies within the Union) is the term appearing quite regularly throughout the Constitution and the Draft Treaty presented to the Intergovernmental Conference (July 2007). It is gradually becoming a magical catchword, empty of concrete content. Coordination of truly vital policies (e.g. of the fiscal ones) still does not seem possible. Monetary policy of the Union is also left to itself. The Economic and Financial Committee (to consist of the representatives of the member states, the Commission and the ECB) is highly unlikely to bring about any coordination of monetary and fiscal policies. At best it will become a forum for voicing finance ministers' discontent with the ECB policy.

All in all, the Reform Treaty will leave the provisions on monetary/economic policies essentially unaffected. Of course, in practice things will be changing anyway. People (including decision makers) learn by doing. On that principle the policy of the ECB has been gradually improving (the Stability and Growth Pact has been modified etc.). There are however some limits to the improvements that can be achieved within the present institutional and legal arrangements. The major problems (or deficiencies) of the present system are unlikely to be tackled successfully without some radical changes in the way the Union functions (economically and therefore also on the political level). Specific problems that I have in mind relate to (1) destabilizing macro effects of a single monetary policy applied to countries that do not share a common business cycle; (2) emergence of harmful 'beggar thy neighbour' practices (through real competitive devaluation based on inordinate suppression of domestic wages and demand in some euro countries); (3) absence of an authentic central bank for the euro area that would be capable of acting as a lender of last resort under a financial crisis of truly pan-European proportions.

The Monetary Policy Provisions of the Reform Treaty: Most Likely Not Quite New

The *Draft Treaty amending the Treaty on European Union and The Treaty establishing the European Community (The Draft…),* presented to the Intergovernmental Conference (July 2007) does not seem to be much different *in substance* from the Treaties it is supposed to be amending – at least as far as the monetary (and economic) policy matters are concerned. (I am referring here particularly to points 82) through 102) of the *Draft…*, as well as to the *Specific Amendment 10)* appended in the *Protocols to the Draft…,* which proposes some fairly minor changes to the Statute of the ESCB and the ECB.) It may be noticed that the *Draft…* does not seem to differ much in substance also from the provisions on monetary and economic policy matters contained in the (failed) constitutional treaty (here I am referring primarily to Articles I-30, III-177 through III-202 (and also I-15) of the Constitutional Treaty).

Three conclusions follow: (1) the new treaty, should it become reality, is indeed likely to include the monetary/economic policy provisions already present in the constitutional treaty; (2) the new treaty, should it become reality, would not entail any changes to the *substance* of the present provisions (e.g. from the EC Treaty) and therefore would leave the tasks, mandate and legal status of the ECB unchanged[7]; (3) the new treaty, should it become reality, is unlikely to substantially affect the actual conduct of monetary (and much of the overall economic) policy in the EU.

Of course, the whole legislative effort, even if restricted to streamlining, updating, clarification etc. of the existing legislation (and of the existing practice – also when this is not quite consistent with the spirit of the existing legislation), is not useless. For instance, it is reassuring to learn that the constitutional treaty (as well as the Draft…) makes it quite clear that the Governors of the central banks of the non-euro EU countries cannot sit on the Governing Council of the ECB, or that the 'Eurosystem' is to be officially recognized; or that it will *now* be constitutional for the Council of Ministers of the eurozone countries to make decisions on the basis of the votes of the member states of the eurozone (without the participation of the other member states) with regard to e.g. 'measures to strengthen the coordination and surveillance of budgetary discipline'.

Too much of unspecified 'coordination'

'Coordination' (of economic policies within the Union) is the term appearing quite regularly throughout the Constitution and the Draft… . 'Coordination As Such' is even given a separate Article (I-15) in the prominent Part I of the constitution. A (possibly incomplete) list of references to 'coordination' includes Article III-177 (which even demands 'close coordination'), Article III-179 (countries to contribute to the achievement of the Union's objectives through coordination), Article III-192 (to promote coordination an Economic and Financial Committee is to be set up), Article III-194 (the Council to adopt measures specific to the euro countries, with the aim of – among others – strengthening the coordination and surveillance of their budgetary discipline), Article III-199 (the ECB to strengthen coordination of the monetary policies of the non-euro member states), Article III-208

[7] The ECB's corrections (fairly minor in my judgement) suggested, back in 2003, in its opinion on the draft constitution were largely accepted. Overall, the ECB seemed quite satisfied with the constitutional treaty – although (or perhaps because) that did not really attempt to change anything of substance (as far as monetary policy was concerned). Interestingly, the seemingly innocuous provision of the present Draft… (2007) making the ECB a European Institution has provoked an angry response from the ECB. In a letter to the Portuguese Presidency dated 2 August, Mr. Trichet expressed 'a strong view' that 'because of its specific institutional features, the ECB needs to be differentiated from the Union's institutions'.

(encouraging coordination of labour market policies), Article III-213 (on coordination of social policy actions), and Article III-221 (requesting coordination of economic policies strengthening economic, social and territorial cohesion).

'Coordination' is slowly becoming a magical catchword – a close equivalent (or perhaps even a relative) of the term 'planning' which littered the constitutions of the defunct 'planned economies' of central and eastern Europe.[8] Of course, 'coordination', like 'planning', may be a good thing – provided it is technically feasible, and serves an uncontroversial purpose. Surely, there must be many specific economic policies that could perhaps be coordinated across countries – and across specific policy areas. However, it may still be rather unrealistic to expect any meaningful coordination of major, truly important policies – and of the fiscal policies in particular. What specific rules would guide coordination of fiscal policies of 27 or more sovereign national governments? Besides, even assuming unanimity on goals and uniformity of circumstances facing the individual countries, a meaningful coordination of fiscal policies of 27 countries would probably consume unimaginable resources. Or it would require a strong EU fiscal authority, with the national fiscal authorities becoming its regional departments. This is still out of the question. Fiscal policies are to remain the sole responsibility of the member states. It may be observed that the fiscal provisions of the Stability and Growth Pact apply to the fiscal policy of individual member states, without taking into account the fiscal developments in all other member states. Thus, the SGP is mute on *coordination* (or otherwise) of national fiscal policies. This is natural not only because the business cycles in individual countries (even within the eurozone itself) are still far from synchronized. Fiscal policies also differ because specific political and economic preferences are not the same across the member states. It should be observed here, that the Union's *own* fiscal policy cannot contribute to a coordination of fiscal policies (and actual fiscal developments) across the member states. The Union's budget is miniscule (in comparison to the national budgets). It is important for some (limited) redistribution of resources within the Union, and for the advancement of some specific goals of the Union. But the Union budget is not permitted to run deficits. Hence it cannot contribute to e.g. macro stability in the Union (and even less so in individual member states).

No concrete provisions on coordination of fiscal and monetary policies

The fact that fiscal policies in the Union (or even within the eurozone) are left uncoordinated may explain the absence of more specific provisions demanding coordination of the monetary policy (of the Union – i.e. of the ECB[9]) with the fiscal policies followed in the member states. The Union's monetary policy does not have a single fiscal counterpart. And it need not take into account the fiscal considerations of individual member states. Moreover, the ECB often claims that it *must not* take such considerations into account. As things stand now, the monetary policy has gained an upper hand in the overall economic policy making in the Union (or, rather, in the eurozone). The ECB makes use of its unique independence to take decisions to which the individual fiscal policies of the member states have to adjust. This arrangement is inconsistent with what is believed to be necessary for the optimal conduct of the macroeconomic policy – which is the *coordination* of fiscal and monetary policy. The inherent sub-optimality (to put it mildly) of the present arrangement will, almost certainly, be preserved in the future Reform Treaty. Things cannot be different unless a much stronger Union's fiscal authority is set up – or unless the ECB develops a truly *cooperative*

[8] Ironically, the omnipresent planning under 'central planning' ended up in a total economic disorganization.

[9] There is another complication here. Although the ECB runs, according to the Letter, the monetary policy of the entire Union, in reality it does not do so. The ECB may be expected to 'strengthen coordination' of the monetary policies of the non-euro member states, but it has no right to meddle in the policies of The Bank of England, Sveriges Riksbank, Narodowy Bank Polski, etc. Thus, within the whole Union there are still many monetary policies that in actual fact remain uncoordinated.

relationships with the finance ministers of *individual* member states. Of course, the Treaty is unlikely to require the ECB to behave cooperatively in its dealings with the finance ministers. Rather, it will extend the existing provisions that guarantee the unique independence of the ECB.

But there is perhaps a growing uneasiness over this arrangement. This is testified by Article III-192 of the Constitution which establishes an 'Economic and Financial Committee' (to consist of representatives of the member states, the Commission *and* the ECB). The mandate of the Committee will be 'to promote coordination of the policies of the Member States'. I do not believe that this Committee will contribute, in the foreseeable future, to any meaningful coordination of economic policies in the Union. In particular, given the economic doctrines popular among the central bankers generally (and at the ECB in particular), the Committee is highly unlikely to bring about any coordination of monetary policy (of the ECB) with the (national) fiscal policies. At best the Committee may become a forum for voicing the finance ministers' discontent with the ECB policy (and for the ECB lecturing its partners on the advantages of flexible labour markets, balanced budgets, low taxes etc.).

Some fundamental problems remain

The ECB monetary policy has been gradually improving. Opinions of politicians (e.g. EU Parliament Members[10]) have already had some (delayed) impacts on the conduct of the ECB policy. For instance, the notorious 'monetary pillar' of the ECB policy seems to be losing importance, the definition of the inflationary objective ('inflation rate close to but below 2% over the medium run') is currently somewhat less ambiguous than it was initially. Further improvements may be expected, especially as concerns e.g. the definition of the ECB strategy, some operational practices, transparency, communication, accountability – possibly also the nature of the ECB independence. Progress to be made in these areas does not – in most instances – seem to require substantial revisions of the existing treaties.

There are, however, some more fundamental problems with the current system that may need, in my opinion, to be somehow addressed (preferably sooner rather than later). Workable solutions to these problems (if found – and generally approved) would then require rather radical changes in the way the Union functions economically (and therefore also on the political level). No doubt these changes would necessitate a rather different legislative framework. In what follows I briefly outline three problems I consider the most important.

1. A single nominal ECB interest rate implies different real rates across the euro area

The principle of one single policy interest rate for the whole of the eurozone has proved to be destabilizing macroeconomically for individual member states. The ECB interest rate has had radically different consequences throughout the eurozone. While in low-inflation countries (such as Germany) the ECB rate has – in the past – implied quite high real market interest rates, in higher-inflation countries (such as Spain or Ireland) that same ECB rate implies low (or even negative) real market interest rates. The perverse consequence of this is that the same monetary policy which is actually too restrictive in low-inflation (and hence usually also low-growth) countries, is at the same time too lax in higher-inflation (and quite often high-growth) countries. Thus, the present ECB mechanism actually amplifies rather than reduces cyclical fluctuations in individual member states. In practice the 'one-size-fits-all' principle tends to read 'one size does not fit anyone'. There is no guarantee that the business cycles in individual member states will become synchronized in a reasonably short perspective (or ever).

[10] Supported by their humble experts.

2. Common currency does not preclude 'beggar thy neighbour' practices

With the common currency no member of the euro area can resort to 'nominal competitive devaluation' of its own currency vs. the currencies of other member states. (This was certainly an important consideration (e.g. for Germany) when the euro was designed.) However, it has become apparent that some countries can – and do – engage in '*real* competitive devaluation' which does genuine harm to their euro area partners. The trick behind the policy of 'real competitive devaluation' is to suppress the legitimate growth in domestic wages (i.e. growth that would be broadly consistent with rising labour productivity). Suppression of wages (which is facilitated by high unemployment, attempts at cutting public sector spending and also restrictive monetary policy) brings about gains in unit labour costs – especially versus the countries which do not suppress the legitimate growth of their domestic wages. Germany is the prime example of a country indulging in such a real competitive devaluation.

In *real terms* the German exchange rate (deflated with unit labour costs) has been devalued very strongly against that of, say, Italy or Portugal.[11] For Germany two consequences follow:

(1) the suppressed domestic wages restrict growth in domestic consumption and demand, thereby adding to the tensions on its labour market;

(2) the already gigantic trade surpluses rise further[12]. A trading partner thus out-competed by Germany registers rising trade (and current account) deficits and consequently overall stagnation/high unemployment, with no obvious way out of the situation.[13]

All in all, at present there is no prohibition of the 'beggar thy neighbour' policies, whereby some countries can try to push their own unemployment on to their euro area partners. But the fear is that the resulting disequilibria can release centrifugal forces that may threaten to tear the euro area apart. Clearly, something must be done to prevent the members of the euro area (and of the Union as well) from potentially destructive, aggressive, real competitive devaluation practices.[14]

3. A genuine Central Bank for the euro area is missing

Unlike the national central banks (also of the euro area countries), the ECB does not actually issue money. This is the prerogative of the national central banks of the euro area. Moreover, unlike the national central banks, the ECB it is not backed by any fiscal authority. Thus the ECB does not have the Lender-of-Last-Resort capability which may be essential for the *management* of systemic financial crises of truly pan-European proportions. In the euro area the financial crisis management arrangements boil down to the provisions stipulating for voluntary cross-border cooperation between the central banks, payment systems, finance ministries, deposit-guarantee schemes, EU committees etc. The first fiddle in the crisis management is still played by the national central banks (in tandem with their finance ministers) of the countries likely to suffer most. The recent financial crisis ignited by the sub-prime mortgage crisis and the bursting of the house price bubble (in the USA) is actively

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[11] Specifically, by 19% and 23% respectively, over the period 1999-2005.

[12] Germany's trade *surplus* vs. the euro area rose to ca. 100 billion euro by 2005 (twice the 1999 level).

[13] One way for such a partner would be to counteract the German policy by massive cuts in its *nominal* wages. But it is hard to imagine the levels of unemployment and overall misery that would be necessary to restore, that way, the parity with the German unit labour costs. The second, equally nasty solution, would be to re-introduce an own currency whose value could then be freely adjusted vs. the (German) euro. There is – in theory at least – a third way: to induce Germany to allow its labour force earn wages that would be more in line with its productivity. Or, to encourage the Germans to consume much more rather that to generate, at the expense of others, excessively high savings.

[14] One cannot mind countries' gaining competitiveness through innovation, rising efficiency etc. But one is right to mind rising net exports of e.g. China – knowing full well that these exports represent repressed wages and living standards of the Chinese workers.

dealt with primarily by Deutsche Bundesbank and Banque de France – the two countries whose banks had exposed themselves to too much risk.[15] The potential weakness of the present arrangement may be hard to neutralize without *some* centralization of the EU crisis management. As emergency lending (or the potentiality of extending such lending) is essential to crisis management, an EU institution (ECB?) to be involved in the actual crisis management would have to be in a position to act – within some limits at least – as the Lender-of-Last-Resort. For that, it would need to have sufficiently deep pockets (Treasury backing) and/or have the unrestricted right to issue money itself. In any case, that institution would acquire attributes of an authentic central bank which the current ECB lacks.

[15] The media reporting notwithstanding, the hundreds of billions of euros of the emergency assistance that have flown into the European banking system could not have come from the ECB (whose own capital is about 5 billion euro).

TREATY REFORM: CONSEQUENCES FOR MONETARY POLICY

Briefing paper for the Economic and Monetary Committee of the EU Parliament

October 2007

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The Reform Treaty shall be drawn up by October 2007 and signed at the December 2007 summit at the latest. This paper is based on the first draft of the Portuguese EU presidency (July 2007) including corrections communicated until the deadline of this paper on Sept. 21, 2007.

President Trichet criticised the first draft stipulating that the ECB is included in the list of EU institutions as this is at odds with the EMU pillar of independence. The ECB should be classified – as agreed in the Constitutional Treaty – as an "other institution of the EU" on the basis of the ECB's correction proposals. We share these concerns.

The six members of the ECB's Executive Council are to be appointed by majority vote of the European Council instead of a consensus decision. This will expedite the appointment process and reduce associated uncertainty in financial markets.

The June 2007 EU summit decided that competition is no longer considered as an EU target. It should, however, not be overlooked that monetary and competition policy share the common goal of price stability. There are some risk areas regarding competition. Some member states might be tempted to expand their scope for state support and industrial policy.

The Reform Treaty will contain several special provisions strengthening EMU's economic governance. They comprise the appointment of a Eurogroup president, fiscal coordination and the Broad Economic Policy Guidelines (BEPG).

- **The election of a Eurogroup president is only a formal innovation** as president Jean-Claude Juncker was already appointed in 2005. The president's frequent request for close policy coordination with the ECB has been a challenge to its independence.
- **The Reform Treaty will promote fiscal coordination within the reformed Stability and Growth Pact.** The preventive arm is to focus on medium-term budgetary planning and sustainable fiscal positions. Yet, the political will of EMU states remains essential. The corrective arm will address some flaws regarding the incentives to reduce excessive budget deficits.
- **The Reform Treaty also contains two changes regarding the BEPG.** For instance, the Commission may address warnings directly to a member state that is not complying with the BEPGs. This provides an incentive for EMU member states to increase flexibility in product and labour markets and reduce costs and inflationary tendencies.
- **EMU's international voice will be enhanced by institutional reforms** and the formulation of a common position in international institutions. A target for the euro/dollar exchange rate could result into a conflict for the ECB between price stability and an exchange rate target.

I. State of the Reform Treaty process

Reform Treaty to be agreed on in 2007

The European summit in June 2007 constituted an Intergovernmental Conference (IGC) with the mandate to draw up a Reform Treaty by October 2007 on the basis of key elements of the Constitutional Treaty. The Portuguese EU presidency presented the first draft on 23 July, 2007. It is planned to conclude the IGC at a special EU summit in Lisbon on 18 and 19 October and to sign the Reform Treaty either immediately or at the regular EU summit in December 2007. Ratification is to be completed ahead of the European elections in June 2009. The changes of the Reform Treaty will, however, only come into effect if all ratification hurdles – including referenda in some countries – are overcome.

II. Task and assumptions

Due to this schedule, the final version of the Reform Treaty is unlikely to be agreed on prior to the deadline of this briefing paper on September 21, 2007. Thus, it is necessary to make assumptions on information available on Treaty changes when analysing the consequences for monetary policy of the ECB. It is assumed that the Reform Treaty will contain the changes laid down in the first draft including those corrections agreed on and communicated by the IGC until this deadline.

The Constitutional Treaty is the basis for the Reform Treaty

According to the IGC mandate[16], the aim of the Reform Treaty is to enhance the efficiency in decision-making, democratic legitimacy and to strengthen its international voice and clout of the enlarged Union. The Reform Treaty will amend both the Treaty on the European Union (TEU) and the Treaty establishing the European Community (TEC) which is to be renamed the Treaty on the Functioning of the Union (TFU). The IGC mandate is based on the general understanding that the key Maastricht pillars of EMU remain unchanged, in particular the provisions regarding the objectives and tasks of the European System of Central Banks (ESCB) and the ECB. Further, there is also broad understanding that the innovations of the Constitutional Treaty agreed by the European summit in June 2004 should be transferred to the Reform Treaty and remain untouched. But the IGC mandate also includes additional modifications in the Reform Treaty, e.g. the Constitutional Treaty's reference to free and undistorted competition as a target of the EU was deleted above all on French request.

The innovations of the Constitutional Treaty combined with additional modifications provide the basis for the changes in the Reform Treaty. While only a few changes touch monetary policy directly, there are several changes regarding economic governance, i.e. economic, fiscal and competition policy as well as institutional reforms which may indirectly refer to monetary policy. Thus, it seems reasonable to differentiate in our analysis between treaty changes with direct and indirect impact on monetary policy.

III. Direct consequences on monetary policy

1. The ECB's criticism of institutional status

The ECB welcomed the summit decision on the IGC mandate on a Reform Treaty in its opinion paper of July 5, 2007 and stressed that it "understands that, except as indicated in the IGC mandate, the text of the Treaty on European Union (TEU) will remain unchanged"[17]. Accordingly, the ECB assumed that the Reform Treaty "will introduce the innovations resulting from the 2004 IGC into the Treaty on European Union (TEU) and …the Treaty on the Functioning of the Union (TFU)".

Concern about independence should be taken seriously

Surprisingly, there are some ECB-related passages in the first draft of the Reform Treaty which are not mentioned in the Constitutional Treaty. This has caused heavy criticism by the

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[16] Brussels European Council, 21/22 June 2007, Presidency Conclusions, Annex 1. The IGC mandate includes that the Union is to get a single legal personality. The word "Community" will throughout be replaced by the word "Union".

[17] Opinion of the ECB of July 5 2007 at the request of the Council of the European Union on the opening of an IGC to draw up a Treaty amending the existing Treaties, ECB web site, http://www.ecb.int/ecb/legal/pdf/en_con_2007_20_f_sign.pdf

President of the European Central Bank, Jean-Claude Trichet[18]. The main issue is the first draft of the Reform Treaty stipulating that the ECB is included in the list of EU institutions[19] and not characterised – as agreed in the Constitutional Treaty – as an "other institution of the EU". This would imply that the ECB could readily be treated as an ordinary EU body such as the Commission and in that capacity be obliged to cooperate closely with all other European institutions to pursue the set of common European targets. A point of concern is the possible demand for ex-ante-coordination of monetary and fiscal policy on the part of EU institutions and member states. Thus, the ECB is right in pointing out that this classification of the first draft is at odds with the key Maastricht principle of independence. This is irritating for market participants although the principle of independence is also stipulated in other parts of the Reform Treaty. The wording on independence should be unambiguous.

The current distinct wording has helped the ECB to establish and maintain a high reputation in financial markets. The ECB does, of course, not operate in a policy-free area. The other side of the coin is, however, its accountability vis-à-vis the general public and the European Parliament which has also been successfully practiced since 1999.

Further, ECB's independence has decisively contributed to the high degree of price stability in the euro area since 1999 and the low nominal (and real) interest rates which are a main prerequisite for sustainable growth. This is a great achievement given the fact that oil prices have tripled between 1999 and 2007. Interestingly, the ECB has shown a better stability performance for the euro area (with an average annual inflation rate of 2.1% since 1999) than the Bundesbank in Germany during the D-Mark period from 1948 to 1998 (2.8%).

Diluting independence could harm ECB's reputation

As things are now, the ECB reasoning deserves political support as well as support from financial market participants in demanding the implementation of the wording of the Constitutional Treaty treating the ECB as an "other institution" of the EU. This would clarify the special status of the ECB as a legal entity. The Reform Treaty should not be used wrongly to dilute the ECB's institutional status of independence through the backdoor since it would encourage some countries to rekindle the debate about independence. The repeated demand of the French president to establish an economic government as political counterpart to the ECB must be interpreted as an attempt in this direction. Any attempt to water down the independence could easily harm the high reputation of the ECB in the general public and in financial markets, in particular in market situations characterised by high uncertainty. It could increase the risk of higher interest rates in the medium and long-term.

Further criticism of the ECB concerns the provisions for the national central banks (NCBs) and the European System of Central Banks (ESCB) in the Reform Treaty. The NCBs should explicitly be mentioned[20] in the Treaty on European Union (TEU) to stress their status of independence and of being an integral part of the Eurosystem in which they play a crucial role in implementing monetary policy in the day-to-day business. There should also be a reference to the ESCB in the Reform Treaty emphasising the monetary linkage between the ECB and the central banks of those EU countries that are not yet a member of EMU but are supposed to join EMU in future.

Wanted: Sensible Solution

A convincing way out is deemed to be necessary to avoid any harm to EMU's institutional framework. The best solution would be obtained if the correction proposals of the ECB are fully accepted by the IGC (see also footnote 3). If the IGC does not accept the proposals of the ECB it will primarily be the task of euro area member governments with a long stability tradition – such as Germany – to pick up the ECB's issues again and insist on elaborating a sensible solution before agreeing on the Reform Treaty.

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[18] Letter of the president of the ECB to Manuel Lobo Antunes, President of the Council of the European Union, dated from August 2, 2007, ECB web site, http://www.ecb.int/pub/pdf/other/jct1080en.pdf; the annex on page 3 to the letter contains correction proposals of the ECB.

[19] Draft Treaty amending the Treaty on the EU and Treaty establishing the EU, Article 9.

[20] in Article 9.3 about the Union's institutions: the provision relating to the ECB which together with the National Central Banks constitute the European System of Central Banks… are set out in the Treaty of the Functioning of the Union, see Letter of the president of the ECB to Manuel Lobo Antunes…annex page 3

2. Executive Council to be appointed by majority vote

The Reform Treaty stipulates that the six members of the Executive Council of the ECB are to be appointed on the basis of a majority vote by the European Council instead of on the basis of a consensus decision. This should be a positive message for monetary policy insofar as a majority vote is expected to expedite the nomination and appointment process of a new member of the Executive Council. It will reduce the likelihood of a long public discussion about the appropriate candidate and the associated uncertainty in financial markets.

Appointment may be a non-event

However, the uncertainty aspect of an appointment should not be overemphasised regarding the "noise" it might cause in financial markets. A recent study based on nominations of central bank heads in 15 countries concluded that financial markets react only moderately to a new appointment such that it is considered to be a "non-event"[21]. Furthermore, there are no reported reactions of financial markets concerning the appointments of ordinary central bank board members. Given the fact that members of the Executive Council are appointed for a nonrecurring term of eight years there will usually be only six appointments within a period of eight years. The next regular appointment is scheduled for June 2010 as the term of Vice President Lucas Papademos will expire at the end of May 2010. Thus, this treaty change should only have a minor influence on monetary policy.

IV: Indirect impact on monetary policy

1. Competition policy: Cause of concern for the ECB?

Monetary and competition policy share the goal of prices stability

The EU summit in June 2007 weakened the role of competition in the Single Market by agreeing on the mandate of the IGC for the Reform Treaty. The Constitutional Treaty's reference to free and undistorted competition as an EU target was not transferred to the Reform Treaty. While the current EC Treaty[22] alludes to the key provision of "a system ensuring that competition in the internal market is not distorted", the relevant new article merely states: "The Union shall establish an internal market".[23] Hence, competition is no longer regarded as a target of the EU but only as a means to achieve EU policies. This might imply that other institutions such as the European Court of Justice cannot use it as a reference in their decisions. The key question is whether this change in wording will weaken EU's competition policy and the political discipline to secure competition in the single market in the future or whether it is only semantics. The problem is that any reduction in competition is likely to raise the price-hiking power of companies and thus impeding the ECB's task of price stabilisation. For this very reason, it should not be overlooked that monetary policy and competition policy share a common goal, namely price stability.[24]

Nevertheless, the connectivity between monetary policy and competition policy has been disregarded so far. For instance, the European Commission has recently played down the practical relevance of this change for competition policy[25]. Indeed, the EU's competition policy might remain unchanged. A critical view must, however, be allowed with regard to the political attitude towards competition on the national level. In particular, French President Nicolas Sarkozy even questioned the essence of the antitrust policy within the EU by claiming that competition has done nothing but undermined the popular support for the EU.

Workable competition is key to monetary policy

Functioning competition is not only essential for monetary policy but also for growth and income origination for at least three reasons. First, competition is putting permanent pressure

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[21] Kenneth N. Kuttner and Adam S. Posen (2007), Do Markets Care Who Chairs the Central Bank? Working Paper 07-3, Peterson Institute for International Economics, Washington DC

[22] Draft Treaty amending the Treaty on the European Union and Treaty establishing the European Community, Article 3 (1) (g)

[23] Instead an understated reference to competition is mentioned in a protocol: "The High Contracting Parties, considering that the internal market as set out in Article 3 of the Treaty of the European Union includes a system ensuring that competition is not distorted."

[24] Mario Monti (2006), Competition Policy and Monetary Policy: A Comparative Perspective, Bank for International Settlements, Per Jacobsson Foundation.

[25] European Commission, Press Release, July 10 2007, Memo 07/ 283, Questions and Answers on the IGC mandate for a Reform Treaty

on companies to cut costs, improve productivity and secure competitiveness in a globalised environment. Second, competition is an optimum way to discover better products and methods of production. Third, it works as a tool to restrict the pooling of economic power, e.g. in form of monopolies.

Three risk areas for competition policy

At the same time, competition is frequently considered inconvenient by companies and politicians. This is closely associated with the desire to reduce or avoid competition. Thus, it is important for analysing the consequences for monetary policy to identify risk areas in the single market in which the change in competition wording might foster the temptation on the part of governments to restrict competition. There are at least three risk areas:

State aid

First, a weakening of the competition approach might be exploited by member states to expand their scope for state aid and subsidies which would be ultimately even harder to monitor by the Commission.

State intervention

Second, the EU has witnessed a wave of economic *patriotism and state interventionism* in the wake of globalisation in recent years. The change in competition wording might be exploited as an argument to boost industrial policy in some countries even further and shape national champions regardless of their effect on competition.

Lack of structural reforms

Third, a key issue for stimulating growth and supporting ECB's monetary policy is the continuation of EMU member states to carry out *structural reforms* in the labour and product markets which are meant to increase the flexibility of price setting and competition.

Therefore, any attempt to reduce the key role of competition in the single markets could easily make an impact on the conduct of monetary policy. The problem, however, arises in the difficulty to predict which immediate consequences this treaty change might have on the management of EU competition policy and which consequences might follow for monetary policy. Nevertheless, the effects of subsidies, state interventions and structural reforms on competition, price stability and monetary policy should be closely monitored not only by the Commission and the ECB but also by the European Parliament.

2. ***The strengthening of EMU's economic governance may exert influence on monetary policy***

Special provisions for EMU's economic governance

Under both old and new EC Treaties member states are obliged to treat their economic policies as a matter of common interest and to coordinate economic policies, in particular within the framework of the Stability and Growth Pact, the Broad Economic Policy Guidelines and the Lisbon Agenda. While the pillars of economic governance in the EU will witness hardly any change, the Reform Treaty will contain several special provisions which only apply to EMU countries. Policy coordination is necessary in EMU as a centralised monetary policy is confronted with decentralised economic, fiscal and structural policies. In this field the Eurogroup of EMU finance and economics minsters has been a very helpful forum to discuss common policy issues and coordinate policies.

Yet, policy coordination has also shown some shortcomings such as the excessive budget deficits in several EMU countries (incl. Germany and France) in the period from 2002 to 2005.

Moderate strengthening of the Eurogroup

Therefore, the aim of the Reform Treaty is to moderately strengthen the role of the Eurogroup and improve policy coordination within the euro area. The Eurogroup will also be officially recognised as a kind of "Euro-ECOFiN-Council" and the term Eurogroup mentioned in the Treaty for the first time. This will also address the rising political clout of the Eurogroup within the EU and internationally. Nevertheless, the Reform Treaty does not consider the Eurogroup as an official Council formation but only confirms the established practise of informal meetings.

As regards monetary policy, the following Reform Treaty changes in the area of economic governance are worth to be mentioned[26]:

1. The appointment of a president of the Eurogroup;
2. Coordination of fiscal policy;
3. Implementation of economic policy guidelines for the euro area;

In these areas the Eurogroup can make decisions without participation of non-EMU member states. Thus, the euro area will get more scope to act legally independent within the EU legal structures.

2.1. The election of a Eurogroup president: old wine in new skins?

Chairman for the Eurogroup confirmed

A formal innovation of the Reform Treaty will be the election of a full-time chairman by the Eurogroup for a term of two and a half years by a majority of its member states. However, this innovation of the Constitutional Treaty had already been introduced well ahead of ratification in a slightly modified version concerning the term of the presidency. The Eurogroup initially appointed the Luxembourg Prime and finance minister Jean-Claude Juncker as its president for a term of two years starting in January 2005 and re-elected him for a second term terminating at the end of 2008.

The election on a Eurogroup president has been a sensible and desirable step forward as it has given the euro area greater continuity in leadership and greater recognisability in the general public as well as international representation. It has been positive for the conduct of monetary policy insofar as stronger leadership has also contributed to improve fiscal policy coordination in EMU within the framework of the reformed Stability and Growth Pact in 2005.

Ex ante-coordination collides with independence

Therefore, the formal inclusion of the election of a Eurogroup president in the Reform Treaty should mean business as usual. But the experience of the dialogue between the president of the ECB and the president of the Eurogroup since 2005 deserves a closer observation. The cooperation between the ECB and the executive bodies of the EU (Eurogroup, Commission) is well organised by the existing Treaty.[27] There are three meetings per month which should be sufficient to exchange views between the ECB and the Eurogroup. Still, the president of the Eurogroup has repeatedly demanded further meetings with the ECB president with the aim of even closer cooperation. The president of the ECB declined closer cooperation as he is obviously concerned that this could easily end up in an ex ante coordination of monetary and fiscal policies. In turn, this could bind the hands of the ECB with regard to meeting its mandate of price stabilisation. Moreover, ex ante-coordination can easily be in conflict with the principle of the independence of the ECB. Pressure on the ECB to intensify policy coordination with the Eurogroup is likely to be continued both prior to and after ratification of the Reform Treaty with the formal rule to elect a Eurogroup president. And it is unlikely that the ECB will change its stance vis-à-vis the president of the Eurogroup.

2.2. Some progress in fiscal policy coordination

Monetary policy needs the support of sound fiscal policies in EMU member states under the umbrella of the reformed Stability and Growth Pact (SGP). The ECB has, however, voiced concerns regarding both the preventive and the corrective arm of the SGP[28].

Reformed SGP should be implemented

The ECB argues with regard to the preventive arm (which calls for strict consolidation in good economic times) that there are shortcomings in the incentives for compliance as well as in the clarity of rules. This point has been taken up by IGC by issuing a declaration which refers to possible proposals of the Commission and member states clarifying the

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[26] Draft Treaty amending the Treaty on the European Union and Treaty establishing the European Community, Chapter 3a, Articles 114 and 115

[27] The president of the Eurogroup and the Commissioner for economic and monetary affairs (Joaquin Almunia) are invited to participate at the ECB's governing Council meetings every fortnight while the president of the ECB can participate in the monthly meetings of the Eurogroup.

[28] ECB, The Reform of the Stability and Growth Pact, Monthly Bulletin, August 2005, page 59 f.

implementation of the pact. The Commission has recently presented a proposal to boost the preventive arm[29]. Aims of the proposals are securing medium-term budgetary planning and sustainable fiscal positions. The proposals are pointing in the right direction. It remains, however, to be seen whether the proposals will increase the incentives for compliance in a satisfying matter. In this context it is the political will of member countries that counts. This is highlighted by a recent forecast of the Commission stating that only 10 out of 27 EU countries will have reached their medium-term budgetary objective under current policies in 2008, despite three years of dynamic growth. Moreover, the announcement of the French government not to comply with the agreed objective to reach a balanced budget in 2010.

With regard to the corrective arm, the ECB has expressed concerns about the great emphasis on flexibility and discretion in identifying and reducing excessive budget deficits. The ECB also conceded that much depends on the implementation of the reformed pact. Initial experience since the pact reform in 2005 has been encouraging insofar as excessive deficit procedures (EDP) were closed against France, Germany and Greece while Italy and Portugal, although still subject to EDP, have achieved remarkable improvements in their structural deficits in 2006. It should, however, not be overlooked that the lion's share of consolidation was due to the strong upswing.

Enhanced role of the Commission

The Reform Treaty will pick up some concerns of the ECB regarding the lack of incentives to reduce excessive budget deficits. The role of the Commission is enhanced in two ways: (1) the Commission is entitled to directly address a member state that is about to suffer an excessive deficit (instead of a Commission recommendation to the ECOFIN Council which decides to caution the member state according to current rules); (2) The ECOFIN Council's decision on the existence of an excessive deficit will be based on a firm proposal of the Commission (instead of a loose recommendation). As an implication, the ECOFIN Council will not be able to deviate from the proposal unless it will decide unanimously[30].

Voting procedure to be improved

Two further changes in the Reform Treaty relate to the voting procedure of the ECOFIN Council on the existence of an excessive budget deficit. In contrast to the current EC Treaty of Nice, a budgetary offender is no longer allowed to participate in casting votes on measures to correct an excessive budget deficit. This will terminate the inconsistency that a budgetary offender is allowed to be judge and defendant at the same time. Moreover, a qualified majority in this case does no longer require two thirds of EU member states but a qualified majority of EMU member states will be necessary, i.e. 55% of member states representing at least 65% of the population of the euro area. The combination of all these four measures is expected to promote fiscal discipline and support monetary policy from the fiscal side.

2.3. BEPG may support monetary policy

The Integrated Guidelines for growth and jobs are important tools of the revamped Lisbon agenda[31]. Within the Integrated Guidelines the Broad Economic Policy Guidelines (BEPG) comprise macroeconomic policies as well as structural reforms agreed on EU level on the basis of National Reform Programmes (NRP).

Commission: direct warnings to member states

The Reform Treaty also contains two changes regarding the BEPG. Just as in the case of the SGP the Commission may address warnings directly to a member state that is not complying with the broad guidelines. Moreover, a defendant country which does not implement the agreed BEPG guidelines will no longer be allowed to take part in voting on its policy. This might – similar to the SGP – increase the incentives to continue carrying out structural reforms.

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[29] European Commission, Preventive arm of the Stability and Growth Pact needs to be made more effective, IP/07/811, Brussels, 13 June 2007.

[30] Subsequent recommendations of the ECOFIN Council to the member state concerned will continue to be a simply Commission recommendation and provide more scope for assessment for the ECOFIN Council. However, recommendations must be adopted by the ECOFIN Council without undue delay.

[31] The EU summit in March 2005 did not only agree on the reform of the SGP but also on the revamped Lisbon agenda and on the merger of the Broad Economic Policy Guidelines and the Employment Guidelines (which are called Integrated Guidelines).

Structural reforms support monetary policy

In contrast to the SGP, the BEPG are a soft approach of policy coordination. BEPG are a helpful tool to keep structural reform on the national political agenda. Structural reforms not only provide an incentive for EMU member states to sustain growth but also may increase flexibility in product and labour markets and reduce costs thus reducing inflationary tendencies on the national side. Therefore, they are a welcomed instrument to support monetary policy. However, the track record of structural reforms of EMU member states since the start of EMU in 1999 is mixed[32]. Labour market reforms in the euro area have contributed to raise employment and the labour participation. Yet, there is more scope for action regarding sectoral and regional mobility as well as non-wage labour costs. Product market reforms have contributed to a reduction in regulation and brought about more price flexibility, in particular in the network industries such as telecommunication and transportation. Still, further action remains to be taken in the network industries (for instance in energy, postal services and transportation).

2.4. Eurogroup gets more influence in EMU enlargement

The Reform Treaty will enhance the Eurogroup's role with regard to the accession admittance of EU member states to the euro area, i.e. the Eurogroup must present a recommendation on an EMU candidate countries before the Council in full formation can decide on the EMU entry of a new country. This is intended to give the Eurogroup a greater say in EMU enlargement. It remains to be seen whether a recommendation of the Eurogroup will influence the speed of future EMU entries at all since the recommendation of the Eurogroup is likely to be based on the convergence reports of the Commission and the ECB. Those reports are probably presented prior to a Eurogroup's recommendation for a candidate country.

EMU enlargement will trigger rotation system

EMU enlargement will still have an influence on monetary policy insofar as a rotation system was agreed on in 2003 in order to adapt the voting procedure in the ECB's Governing Council to the needs of EMU enlargement.[33] The rotation system has serious disadvantages such as high complexity and intransparency.

Another problem is that, in the extreme, the central bank governors from the small and medium-sized countries could outvote the four large countries and the six members of the Executive Board, and therefore could shift the emphasis in monetary policy from price stability towards greater promotion of growth in the catch-up process.

3. Strengthening EMU's international voice – a source of conflicting interest?

The aim is more international clout for the EU and EMU

The Economist has recently published an article about the EU's international role with the heading: "The European Union is an economic giant but with surprisingly little clout"[34]. International representation of the EU and the euro zone is, however, an important issue in a globalised world economy as the EU is the largest global trading partner and the euro has become the second largest international trade, investment and reserve currency after the dollar. The euro's rise has been particularly distinct in issuing international bonds, while its role as an international trade and reserve currency has remained far behind the dollar. The euro's growing role should also be reflected in the euro area's clout and responsibility in the international monetary and financial system. The Reform Treaty will address the issue of strengthening the international voice of the EU and EMU along two lines of action.

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[32] Klaus Regling (2007), Strengthening the economic leg of EMU, Central Banking, volume XVIII. 1, page 54 f

[33] Lucas Papademos, Economic Heterogeneity, Convergence and Monetary Policy in an Enlarged Euro Area speech delivered at the 7th Biennial Athenian Policy Forum conference, Frankfurt am Main, 29 July 2004. At present, EMU comprises 13 member states. The entry of Cyprus and Malta in January 2008 will not yet change the voting procedure. A two-group model will be introduce if there are more than 15 EMU member states, and a three-group-model if there are more than 15 EMU member states. However, the number of the members of the Governing Council of the ECB with voting rights will be capped at 21: six permanent voting rights for the members of the Executive Board and 15 voting rights for the governors of national central banks, to be exercised on the basis of a rotation system. All members entitled to vote will have one vote, in line with the one person, one vote principle. All members will have the right to attend and to speak. See also Werner Becker, (2004), The institutional framework for accession to EMU, in EU Monitor, Reports on European integration, No. 12, Deutsche Bank Research, page 5 f.

[34] The Economist, Overweight but underpowered, September 6, 2007.

Common position in international institutions

First, in terms of monetary and economic policy the ECOFIN Council is requested to formulate common positions within international financial institutions and ensuring a unified global representation[35] while the Council has to consult the ECB before taking action.

Greater continuity in international representation

Second, the appointment of a Eurogroup president has provided a greater continuity and stability of in the external representation of the euro area.[36] For instance, the attendance of the Eurogroup president in the G7 meetings has been quite helpful to keep euro area issues in the general debate about global governance.

Political will is essential

The institutional reforms, the formulation of common positions concerning international financial institutions as well as the appointment of a Eurogroup president provide a good basis for strengthening the international voice of the Union in general and that of the euro area in particular. The Reform Treaty paves the way for a more efficient international representation of the euro area, for instance within the IMF and the G7. Still, the EU and the euro area can only gain more clout in the global monetary and financial system if there is a political will to speak with one voice.

International accord on the EUR/USD rate unlikely

However, consequences for the conduct of monetary policy may also arise if both the euro area speaks with one voice and the Eurogroup concludes an international agreement within the G7 concerning the exchange rate vis-à-vis the dollar. The competence for exchange rate policy in the euro area is split into fundamental and day-to-day decisions. The latter are made by the ECB, for instance in form of interventions in the foreign exchange market, while the ECOFIN Council is responsible for the former and decides on the exchange rate regime – e.g., whether there are flexible or fixed exchange rates vis-à-vis the dollar. If a fixed exchange rate regime or a target zone for the euro/dollar exchange rate is agreed on by a political decision within the G7, the ECB could get into conflict between securing price stability and supporting an exchange rate target[37] as it had been the case in 1988 under the aegis of the Louvre Accord obliging central banks to defend the dollar rates "around current levels". An international agreement on the euro/dollar exchange rate is possible. Yet, it seems to be rather unlikely in near future for two reasons.

First, regarding a managed reduction of the huge US current account deficit there has also been a fierce debate about a substantial devaluation of the dollar exchange rate against the Asian currencies whereas a further weakening dollar against the euro has not been considered necessary given the balanced current account of the euro area. At present, the US current account deficit is falling due to weaker US growth in absence of an international economic policy and exchange rate accord à la Louvre (from 6.1% of GDP in 2006 to a good 5% in 2007).

Second, it would be extremely difficult to defend a certain dollar exchange rate as the euro/dollar market is huge and dominated by large and volatile international capital movements.

A different exchange rate situation for the ECB might emerge from the recent French-German government declaration to initiate a joint economic policy to buttress EU competitiveness vis-à-vis important countries such as China that keep the euro exchange rate of their currency artificially low. Assuming the euro area will embark on a joint exchange rate policy vis-à-vis the yuan and an exchange rate target for the euro yuan rate being fixed by the Eurogroup, the ECB would be obliged to intervene in the euro/yuan forex market in order to support a revaluation of the yuan vis-à-vis the euro, i.e. it would have to buy yuan and sell euros thus accumulating liquidity in the euro area all other things being equal. Basically a conflict between price stability and an exchange rate target will arise. Yet, the volumes of intervention should be easily manageable by the ECB as the euro/yuan exchange market is relatively small

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[35] Draft Treaty amending the Treaty on the European Union and Treaty establishing the European Community, Chapter 3a, Article 115a.

[36] Klaus Regling (2007), Strengthening the economic leg of EMU.

[37] In that case the ECB has to intervene in the forex market through buying dollars and selling euros which increase euro liquidity all other things being equal and make the job of monetary policy more difficult.

and therefore less important as a source for enhancing euro liquidity to a large extent.[38.] A euro/yuan exchange rate arrangement might also have an impact on the euro/dollar rate: if the yuan does not appreciate the euro will face further upward pressure vis-à-vis the dollar.

[38] The global turnover of the euro/yuan exchange market is not even mentioned in BIS, Triennial Central Bank Survey, Foreign exchange and derivatives market activity in 2004.

Criteria for Monetary Union Accession

MAASTRICHT CRITERIA FOR NEW EU MEMBER COUNTRIES ACCESSION TO EMU

Briefing paper for the Economic and Monetary Committee of the EU Parliament

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Executive Summary

Two previous remarks are necessary: First, past experience with the 12 present member countries when joining EMU shows that the benefits of joining the Euro tend to overcome, in the short to medium term, the costs of adapting to EMU and the costs of higher macroeconomic volatility by being outside the Euro. The Euro appears to be a strong shield that tends to insulate joining countries from exogenous shocks and to help them to achieve macroeconomic stabilization. The dangers of macroeconomic instability tend to be even larger for small, open economies, as are those of the candidates about to join now so they could enjoy larger benefits.

It is all a question of gaining more credibility with the financial markets: once a country joins a well established and credible monetary union, it also becomes credible. This is the main reason why these new EU members are willing to join as soon as possible and therefore, try to meet the Maastricht criteria as fast as they can in order to enjoy lower inflation and interest rates and more trade and capital flows.

Second, some old and new solid critiques have been made of the nominal convergence criteria that these countries have to fulfil in order to become EMU members. Nevertheless, even if these critiques are necessary and make economic sense, they do not have any chance to ever be implemented, given that any reinterpretation, modification or derogation of any of the criteria would violate the "prerequisite of equal treatment" considered to be a cornerstone of EMU, as it was pointed out by the Convergence Report of the ECB (2004).

As a quick reminder, the four Maastricht nominal convergence criteria are the following:

"Price stability", that means an average consumer price inflation rate that does not exceed by more than 1.5 percentage points that of the three best performing member EMU countries.

"Sustainable fiscal position", that means not having excessive general government budget deficits or debt. Excessive government budget deficit means higher than 3 per cent of GDP, unless it is declining and has reached a level close to 3 per cent of GDP or if the surpassing of the 3 per cent level is only exceptional and temporary and remains close to 3 per cent. In the case of the gross government debt criterion, the gross debt to GDP ratio should not go beyond 60 per cent of GDP, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

"Exchange rate stability", that meaning that the currency has respected the normal fluctuation margins of ERM II (15 per cent) without severe tensions for at least two years.

"Low long-term interest rate", meaning that the average long-term interest rate should not exceed by more than 2 percentage points the interest rates in, at most, the three best performing member countries in terms of price stability.

One of the major initial critiques was made by De Grauwe (1994) when he said that the Maastricht convergence criteria involving exchange rates, inflation rates and interest rates were paradoxical: they could be easily met once countries formed a monetary union, while it will be extremely difficult to meet the three criteria simultaneously before the union was

realized. The Maastricht Treaty "had it back to front" since it was nominal convergence before monetary union. Moreover, it would make more sense to go to EMU without the nominal convergence criteria (De Grauwe, 1993).

The lack of enough theoretical foundations in the nominal convergence criteria has been well explained by Eijffinger and de Haan (2000). Later, Hughes Hallet and Lewis (2004) have found that the nominal Maastricht criteria are, at best, irrelevant and at worst, damaging for the duration of the catch-up process of the new EU member candidates to EMU and that, moreover, the three nominal criteria make harder to meet the fiscal criterion. Thus, they suggest that the "principle of subsidiarity" be applied to Euro membership, placing decisions over entry in the hands of the individual member states.

Nominal versus Real Convergence

Charles Wyplosz (2002c) has rightly pointed out that the four Maastricht criteria for nominal convergence, in order to joining EMU, were originally introduced because most European Union member countries had achieved a reasonable degree of real convergence towards the EU average levels of GDP per capita (under PPP terms), but this real convergence had been reached in spite of a persistent nominal divergence among most EU members. Thus, it made sense to choose nominal convergence as the main requisite for joining EMU (even if the important Mundell's OCA (Optimal Currency Area criteria) were not yet met; as shown by Bayoumi and Eichengreen (1993). The original choice of these criteria was based much more on politics than economics, mainly because of Germany's fears of some "fiscally badly behaved" EU members joining too soon. Later on, the Stability and Growth Pact (SGP) had to be introduced to try to bring back to virtuosity some other EMU members, which became fiscally prodigal.

Now, in the case of the new EU member countries candidates to join the EMU, the problem is exactly the contrary. Although they have made some catching up progress, their real convergence is still a far away aim, since it will take many more years for most of these new members to get closer to the EU average GDP-PPP per capita, while their nominal convergence is even closer today than that achieved then by some of today's incumbent members when preparing to join EMU. Thus, as real convergence is going to be only achievable in the long run, then, nominal convergence has been chosen to be achieved as a short to medium term target.

Therefore, the main challenge for the new EU member countries joining EMU is how to achieve nominal convergence starting with a rather low real convergence. Past experience with the first group of candidates to EMU shows that it is easier achieving nominal convergence with a higher level of real convergence than without it, as shown by the greater difficulties to joining EMU for Greece or even Portugal or Spain than for other EMU members (being Italy, with high real convergence, the exception to this rule).

The challenge for the new EU members becomes somehow even greater than for the incumbent members for other reasons as well (Eijffinger, 2006):

The first is that new EU members do not have a formal derogation as the UK or Denmark achieved earlier. Therefore, they have an obligation to join the EMU and to fulfil the Maastricht criteria but, in principle, it is to their discretion to choose the time to achieve them, following the example of Sweden, which has thus far avoided the obligation to joining by not meeting the exchange rate criterion, as shown by Buiter and Grafe (2002b).

The second is that the present ERM II (Exchange Rate Mechanism) is different from ERM I. The new members have to be formal members of ERM II for two or more years after EU accession, when Italy as well as Finland and Greece joined EMU right from the start, even though they did not spent two years in ERM I, (Buiter and Grafe, 2002b).

The third is that in ERM I, all member currencies were bilaterally tied to each other and the burden of intervention in support of each pair was fully shared. By contrast, in ERM II, each currency is tied to the Euro and the ECB does not make any formal commitment to support the parities. Thus, in principle, each country bears the burden of defending its parity (Wyplosz, 2002b).

The fourth is that accession to EMU requires member countries to fully liberalize their current and capital accounts. This is another major issue, since one of the agreed critiques is that their transition period of two or more years at ERM II with limited fluctuations around their parities can be dangerous, not only because some investors can launch speculative attacks against their currency betting on a country or countries not making it, but also because it is a period in which most foreign and mainly Euro Area investors tend to discount its entry and flood them with capital inflows to be the first to get a foot in the new EMU markets, without exchange rate risk. Previous evidence suggests that speculative attacks were large and painful as it was the case of France and the UK (Begg, Eichengreen, Halpern, von Hagen and Wyplosz, 2003).

In this latter case, either new EMU candidate country is not able to fight the speculative attack for lack of financial muscle by its central bank and thus its currency falls beyond its agreed ERM II bands or if there is not such an attack, it gets very large amounts of FDI, portfolio and real estate inflows which appreciate its exchange rate and may provoke a loss of competitiveness, which tends to undermine the growth prospects derived from the same capital flows. Moreover, these capital inflows may also be quite volatile and leave the country if there are increasing doubts about its probability of joining EMU, even more so if there are expectations of a speculative attack on its currency.

If the central bank intervenes to prevent such an appreciation, since only non-sterilized interventions work, monetary policy becomes too lax and inflation ends reducing competitiveness and eventually its rate may go up beyond the bands established for ERM II. Furthermore, as part of the intervention process, the central bank acquires low-yielding foreign assets while issuing high-yielding domestic liabilities, which can reduce notably its muscle to fight a speculative attack or even can provoke doubts about its solvency and increase the pressure from its government, which is its "financer of last resort", which may end reducing its independency (Wyplosz, 2002b).

Past experience with EMS has shown that a full liberalization of capital flows made more difficult to maintain the ERM I for two years or more, unless exchange rate bands were enlarged (what it was done in 1993) or alternatively, a final realignment of parities was allowed just before joining (de la Dehesa 1993)

The fifth difficult issue facing these new EU member countries candidates to join EMU, is the conflict between real and nominal convergence during their run-up to EMU and mainly between catching up and inflation, given that their level of real convergence is lower than that of the previous EMU candidates (De Grauwe and Schnabl, 2004) If there is no possibility of changing any of the nominal criteria, mainly the inflation one, as it is now the case, then the new EU member countries which want to join EMU need to show a "careful timing" of EMU accession as suggested by the Bundesbank (2003).

Alternatively, they need to introduce restrictive fiscal policies in the run-up to accession, as suggested by Begg et al. (2001) who argue that tighter fiscal policies can be helpful in controlling inflation and overheating and by Gros et al. (2002) who argue that a restrictive macroeconomic policy would help dampening the price gap between traded and non traded goods as well as the upward drift of consumer price inflation. This fiscal contraction could be supported by wage moderation as well. Or, finally, a transitional recession to depress inflation as suggested by Buiter and Grafe (2002a)

De Grauwe and Schnabl (2004b) think that a nominal appreciation is the main option to achieve a smooth EMU membership. Given that systemic upward pressure on inflation, a number of candidates will have to follow a policy of fiscal consolidation but other do not need to do that but just to try to avoid a real appreciation of their currencies by allowing for their gradual nominal appreciation, as Ireland and Greece did show when they joined. This latter strategy could be the blueprint to follow for the candidates during ERM II, given that

the lower their achieved nominal appreciation, the harder their fiscal restriction needed. Therefore, choosing an entry currency rate in ERM II above the central rate can help to reduce exchange rate fluctuations and volatility and achieve a safe EMU entry for the candidate country. The only exception to this rule would be those new candidate countries which have decided to adopt credible hard pegs to the Euro and have invested a great deal of effort in it.

Inflation criterion

There are many reasons why inflation in the joining candidate country will take time to come down. First is the Balassa-Samuelson effect. As these new EU member countries are trying to catching up with the EU average, some of them coming from a distant level of GDP per capita, their level of prices is still very low compared to the EU average, so that when catching up, its price level, expressed in euros, tends to rise. This effect can be achieved through stable prices and a nominal exchange rate appreciation or through stable exchange rate and higher inflation (a real exchange rate appreciation) or a combination of both.

This effect is mainly produced by the faster increases in productivity in the tradable sector than in the non tradable sector of these catching up countries (due to facing greater competition, to receiving larger FDI inflows into technology and equipment and to achieving a faster absorption of technology). By contrast, productivity growth in the non tradable sector tends to be lower, among other reasons because it tends to be more labour intensive and have a lower level of competition than the tradable one.

As wage collective bargaining systems do not differentiate much between the two sectors of the economy (because in most countries are not agreed at company or sector level but at national levels), wages in the tradable sector tend to bid up wages in the non tradable sector, which end rising faster than productivity and thus producing a persistent higher inflation rate in this sector. Thus, the catching up country trying to join EMU tends to get a higher average inflation rate than the three best incumbent members that are the benchmark.

Furthermore, when the growth rate of productivity in the catching up countries is higher than in the three best performer incumbent EMU member countries, which it is now the case, since they start with a level of productivity much lower, the new candidates will tend to have a higher inflation rate than the incumbents. There other reasons for the catching up countries surpassing the inflation rate of the best performers. Purchasing power parities are not reached in the short run, since domestic and foreign goods are not perfect substitutes, non tradable sector do no face the same pressures than tradable sectors, wage contracts are often backward looking and the wage adjustment a takes longer time than other prices in the economy (Roubini, 1999).

Most empirical evidence, about the Balassa-Samuelson effect on the inflation rate differential of the new EU members with the EMU member states, finds out that it can be of 2 percentage points, instead of the 1.5 percentage points set up as a limit in the Maastricht criterion (Halpern and Wyplosz, 2001) (Rogers, 2001). Others, like Pelkmans, Gros and Nuñez Ferrer (2000) find that this differential can go up to 3.8 percentage points. Today if the same analyses were done, the Balassa-Samuelson effect might be lower, given that the rate of growth of productivity tends to decelerate as higher productivity levels are reached by the catching up EU member countries (Backé, Fidrmuc, Reiniger and Schardax (2002).

As a consequence, some economists have argued for the convenience to modify or reinterpreted the inflation criteria. For instance, following the pioneer work of McKinon (1984), Buiter and Grafe (2002b) and Rebelo (1993) propose to apply the inflation criterion to traded goods only, to exclude the productivity driven CPI inflation from the convergence process. Szapáry (2002) suggests a waiver or derogation to the inflation criterion for

countries with a strong Balassa-Samuelson effect. Coricelli and Jazbec (2001) propose other modifications as either using the three least developed EMU member countries as the inflation benchmark, instead of the three best performers, or allowing for higher percentage point inflation differential.

Eijffinger (2006) shows that the fear by incumbent countries to allow any change in the inflation criterion because new EMU members joining with higher inflation rates could increase the average Euro Area inflation rate is somehow exaggerated given that their impact will be very small, given their smaller relative size in terms of GDP. Egert (2002) finds that a 3 per cent differential in the inflation rate between the 1998 accession group and the rest of the Euro Area would only imply a 0,1 per cent in the total Euro Area GDP-weighted inflation.

Exchange rate criterion

The same can be said about the exchange rate target. Buiter (2004) has warned that forcing the new EU member countries to enter the ERM II "waiting room" for the Euro is both pointless and dangerous, thus, a creative reinterpretation is essential to avoid unnecessary to their financial stability. According to him, no central bank should be asked to pursue more than one nominal target and in the Maastricht criteria there are three (inflation, exchange rate and long term interest rate) so the probabilities to get into a major financial crisis is enhanced. Therefore, he urges Euro membership for the new candidates as soon as possible, given that they are relative small and open economies (even Poland). If they are not changed, eventually the risks of one or more candidates not being able to join may result in harm to old and new EMU members.

A similar view was previously argued by De Grauwe (1994) who found, after studying the EMS crisis, that Maastricht criteria did not lead to EMU, first and foremost because almost fixed exchange rates could not be maintained for a sufficiently period of time and expectations of a final realignment would inevitably lead to speculative attacks. Thus, their exchange rates should be allowed to fluctuate within larger bands for the transition period, as it was previously stressed by Fratiani et al. (1992). Nevertheless, De Grauwe recognizes that the present more flexible bands, introduced after August 1993, could make technically easier to move to EMU by the new candidates than before.

Most economists think that it is too dangerous to be more than two years in ERM II with free capital controls, given that these tend to be very volatile and put macroeconomic stability at risk, provoking sudden reversals, endangering ERM II exchange rate bands and postponing EMU membership. This is the reason why, on the one side, most candidates want to be keep their time in ERM II as short as possible, while, on the other, the European Commission, by contrast, stresses the disciplinary function of ERM II as an "internship" for macroeconomic discipline (De Grauwe and Schnabl, 2004) (Begg et al. (2002) and (Corker et. al. 2000).

Fiscal criterion

Finally, as shown by Montanino (2004) the fiscal criterion is better theoretically founded for the following reasons:

First, a growing debt can undermine price stability. That is, fiscal policy can be "non Ricardian" in the sense that governments do not increase the present value of future primary surpluses to counterbalance increasing outstanding debt. If governments were increasing primary surpluses in the future to control their excessive current debt dynamic , then additional government debt would be perceived as wealth by agents and thus private savings do not adjust to anticipate future tax liabilities. This leads to increasing demand at current prices which have to adjust in order to restore equilibrium (Barro, 1974), (Woodford, 1996)

Second, a high debt level leads to budget inflexibility and in particular it reduces the room for devoting additional resources to growth enhancing public expenditures or to reduce employment or investment unfriendly taxes as well as reducing the room to manoeuvre for countercyclical fiscal policy (Chouraqui et al. 1986).

Third, high and increasing debt positions can lead to rising interest rates in order to allow governments to attract private savings, crowding out private investment (Tanzi, 2003) If the debt level is high, agents can perceive the need for future monetization of the debt and this will impact not only inflation expectations and conversely long term interest rates. In addition, in a context of easily accessible capital markets, after joining EMU, the cost of issuing new debt for the new members will be lower than in the past, thus this could lead to a higher stock of debt in the aggregate level and to higher interest rates if budgetary policies are not coordinated across countries (Beetsma, 2001).

Nevertheless, major critiques have been expressed by economists about the lack of flexibility of the Maastricht EU fiscal rules framework, mainly about the Stability Pact (SGP) which can be also applied to the Maastricht fiscal criterion:

On the one side, it has been argued that the current criterion reference fiscal values are arbitrary (Fitoussi and Saraceno, 2003) or to its weak institutional design (Tabellini, 2002), (Alesina and Perotti, 2004) That the present fiscal framework does not take into account differences among EU countries on reform need, initial conditions in economic development and in debt levels.

Most economists suggest that budgetary coordination should concentrate more on debt levels to differentiate across EU countries instead of budget deficits. In this sense, there are very strong arguments against mechanical rules which limit budget deficits. As Kotlikoff (1986) pointed out: the deficit is an inherently arbitrary accounting construct that provides no real guide for fiscal policy. Hence the need for a judgment passed by ECOFIN before a deficit is considered excessive. For instance, a country with a low debt level should be able to be allowed an excessive deficit when it needs it, while another with a high debt level should not. Debt levels are much more important than short or even medium term deficits (Calmfors and Corsetti, 2003), (Buiter, 2003), (Wyplosz, 2002a), (Buti and Giudice, 2002)

On the other side, many critiques have attacked the excessive focus of the fiscal rules on short term fiscal behaviour, without taking properly into account the debt sustainability and the impact of ageing populations on public finances (Couré and Pisani-Ferry, (2003), (Buiter and Grafe, 2002a)

Others have stressed that the nominal criteria make it harder to meet the fiscal criterion and that price and output levels of convergence between the new candidates and the incumbents necessarily implies inflation and growth convergence for many years to come making it more difficult to restrain debt growth within the Euro (Hughes Hallet and Lewis, 2004).

Finally, other concerns focus on the very little emphasis devoted by EU fiscal rules to the composition of public finances and, in particular, on differences between current and capital expenditures, underlining that the latter should be treated differently in budgetary surveillance (Blanchard and Giavazzi, 2003) A major critique is based on the conflicts of interest in their surveillance, given that enforcement relies on a political decision to be taken by the same member countries that are under scrutiny (Eichengreen, 2003) (Strauch and Von Hagen, 2001).

Long-term interest rate criterion

The long term interest rate is a market price that merely reflects the inflation and exchange rate expectations and the level of debt of the member country concerned. The interest rate criterion is a clear test of whether the country is in fact prepared to make a sacrifice of monetary sovereignty and economic independence that joining EMU requires. Interest rate convergence comprises two distinct kinds of integration according to Frankel et al. (1993) First it implies the elimination of capital controls and other barriers to capital flows across national boundaries, that is, “financial integration” and second it implies the elimination of investors perception that the exchange rate is likely to change in the future, that is, “currency integration”.

They found that currency factors (the exchange risk premium and expected depreciation) were a more important component of interest rate differentials that are capital controls and other barriers. But, as shown by Dornbusch (1993b) experience with ERM I, show that, even if there was a certain but slow trend of long term interest rate differentials to converge, the differentials between the bid/ask rate spreads were very high, showing that investors were still expecting a realignment, as it finally happened in 1992.

In this sense the late Dornbusch (1993) made another of his polemic statements by pointing out when referring to the speculative attacks on ERM I that: “On this occasion the speculators, who finally made the ERM blow and forced interest rates down, were the best friends of the unemployed and… of many monetary authorities who made unsustainable promises”.

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CRITERIA FOR MONETARY UNION ACCESSION

Briefing paper for the Economic and Monetary Committee of the European Parliament

October 2007

Jean-Paul Fitoussi

Executive summary

The criteria for joining the Economic and Monetary Union (EMU) were laid down in the Maastricht Treaty (1991) when the governments of Europe agreed on the steps to be taken for countries to be accepted in the euro area in 1997 or 1999. Besides the well known deficit (and debt) targets the other criteria included inflation and the interest rates (that needed to be close enough to those of the most virtuous countries), and exchange rate stability. The Stability (and Growth) Pact, SGP, negotiated in the run-up to the Amsterdam Treaty, extended the requirements about public finance to be met even after accession, and put in place a mechanism (the Excessive Deficit Procedure, EDP) to sanction countries not respecting the criteria. The SGP also introduced an important qualitative innovation, in that it requires a balanced budget over the cycle, on top of the permanent 3 per cent limit to total deficit.

The Stability Pact came under increasing criticism, especially when it seemed to be among the factors behind the prolonged period of soft growth started in the year 2000. The debate slowly gained the policy makers, and a revised version of the Pact, agreed in March 2005, introduced some flexibility in the norm: on one side the medium term objective of a zero structural deficit is relaxed for countries with low debt and/or with high potential growth; and on the other, the reformed Pact contemplates a number of circumstances (e.g. a strong engagement in costly structural reforms) allowing temporary deviations from the deficit ceiling, and longer delays for correcting them.

In this paper I will firstly argue that the Maastricht Treaty, and the institutions for the economic government of Europe that it designs, are children of the doctrine that was dominating in the 1990s. I will also argue that at the time, for a number of reasons it was chosen to give to that doctrine constitutional dignity, embedding the criteria into a treaty, and making it very hard to adjust these criteria. Then, I will explain what the theoretical underpinnings of the Maastricht criteria are, and discuss their validity. I will shortly argue that in fact the Maastricht criteria and the SGP have weaker theoretical and empirical foundations than usually believed. By means of a very sketchy comparison with the behaviour of the US and of the UK, I will then argue that the Maastricht framework did actually affect the euro area economic (fiscal) policy, and that the differences in policy may be one of the factors explaining the different performances of the EMU and of the US over the first half of the years 2000. This will bring me to consider some realistic modifications for the criteria to be applied to the new applicants for the euro: allowing for a higher inflation rate; a higher deficit ceiling for current expenditures (which include expenditures on health, education, and social protection) and the application of the golden rule of public finance to allow infrastructure building. The paper will then conclude with some more radical reform proposals that stem from the criticism of the theoretical underpinning of the Maastricht framework: criteria concerning the corporate tax rate and the ratio of social expenditures over GDP.

1. The Theoretical Doctrine Behind the Maastricht Treaty[39]

The institutional setup designed in the 1990s is rather complex. Supranational and national competencies intersect and interact, sometimes in odd ways. Competition policy is completely delegated to the European level, and the Competition Commissioner has executive and judicial powers. For macroeconomic policies, on the other side, the assignment of tasks and objectives is vaguer. Monetary policy is in the hands of a technical and largely unaccountable body, the European Central Bank (ECB), which is given by treaty independence of targets and instruments (within the broad objective of price stabilization). Fiscal policy, the only instrument left in the hands of governments, is subject to the constraints of the Stability pact, whose scope is to limit fiscal stabilization to the operation of the automatic stabilizers. The Commissioner for Economic and Financial Affairs is formally limited to a monitoring task, but has very considerable political influence magnified by the publicity given to its recommendations, and their effects on the reputation of governments. To further add to the complexity of the institutional setup, the treaties do not provide for a coordination mechanism or authority (a "prime minister") between the different actors; this gives even more power to the strongest actors (the ECB, the Competition Commissioner). In other words, while on one side, competition and monetary policies are conducted at the European level, with the unambiguous task of promoting free trade minimising monopolistic distortions and insuring price stability, fiscal policies are carried on by a number of relatively weak and uncoordinated actors.

This setup is no accident. It reflects the new classical doctrine that prevailed in the early 1990s according to which the areas of competition and macroeconomic policies have to be seen largely as substitutes, with the former being superior in terms of efficiency: In fact, once public intervention has coped with externalities, clearing and complete markets, populated by fully rational agents, usually yield the best possible outcome in terms of resource allocation and growth. And when that is not the case, it is because frictions and market failures prevent this from happening. The role for policy is then simply to remove or minimize these frictions on the supply side, i.e. to intervene on the structure of the economy to assure that it conforms as much as possible to the reference model.

In this perspective, any intervention on the demand side is useless, if not harmful. Once the conditions on the supply side are fulfilled, the economy attains the most efficient position, unless disturbed by distortionary public measures. This has important consequences in terms of policy: If tradeoffs do not exist, the policy maker is not confronted by choices, and there is no role for activist policies. Rules become the preferred method for conducting policy, as they prevent biases in policy makers' action, and constitute an anchor for private expectations. The distortionary presence of the government in the economy can be reduced by reducing its size, by balancing the budgets, and by fighting inflation; the freed resources can be used to increase competition by means of structural reforms aimed at the smooth working of markets.

The European "doctrinal bias" is further aggravated by the difficulties of a currency area that is far from optimal. The low labour mobility creates rigidity in the system for which the solution would be price and wage flexibility, that in the form required by the theory has not been experienced anywhere, as it would be socially unbearable. The only way out from this impasse, consistent with the neo-liberal doctrine that permeates the European institutions, is a form of indirect “flexibilization”: Cost reduction through fiscal competition and the progressive leaning of the welfare state (social competition), on one side are the only form of policy available to national governments for reacting to idiosyncratic shocks; and on the

[39] This section and the following borrow from Fitoussi and Saraceno (2007; forthcoming), that can be downloaded respectively from (http://ideas.repec.org/p/fce/doctra/0722.html) and (http://ideas.repec.org/p/fce/doctra/0402.html).

other, respond to the more general objective of reducing the weight of the state in the economy, a pillar of the "new" doctrine (see notably the work of Prescott) .

This crystallization of a particular doctrine within economic institutions is a peculiar feature of today's Europe, and is unprecedented on such a scale. The SGP and the Maastricht criteria have been given constitutional dignity, and any modification requires a lengthy ratification process. The reason for this peculiar choice seems to lie in a mix of historical, social and political factors: Germany's historically strong aversion to inflation that made its government give up its monetary sovereignty only in exchange for an insurance of prudent fiscal behaviour. Alternatively it could be, as many argue, the desire of core countries to keep out of the union the so-called "club Med" nations (Greece, Italy, Portugal and Spain).

2. How Robust is the Rationale for the Maastricht Framework?

Several theoretical arguments exist in favour of the existence of a deficit bias; while these arguments may be more or less convincing, it is safe to say that most economists agree on the existence of deficit biases in practice, and that some type of rule may help to limit suboptimal uses of fiscal policy. Nevertheless, the existence of a deficit bias per se is not enough to justify a supranational rule in a monetary union. In fact, the principle of subsidiarity would require these rules to be country-specific and left to national governments, unless it is argued convincingly that the effects of suboptimal fiscal policy spill over to the other members of the union. As a consequence, the main theoretical foundation of the Maastricht framework is a simple *externality* argument: a government running a budget deficit has to borrow; in a monetary union this is supposed to raise the common interest rate, and to have restrictive effects both on public expenditure (the area-wide increased interest payments reduce government consumption and investment possibilities), and on private consumption and investment in the other countries. This negative externality would induce national governments -- free from the control of foreign exchange markets -- to run excessive budget deficits, allowing them to make the other countries pay part of "the bill".

The empirical evidence in favour of this claim rests on several contributions concluding that expansionary fiscal policy has a positive effect on interest rates. Nevertheless, a closer look reveals that this literature cannot be invoked to support the externality argument. In fact, none of these papers looks at the effects on the rates of partner countries, but only on own rates. The need for a common rule has to originate from common effects of government behaviour, domestic effects having to be taken care of by national policies and/or rules. As the evidence on domestic interest rates is not extremely robust, it would be extremely surprising if a study gave empirical arguments in favour of common rules, by finding important effects of a national fiscal policy on interest rates at the European level.

More importantly, from a theoretical viewpoint, the externality argument can be reversed. Suppose that a country implemented an unwarranted expansionary fiscal policy, while close to full employment; this would result in inflationary pressure, and hence in reduced competitiveness. If, on the other hand, the deficit responded to a slump in production, it would sustain demand and hence income and imports. In both cases, the increased demand for the other countries' production would yield larger fiscal revenues and lower deficits. Thus, it may be concluded that *nothing, from a theoretical point of view, may induce one to think that the negative externality would be larger in size than the positive one*. Indeed simple reasoning leads to believe the contrary: generally, a fiscal expansion in a region does not have negative effects on other regions of the same country.

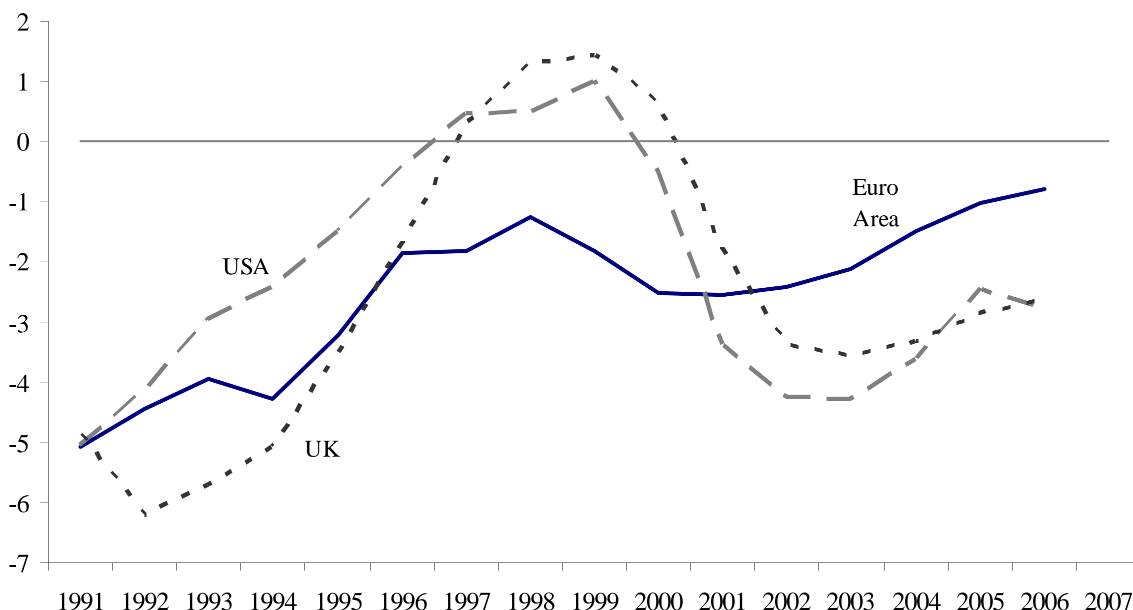
To sum up, while the existence of the deficit bias and the ensuing need for some kind of fiscal rule seem to have become consensual, the theoretical and empirical foundations of a supranational measure like the Stability Pact do not look nearly as solid. Such mixed results may explain why, in spite of the consensus in the academic profession, the instances where fiscal rules have been adopted in practice are quite rare.

3. Some Sketchy Evidence on the Effects of the Maastricht Framework on Policy and Growth

After reviewing the theoretical foundations of, and the criticisms to, the Maastricht Framework, we need to ask whether this framework actually affected the behaviour of policy makers in Europe. I already discussed at length the case of the ECB in a previous briefing paper (Fitoussi 2005), noticing that its behaviour had been inertial when compared to the US Fed. Here I will focus on fiscal policy, also comparing the behaviour of the euro zone with the Anglo-Saxon countries.

In particular, an impressionist assessment may be based on the behaviour of cyclically adjusted (or structural) deficit, an indirect measure of the degree of activism of fiscal authorities. Figure 1 shows the path of structural deficit over the past 15 years (a negative value means a deficit). The three curves show an increasing trend over the 1990s (with the exception of the effects of the EMS crisis for the UK, in 1993). Nevertheless, the prolonged expansion of the 1990s allowed the United States and the UK to attain a surplus, while the European countries experienced soft growth. The most instructive portion of the figure, nevertheless, that induces the guess that the Maastricht framework constrained policy in the euro area, is the one corresponding to the years from 2000 onwards. Faced with the generalized stock market correction and with the economic effect of the terror attacks to the WTC, the fiscal authorities in the UK and USA embarked in a robust countercyclical fiscal

Figure 1 - Structural Balance (OECD definition)



Source: Datastream - OECD

policy. In the euro zone, on the other hand, the debate remained confined to fiscal discipline,

with the effect of an actual *improvement* of structural balances, in spite of a stagnant economy (at least in the main economies). The guess is confirmed by some basic statistical manipulations over the same series; table 1 shows the average balance for the euro area, for the US and for the UK, over two subperiods.

Table 1 - Structural Budget Balance (OECD Definition)

	Average		Standard Error	
	1992-2007	*1999-2007*	*1992-2007*	*1999-2007*
Euro Area	-2.59	-1.83	1.35	0.91
USA	-2.22	-2.16	1.93	2.00
UK	-2.56	-1.51	2.47	2.10

Source: Datastream. % of GDP
2007: Q1 and Q2 only

It is interesting to notice that while the average level of structural deficit is comparable (especially over the longer subperiod, the variability is much lower in the euro area than in the Anglo Saxon countries. The variability decreased in Europe in the past 7 years (corresponding to the implementation of the Stability Pact), while it increased in the US. Even this superficial analysis pushes to conclude for a strong inertia of fiscal policy in the euro area, in the years of the common currency.

A stronger inertia, *per se*, is not necessarily a bad thing, as it may be related to lower income variability. Table 2 allows considering this element. There, we report the correlation coefficient between the growth rate of the economy and the fiscal impulse (defined as the change in structural balance) of the following period. In other words, the correlation coefficient gives a broad assessment of the reaction of fiscal policy to changes in GDP growth.

Table 2 - Correlation Between Fiscal Impulse and GDP Growth

	1996-2007	*1999-2007*
Euro Area	-0.13	-0.11
USA	0.43	0.40
UK	0.12	0.10

Source: Datastream
2007: Q1 and Q2 only

A positive coefficient suggests the possibility of countercyclical fiscal policy (the deficit increases when growth slows down), while a negative coefficient implies procyclical fiscal policy. Once again we see a clear difference between the euro area, where slow growth implied a tightening of fiscal policy, and the other two countries where the contrary happened. Notice also the difference in size between the US and the UK.

To conclude, a simple superficial look suffices to strengthen the claim that (a) the Maastricht Framework affected the conduct of fiscal policy and (b) that the stabilization capacity of fiscal policy in the euro area was negatively affected.

4. A Feasible Modification of the Maastricht Criteria

The preceding discussion brings to the general conclusion that the Maastricht framework criteria should at least be relaxed for all countries, regardless of whether they already belong to the union or not.

In what concerns the countries that recently joined the European Union, additional issues should be mentioned:

The first is the structurally higher inflation rate, a natural effect of the convergence process (the Balassa-Samuelson effect). If inflation is structurally larger in catching-up countries (because of a much lower initial price level), there is little sense in requiring it to be close to the richest countries. The inflation target should either be suppressed, or made significantly more flexible. In other words price levels should converge towards the average level of the existing members of the euro areas, if one wants to avoid unfair competition.

The second peculiarity of new entrants is their chronic lack of infrastructures, and in general their need for public investment ranging from physical capital to items such as education, health, social protection etc. The current 3% deficit ceiling is most likely going to be unattainable by these countries, unless they halt or drastically reduce their investment, with disastrous effects on their potential or long term growth rate. The new entrants need additional slack with respect to the deficit criterion. Furthermore, the possibility of introducing a "golden rule of public finance" of the type of the one used in the United Kingdom, should be seriously (re)considered, as a way to liberate resources for public investment. Ideally, the concept of public investment should be extended to include items of current spending like education and health, which have notorious long term effects.

5. A New Approach. Social Criteria for Accession to the Economic Union

A more ambitious approach to the economic union would require the abandonment of the Maastricht framework, in favour of a series of convergence criteria based on the preservation of the European social model.

In the past few years we observed a worrisome race to the bottom, with countries competing on the ground of corporate tax cuts, mainly financed through cuts to social welfare and increases in VAT. While the welfare system in European countries would certainly need to be rethought and reorganized, this cannot happen in the framework of a race to competitiveness with the European partners. The only possible outcome of such a race would be to leave relative positions unchanged, while at the same time jeopardizing the European social model. Countries wishing to reinforce their ties by joining the Economic and Monetary Union should commit not to pursue this strategy. I can think of two possible convergence criteria that could guarantee this commitment.

First, the corporate tax rate should not be lower than the lowest rate of the Union. This would allow fiscal harmonization from the bottom, and would guarantee that significant tax cuts are implemented only through a coordinated action among all members of the Union.

Second, the ratio of social expenditure over GDP should not be lower than the one of the country having the lowest ratio among existing members. This would prevent countries from slashing their welfare programs to become more competitive, and would force them to find different and less disruptive ways to improve their relative position.

These criteria could coexist with a revised form of the existing Maastricht criteria, creating a framework within which the reform of the welfare system would have to carry on without undermining the European social system, and without deteriorating the public finances of euro zone members.

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CRITERIA FOR MONETARY UNION ACCESSION

Briefing paper for the Economic and Monetary Committee of the EU Parliament

October 2007

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Executive Summary

Four of the five economic criteria set by the Maastricht Treaty for countries wishing to join the European Monetary Union (EMU) have a sound economic foundation and should continue to be used in the future. However, some of the criteria should not only be met in the twelve months prior to the EMU entry, but over a longer period to ensure real economic convergence. Furthermore, the 3% deficit-to-GDP ratio has become too loose to ensure that public debt stabilises at 60% of GDP. The bond yield criterion should no longer be used in the future.

A monetary union only works if the economies of the member states do not differ too much. A sufficient degree of economic convergence is thus a precondition for a successful monetary union. The Maastricht Treaty thus specified a set of economic criteria which a country should meet prior to joining the European Monetary Union (EMU). However, in the end, the decision whether a country is allowed to join EMU, is a politically one.

The Maastricht criteria refer to the following areas:

1. Public debt
2. Fiscal deficit
3. Inflation
4. Bond yields
5. Exchange rates

In the remainder of the paper we discuss why the criteria take the current form, what the economic rationale behind them is and whether we recommend modifying them.

1. Public debt

Definition of the criterion: The ratio of government debt to GDP should be below 60% or the ratio "is sufficiently diminishing and approaching the reference value at a satisfactory pace". It should be noted that "government" refers to a very broad definition including social security.

In an ideal world, the ECB could fulfil its obligation to maintain price stability even if the debt-to-GDP ratio is quite high. However, a very high level of government debt may restrict the government's freedom to act and thus creates strong incentives to lower the real value of debt by creating inflation. The Maastricht criterion on the debt-to-GDP ratio thus aims to prevent high public debt from causing the government to put pressure on the ECB to allow high inflation.

There is no economic theory that says that government debt should be below 60 percent of GDP. But when the Maastricht Treaty was drafted at the beginning of the nineties the average debt-to-GDP ratio was at about 55%. 60% would thus leave some, but not too big a leeway.

Modification of the public debt criterion: The 60% is a pragmatic threshold to prevent highly indebted countries from joining EMU and should not be relaxed. However, one should drop the qualification that a country with a debt ratio above 60% can enter EMU if the ratio is "sufficiently diminishing and approaching the reference value at a satisfactory pace". Nobody can quantify what "sufficiently" means; this leaves the door open for politicians to ignore the problem of highly indebted countries. Exactly this happened when e.g. Belgium (119.6% debt-to-GDP ratio in 1998) and Italy (116.7%) were allowed to enter EMU.

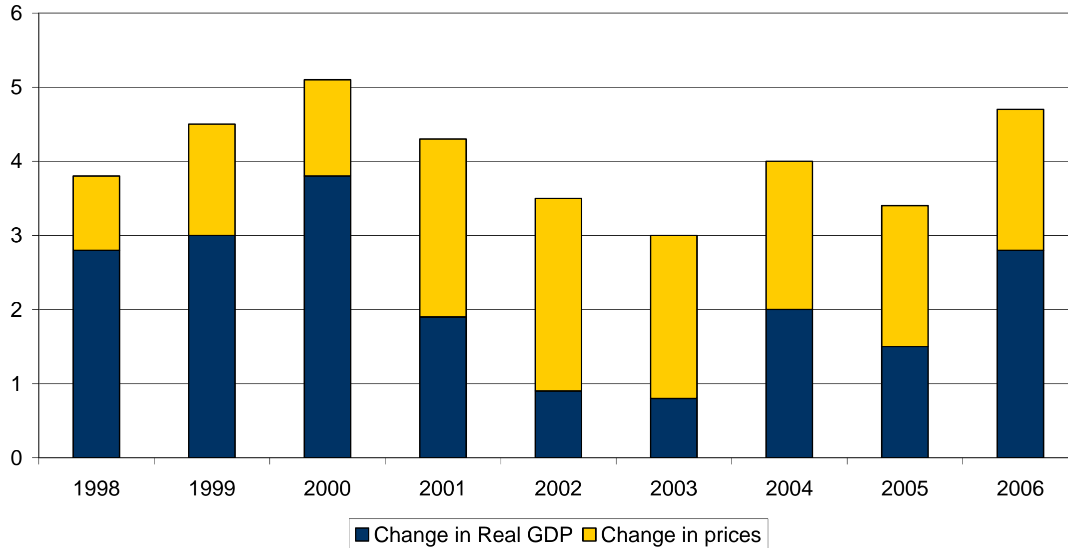
2. Fiscal deficit

Definition of the criterion: The ratio of the planned or actual government deficit should not exceed 3% of GDP or:

- the ratio has declined substantially and continuously and reached a level that comes close to 3%, or, alternatively,
- the excess over the 3% is only exceptional and temporary.

The 3% deficit-to-GDP ratio can be inferred from the 60% debt-to-GDP ratio. If the debt should not exceed 60% of GDP and if the annual increase in nominal GDP is 5%, then the public deficit should not be higher than 3% of GDP. The economic rationale is thus the same as for the debt-to-GDP ratio, i.e. to rule out that a high debt level creates a temptation to loosen monetary policy.

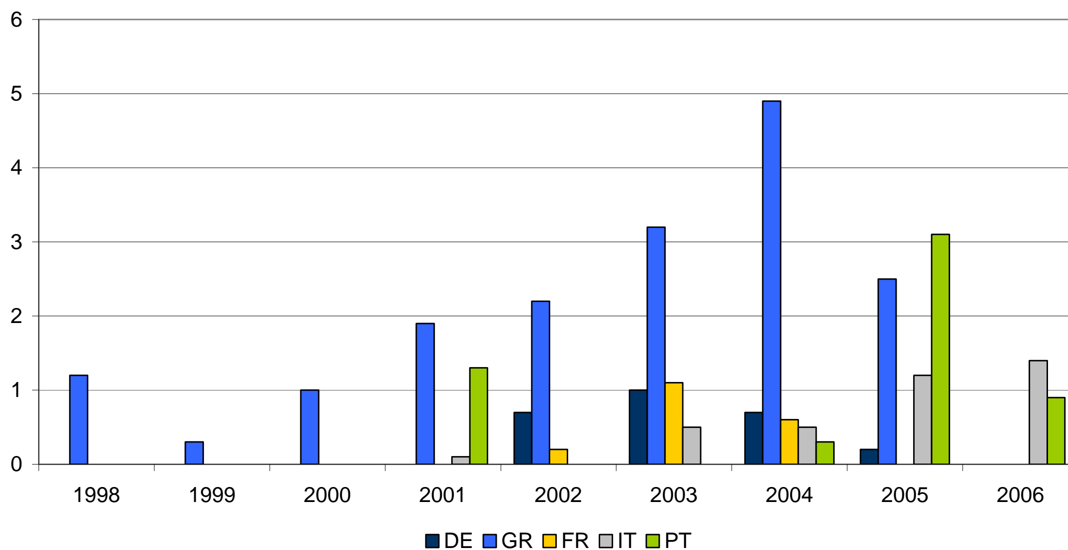
Modification of the fiscal deficit criterion: The 3% deficit rule is based on the assumption of 5% annual growth in nominal GDP. However, this turned out to be too optimistic. We estimate real trend growth to be slightly below 2%; the ECB tries to keep inflation below 2%. Therefore, nominal trend growth (real growth plus inflation) should be around 4%. Chart 1 indeed shows that euro-zone nominal GDP growth has reached 5% only in the boom year 2000.



- Chart 1 -

If one assumes 4% instead of 5%, then the deficit has to be lower than 3% of GDP to prevent the debt-to-GDP ratio from rising. I am therefore in favour of lowering the deficit criterion from 3% to 2½%.

Furthermore, one should take into account that some countries managed to bring the deficit below the 3% mark only in 1999 or 2000, but failed to do so thereafter. This is true for Greece, France, Italy, Germany and Portugal (**Chart 2**). It even became clear that Greek had manipulated its deficit data prior to the EMU entry. All this suggests that countries should not only meet the 3% criterion in one single year, but over a longer period; three consecutive years are reasonable.



- Chart 2 -

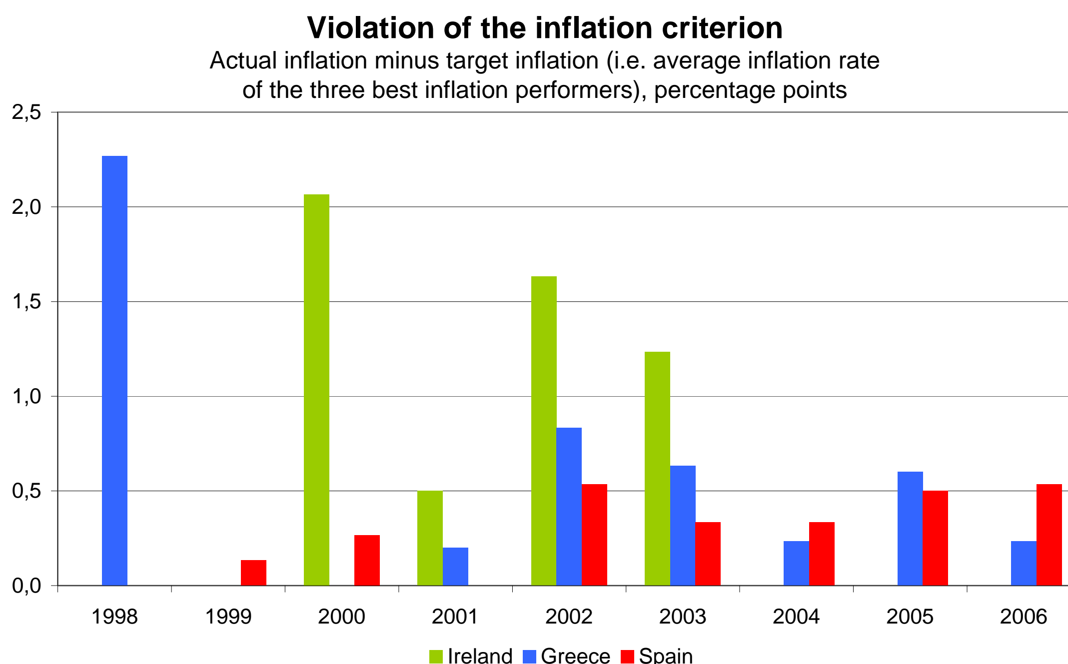
3. Inflation

Definition of the criterion: Achievement of a high degree of price stability means that "a member state has (…) an average rate of inflation, observed over a period of one year before the examination, which does not exceed by more than 1½ percentage points that of (…) the three best performing Member States in terms of price stability."

Within a monetary union countries can no longer offset higher domestic inflation and thus a loss in price competitiveness by letting their currency devalue. Therefore, countries which want to join EMU should have an inflation rate which does not differ too much from the EMU average.

While the economic reasoning behind the inflation criterion is theoretically well founded, there is no theory that tells us that the inflation rate should exceed the one of the three best inflation performers by only 1½ percentage points. However, from a practical point of view this threshold seems reasonable.

Modification of the inflation criterion: The inflation criterion needs to be fulfilled only in the twelve months prior to the EMU entry. However, as with the deficit criterion there are some countries (e.g. Ireland, Greece and Spain) which did miss the inflation criterion after they had joined EMU (**Chart 3**). Therefore, a country should meet the inflation target not only one year prior to EMU entry, but three years before.



- Chart 3 -

4. Bond yields

Definition of the criterion: Durability of convergence should also be reflected in long-term government bond yields. According to the Maastricht Treaty this means that "observed over a period of one year before the examination, a member state has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of (…) the three best performing member states in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds (…)".

On the first hand, the economic rationale of the bond yield criterion seems clear. If government bond yields of a country which wants to join EMU are close to those of EMU members, then obviously investors believe that there is a sufficiently high degree of economic convergence. In other words: Small differences in government bond yields are a market-based proof of economic convergence.

However, the period before the start of EMU demonstrates that bond yield convergence can also be caused by pure political reasons. For example, the yield spread between Italian and German 10-year government bond yields sharply fell in 1996 and 1997 not because of improved real convergence but simply because more and more investors came to the conclusion that Italy would be allowed to enter EMU despite an excessive debt-to-GDP ratio. In other words: The more it became clear that politicians would not strictly adhere to the Maastricht criteria, the tighter the Italian-German yield spread became.

Modifications of the bond yield criterion: All this suggests that the bond yield criterion does not make much sense and should no longer be used.

5. Exchange rates

Definition of the criterion: The Maastricht treaty also requires convergence in the field of exchange rates. A country should join EMU only, if there are "normal fluctuations margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other member state". With the introduction of the Euro, the exchange rate mechanism of the European Monetary System was replaced by a new exchange rate mechanism, known as ERM II. In this new system the participating currencies are allowed to fluctuate by +/- 15% around the bilateral central rates.

This wide band was obviously chosen to make it unlikely that a currency violates the bands. This interpretation is also backed by the observation that the band in the "old" ERM was widened from +/- 2.25% to +/- 15% in August 1993 after some European currencies had violated the narrow band and had caused a crisis and realignment of the central parities.

Modifications of the exchange rate criterion: The current fluctuation band seems to be too wide. It would be better to lower it to +/- 5%.

CRITERIA FOR MONETARY UNION ACCESSION

Briefing paper for the Economic and Monetary Committee of the EU Parliament

October 2007

Jean-Pierre Patat

Executive summary

There is a general consensus about the evidence for countries sharing a single money and a single monetary policy to have not significant differences in inflation rates and in other economic aspects, specifically in fiscal policy.

So, that's why the Treaty has listed four macro economic convergence criteria for monetary union accession, concerning prices, interest rates, fiscal situation and exchange rate stability.

One has to be very cautious in an approach for modifying these criteria. Minor and technical changes could be implemented in the inflation and interest rates criteria. Concerning fiscal and public debt criteria which, moreover, cannot be separated from their institutional extension in the Stability and Growth Pact, one can find a lot of technical and apparently logical arguments for modifying their definition. But one must ask about the consequences of introducing complexity in simple notions and about the risk of de-knitting the criteria.

In fact, in our sense, if fiscal criteria modifications could be introduced, their purpose would be to avoid punctual and even sometimes artificial respect of the criteria at the time of a new entrant examination.

The exchange rate stability criterion is simple to enounce but has raised a lot of interpretation difficulties. Considering the evolution since the creation of the euro area and how this criterion was assessed for examination of new entrants, it appears that a pragmatic approach has prevailed with, in fact, a respect of the spirit of the criterion if not of the letter.

Finally, one can ask if new other criteria could not be introduced, in the field of current account imbalances, especially when "twin" deficits are observed, and in the banking and supervision situation of the candidate country.

Article 121.1/109 Economic and Monetary Union Treaty

Article 121.1/109 of the treaty on Economic and Monetary Union stated the method for assessing the situation of the countries which were supposed to be the first members of the euro area and of those which would be candidate for joining this union afterwards. The treaty has listed four macroeconomic convergence criteria, namely prices, interest rates, fiscal situation and exchange rate stability, and an institutional criterion concerning the independence of the central bank.

As far as macroeconomic convergence is concerned, there is a general consensus about the evidence for countries sharing a single money and a single monetary policy to have not significant differences in inflation rates and in other economic policy aspects, specifically in fiscal policy.

Convergence must in fact be assessed in two ways which implies to have an extensive interpretation of the treaty.

- First, it is necessary for the introduction of the single currency and, in the future, for the affiliation of new members to the euro area, to be limited to countries with similar macroeconomic situations.
- Secondly it is crucial to make sure that the initial convergence is not an exceptional situation, and that member states, after having shown a good look for the "photo", will not let macroeconomic fundamentals diverge from sound levels. Such a constraint is especially important in the fiscal area. So, the two criteria on fiscal deficits and public debt can not be separated of their institutional extension in the Stability and Growth Pact.

We will examine successively the four macroeconomic criteria, discuss their pertinence, the opportunity of restructuring them, and finally ask if new additional criteria could be implemented.

Inflation Criterion

The inflation criterion is described in the article121.1/109J.1 as a high degree of price stability which will result of an inflation rate close to the one of at most the three member states having the best performances in price stability. Concretely, the country is asked to have on average, during a one year period before the examination of its candidature, an inflation rate not exceeding 1. 5 point above the rate of at the most the three member states having the best performances.

There is not, in our sense, room for real criticisms of this definition. The reference to three member states "at the most" gives the possibility of eliminating one, or even two states if they present an extreme situation, for example a negative inflation rate resulting of a recession.

However, it could be conceivable to modify the definition of the three member states in precising "three euro area member states". As the reference remains presently the member states of the European Union (it was of course impossible to have a different approach when the euro area was created), that means the new candidates performances can be compared to those of countries of which the currency is not the euro. The question of this minor modification can be asked as there are now 12 members of the European Union which are not members of the euro area.

Of course the instrument for measuring inflation, the harmonized consumption price index can be criticized and judged too global and abstract and non-representative of the situation of specific categories of households. This critic is important as the monetary policy of the ECB, in maintaining a low level of inflation, aims to conciliate improvement of the purchase power and moderate salaries increases in order to preserve the competitiveness of the euro area. However, concerning this very sensitive problem, eventual changes in instruments are coming within monetary policy modalities, with global and national technical efforts for diversifying the instruments. For measuring convergence in low inflation pressures, one must refer to a global and simple index, even if efforts for strengthening its quality must be permanent.

Interest Rate Convergence Criterion

The interest rates convergence criterion is very similar to the inflation rate criterion. Indeed, it is described as a situation in which a state has had on average during the one year period preceding its examination, a long-term interest rate not exceeding by two points the one of at most the three member states having the lowest inflation rates.

It can seem rational to have a long-term interest rate criterion as this rate is considered to be a good indicator of inflation expectations.

Actually, it can be observed that when a country is close to its candidature examination and if the other criteria, especially the inflation criterion are respected (which can be easily noted by the markets), its long-term interest rates get rapidly closer to those of the euro area countries. This evolution is logically reflecting the new credibility of the country. In that sense, this criterion could be considered as somewhat redundant with the others and its suppression would simplify the procedure.

If not, we consider the problem of the definition of the three best performer states must also be raised as it is clear that large gaps between the euro area countries long-term interest rates (which are very close together) and those of the other European Union countries may occur.

Fiscal and Public Debt Criteria

As mentioned in the beginning of this text, remarks about the fiscal and public criteria must also concern the institutional framework, the so-called Stability and Growth Pact which has transformed punctual observation to permanent obligations.

Regarding the criteria, fiscal discipline is respected:

- if the budget imbalance ratio with GDP does not exceed a reference value of 3% according to the protocol about excessive deficit procedure; exceptions can be accepted if the ratio has been significantly reduced and is close to the reference value, or if the overrun of the reference value is exceptional and temporary,
- if the public debt ratio with GDP does not exceed a reference value of 60%, or if this ratio is strongly decreasing and approaching the reference value at a good rhythm.

Fiscal and public debt ratio criteria are justified by the strong correlation which can occur between public finances situation and the monetary policy stance. Indeed, the central bank can be obliged to maintain a more restrictive monetary policy when the budget deficit increases ex nihilo nominal incomes. One can observe that, unlike the other criteria, fiscal and public debt criteria can be assessed with some judgemental appreciations. Without these possibilities, some European Community founder member states, as Italy or Belgium, would

not have entered the euro area in 1998, according to the very high level of their public debt ratio.

The Stability and Growth Pact which has come into force together with the Monetary Union is based on the respect of the same reference values for the budget deficit ratio and for the public debt ratio. But its objectives are larger and more diversified that those of the criteria:

- First, to avoid that national policies create constraints for or menace the capacity of the Eurosystem to conduct a stable monetary policy;
- Secondly, to protect "virtuous" member states from the negative incidence, especially on the level of long-term interest rates in the whole area, of a "free rider" policy;
- Thirdly, and this point is probably the less clear for a lot of observers and policy makers, the Pact is a real instrument of macroeconomic management. The euro area is not a unified state and, as a result, there is not a federal budget. A primary role of such a budget is to be an absorber and a buffer of the member states cyclical shocks, by receiving more tax payments from the buoyant economies and by receiving less from the others, with even eventually granting some subsidies.

The euro area does not benefit from such a procedure. The purpose of the Pact is to replace them.

Accordingly, the Pact stipulates a general line of behaviour named "medium-term objective" to keep budgets in balance, and even in slight surplus, and to maintain the public debt clearly below 60% of the GDP. In other words, the equilibrium is a medium-term effective constraint and member states must take advantage of good cyclical situations for reducing deficit in order to have room for manoeuvre when economic conjuncture is worsening and, conversely, deficits are growing.

So, the 3% ratio and the 60% limit are red lines. As some European policy makers have interpreted them as a cruise regime, it is not surprising that they consider this limit to be intolerable when their country is in a weak economic conjuncture. A former President of the Commission even said the Pact was stupid.

Like the criteria definition, the Pact originally included a number of exceptions to allow Member states to apply the rules with a certain discretion, especially when the red line has been overstepped very briefly and hardly, and where prolonged economic recession (defined as a minus 2% of GDP during some times) has made compliance with the rules temporarily impossible.

Analysis from 1998 to Present

In 1998, at the time of the introduction of the single currency and of the implementation of the euro area, a rather surprisingly high number of countries succeeded in complying with the fiscal criteria. Admittedly, the respect of the public debt ratio was, in most cases, more judgementally (if not political) than strictly assessed, as this ratio exceeded the limit of 60%, often very widely, in ten countries among the eleven first members of the Monetary Union. Moreover, the ratio was increasing in several countries. But the budget deficit ratio of 3% was strictly respected by the eleven members .Such a performance had not been anticipated: in 1995, three countries only were in the limit, and the majority of observers, economists and even policymakers forecasted there would not be more than six or seven countries which could adopt the single currency two years later.

Eight years have passed since the introduction of the euro and the institution of the Stability and Growth Pact. Some important Member States of the Monetary Union have repeatedly

breached the rule set by the Pact. This fact is a demonstration, first of the punctual and even sometimes artificial respect of the criteria in 1997 for some countries, secondly of the crucial necessity of the Pact which must be considered as consubstantial with criteria.

Between 1998 and 2000 growth was very steady in Europe. A number of member states, mainly the largest, namely Germany and France, did not respect the core spirit of the Pact and did not take benefit from this favourable conjuncture in reducing sharply fiscal deficits. Of course, they widely overstepped the limit during the following gloomy years. Instead of admitting their errors of management, these Member States accused the Pact and its “rigid” quantitative deficit limit to provoke pro-cyclical budgetary policies, whereas the pact is precisely, if correctly implemented, a counter-cyclical instrument.

So these Member States claimed a reform of the Pact, while the others, complying with the rule, considered it had not to be modified.

The reform of the Pact has been enacted, between March and June 2005, by a Council report to the European Council.

The new text maintains the deficit to GDP ratio as the central reference value for assessing the excessive deficit of a Member State. Its important changes come from the margin of discretion for the appreciation of the overstepping.

The new regulation suppresses the minus 2% recession criterion and permits the severe economic downturn to result “from an accumulated loss of output during a protracted period of very low annual GDP volume relative to its potential”.

In addition, it is admitted that the countries with a lower debt level and higher potential of growth can be authorized to a small margin of overstepping. The same concession will be made to member states which introduce costly structural reforms which are likely to reduce their tendency to deficit in the future.

Finally, member states are encouraged more explicitly to anti-cyclical policies, especially in growth period. That is a fundamental point, but the reform does not include steps to constrain governments in this direction.

This short historical reminder must, in our sense, convince that any change in the fiscal and public debt criteria has to be considered very cautiously.

Indeed, any change would of course concern the reference value as it is the core, and almost the lonely element of the definition of criteria. And if changes occur, they will inevitably apply also to the Pact.

Of course, one can find a lot of arguments and technical supports for changing the reference value.

A proposition, with a priori very good technical framework, consists of taking into account the cyclically adjusted deficit instead of the global deficit.

The difficulty is to have a correct calculation of this data at a given point of the business cycle and to agree with the institution authorised to undertake these calculations and to pronounce binding results.

More generally, reference values of criteria are concepts of which the echo is not limited to the club of ministers, European Commission, or ECB, as they are perceived by the markets and even the public. Accordingly, the risk is to replace a perhaps global but simple concept by a perhaps technically better but incomprehensible concept, which would be of course suspected to enable discrete wangling. “All which is simple is wrong and all which is complicated is useless”. One has to choose the lesser between two troubles.

It could also be tempting to deduct from the fiscal balance elements which are not depending on the policy of the government. For instance, the payments to and the receipts from the Community which, in some countries, may reach one, and even more than one point of GDP.

But if one begins to implement such corrections, even if it seems very logical, one can open the doors to a lot of other propositions which will all seem rational but will lead to totally de-knitting the reference value.

For example, it is suggested to deduct public investment charges which are a guarantee for future economic growth strengthening and conversely better fiscal balances, or to deduct defence expenses as some countries support such huge charges which obviously can benefit to the whole area whereas other countries make very few efforts in this field. As we can see, the imagination is not limited and can lead very far. Any way, one can be sure that these points are developed by policymakers when they have to justify excessive fiscal imbalances in front of the Commission and the Council.

Finally it will not be surprising the only proposition of modification of the public finance criteria to be in the sense of the strengthening of the discipline. It could be asked to the candidate state to present a budget imbalance lower than 3%, for the two years , and not only one year preceding the examination. In addition, the state could be required to present a credible forecast of sound budgetary situation for the years following its entrance in the Monetary Union.

Macroeconomic Criteria - Exchange Rate

The last macroeconomic criterion concerns the exchange rate. While it has been simple to enounce, it has raised a lot of interpretation difficulties.

The criterion asks the candidate country to keep its money in the exchange rate mechanism (ERM) of the European Monetary System (EMS) during two years without any voluntary devaluation and with respect of the normal margins (+or-2.25% at the time of the Treaty).

A first difficulty came from the fact that, two years before the first examination of candidatures, some countries were not, or no more in the ERM, mainly the UK, Finland and Italy.

This problem has been relatively easily solved by a pragmatic approach. The participation to the ERM during two years was not required of Italy and Finland whose currencies had joined the system only 21 and 19 months before the examination.

A second difficulty was caused by the decision taken on 2 August 1993 by central banks governors and finance ministers to widen the fluctuation margins in the system from 2.25% to 15%. Following this decisions, was the “normal” margin still limited to 2.25% or extended to 15%?

In fact the common sense concluded that to consider 15% as a normal margin would have been absurd, but that the decision of 2 August implied also not to consider as a red line the limit of 2.25%.

As regards practical experiences it appears that the Finnish currency has remained in the 2.25% limit during the 19 months of its ERM membership before it melted in the euro, and that the Italian lira overstepped modestly the limit during one month.

In 1999, at the time of the birth of the euro, the ERM2 had replaced the ERM for European countries not belonging to the euro area. In this system, the exchange rate fluctuations limit vis-à-vis the euro has been formally 15%.

In fact, this large limit has not been considered as an accurate criterion for assessing exchange rates stability.

Concerning Greece which joined the Monetary Union in 2001, the drachma had belonged to the ERM 2 during two years inside the former limit of 2.25%.

Slovenia which recently joined the euro area has taken the same discipline.

If we consider now the other European non-member states, one can observe three situations:

- For countries which entered the ERM 2, there currency has fluctuated, in some case for a relatively long time, inside the former narrow limit.
- Two other countries have adopted a currency board regime with the euro as an anchor.
- Other countries are not in the ERM 2, but the average fluctuations of their currency regarding the euro have remained very limited for a relatively long period.

Considering the evolutions since the introduction of the criterion, one can fear that any change in its definition may endanger the pragmatic approach which seems to have prevailed, with, in fact, a respect of the spirit of the criterion if not of its letter.

However, a difficulty could concern the formal requirement for belonging to the ERM.

Even if the wording of the criterion is not ambiguous, some countries, especially the UK argue that a de facto situation of limited fluctuations of the currency can be admitted even if this currency does not formally belong to the ERM.

In addition, would countries of which the currency is linked to the euro by a currency board be obliged to abandon this system and join the ERM some time before the examination of their candidature? The answer seems to be a priori yes, as a currency board is not a true exchange rate management on markets. Here again, pragmatic arrangements are not excluded.

Here are several arguments to keep unchanged the definition of the exchange rate criterion.

New Criteria

We have now to examine the opportunity of adding new criteria.

It can be considered rather strange that the current account balance has not been taken into consideration in the assessment of the macroeconomic performances of a country which is candidate to the Monetary Union.

This relative indifference can be linked to the argument (which, to be true, is mainly supported by countries with recurrent and large current account deficits!) according to which, in a globalized financial world, to have a negative external account is not a problem if the country finds foreign saving to finance it at a good price.

In addition, there is a very widespread conviction that balance of payments deficits (or surplus) have no more significance in a monetary union.

One can, in our sense, distinguish two situations:

- A negative current account but a budget in balance. That means that the other economic agents, mainly the firms, have negative net saving (and households insufficient net saving). The situation is not ideal, but there is a presumption that the

external imbalance is caused by investment expenses. It is not abnormal to finance them by other countries' saving.

- Current account and budget deficits. Some large countries in the euro area and in the EU are in this situation of “twin deficits” which means that the domestic saving is not sufficient for financing functioning and consumption expenses. These Member States can be considered as “free riders” who embezzle other countries' saving for financing unproductive expenses.

“Soft” or “hard” solutions can be imagined for integrating the current account situation in the criteria.

A soft issue consists in refusing any possibility of discretion to a country with a current account deficit, in evaluating its compliance to the budget ratio.

A harder issue could be to require a lower limit for budget deficits of countries with important current account deficits. For example, in the case of twin deficits, red lines could be 2% of GDP for budget and current account deficits.

Other criteria could be added in the field of banking and supervision context. Sound banking system, regulation and supervision are presently asked of countries which are candidates for membership in the European Union (Copenhagen criteria). But we know that these situations were examined with some indulgence for a lot of new recent Member States.

The question could be considered as much more crucial in the case of an integration into a monetary union, with a single monetary policy and a single last resort lender. So it would not be absurd to re-examine these points when these countries are to be candidate for entering into the euro area. Considering the successive worldwide financial and banking crisis with regard to which the euro area seems (relatively!) protected, thank to its sound banking system and its performing supervision bodies, such an issue must be considered.

CRITERIA FOR MONETARY UNION ACCESSION

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Introduction

The euro area comprises thirteen EU economies that share a single currency and a common monetary policy driven by the ECB: eleven countries adhered in 1999, and Greece in 2002. Slovenia joined in 2007 and two more countries are joining the euro area in 2008, Malta and Cyprus. Denmark and the UK are members of the European Monetary Union but have exercised an "opt-out clause" that allows them to keep their national currencies. Therefore, after the enlargements of the EU in 2004 and 2007, there are still ten new members that have expressed the wish to adopt the euro and will be required to fulfil the so-called *Maastricht criteria*: Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia, Romania, Bulgaria and Sweden (an EU Member State (MS) since 1995).

The adoption of a new currency is a change of the monetary standard of the economy and, **by itself**, has no relevant long run effects on the real economy. If fully discounted by market participants, the accession to a new monetary area is by definition a **nominal** change that in the end will be reflected in the price of all the goods and services of the economy. However, accession will have **real** advantages if the new standard is governed so as to keep the value of the currency stable long term: there will then be no need to cover against random inflation and deflation and this will result in a higher rate of real growth.

The process *prior* to the countries' accession matters; and so does the behaviour of the monetary and fiscal authorities of the new members *after* euro adoption. This is why there is talk of requiring candidate countries to fulfil four conditions before complete adhesion, to wit:

- A high degree of price stability
- The sustainability of the Government fiscal position
- The medium term stability of the exchange rate
- Suitably low mid term interest rates

These entry conditions are intended to work for the furtherance of two basic aims: firstly, the gradual convergence of the candidate country to a scenario of fiscal discipline and monetary stability; and, secondly, the full contribution of the candidate country to the sound running of the enlarged monetary area as a whole, once it has adopted the new currency.

These "Maastricht criteria" are therefore intended to fulfil a double role: to make the country ready for a smooth transition from a national to a European currency; and to function as a guarantee against financial and fiscal free riding once they have adopted euro.

The long run benefits for the candidate country mainly depend on the fulfilment of these fiscal and monetary requisites – requisites that in fact also help them to put policies in effect that have a positive influence on the type of policies developed as a new member of the monetary area.

Achieving the fiscal and price targets associated with the convergence criteria serves as a useful way to adapt traditionally ill-governed economies to a new stable market-based scenario. If properly designed, fulfilment of the convergence criteria affords a precious opportunity to follow sound and sustainable economic policies.

In the running of its monetary policy, the ECB is primarily committed to price stability in the medium and long term. Since 1999 the ECB has succeeded in achieving this aim. Hence, for new MS, one of the most important long run benefits of accessing the euro area is that of being tied to a credible monetary anchor, since price stability crucially depends on a responsible monetary policy and the expectations it creates. However, in the short run, a strict monetary policy can widen cyclical swings in outlying countries with a rigid or defective institutional structure. The euro policy is tailored to the performance and statistics of the whole monetary area, and produces monetary decisions that apply to all members regardless their national circumstances. Candidate countries will no longer have the exchange rate or interest rates as instruments to adjust their economies in the face of negative lateral shocks. So, the immediate national effects of common monetary decisions will differ according to the structure and conduct of each national economy as compared with the euro area as a whole. To permit their sound performance inside the new monetary area, it greatly helps if candidate countries are well on the way to their economic and monetary convergence with the euro area.

The existing members of the “Euro club” also seek to guarantee the proper running of the enlarged monetary club after new accessions, which means that all members apply the same rules and that free rider behaviour and spill-over effects from errant countries are avoided.

The four Maastricht conditions are of course interlinked: a tight monetary policy is not credible if the country runs large budget deficits; the larger the budget deficit, the higher the interest rates needed to make a restrictive monetary policy bite; the higher the interest rates, the stronger the trend towards foreign exchange revaluation. However, if a high inflation country joins a stable monetary area it runs the danger of coming to a painful stop or, as the saying goes, of hitting the windscreen. If a new member of the club runs high fiscal deficits it forces more responsible members to run especially tight budgets to keep inflationary expectations at bay. Consequently, before accession, low inflation is the more important of the four conditions; and after accession, a sustainable fiscal policy is crucial.

Of the other two requirements, keeping the interest rate stable and low is a symptom of good behaviour in the field of prices and deficits rather than a condition for a smooth transition and positive after-effects. In fact, the full expectation that a country will join the Eurozone will by itself tend to bring interest rates down to the average level. And as to the fourth requirement, keeping the exchange rate within the European Monetary System “tram lines” may prove well-nigh impossible as foreign investment piles into the previously unreliable country. In the rest of this paper we will therefore concentrate on inflation and deficits.

In sum, the really important conditions are those relating to a low inflation rate and a sustainable fiscal regime.

Analysis of the two main Maastricht criteria: price inflation and budget deficits

1. Regarding price stability, the *Maastricht Treaty* (Art. 121 and the *Protocol to the Convergence Criteria*) refers to "*the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three-best performing Member States in terms of price stability*". In the Protocol to the Convergence Criteria, annexed to the Treaty, this criterion is defined as an inter-annual increase of the candidate's *Harmonised Index of Consumer Prices* (HICP) no higher than 1.5% above the unweighted HIPC average of the three lowest inflation Member States (MS).[40]

As we said above, accession to a new monetary standard is in the long run a nominal change that by itself has no permanent real effects on the economy of the candidate country. In the short run, however, a smooth adoption of the new currency would be jeopardised by a violent price deflation in the acceding country. Since exchange rate adjustments are not permitted (neither prior to the accession, nor inside the euro area), we agree that it would be desirable that prices in the candidate country should follow a path similar to that of the monetary area as a whole. This demands changes in the Maastricht rules when applied to new members.

Firstly, the **countries taken into account in the price stability criterion should be those in the Eurozone**, not the whole EU. The comparison with the three best performing MS of the EU as regards inflation made sense in 1998, when the first eleven countries were evaluated for price stability, since there were no euro members yet and, thus, all EU MS were potentially candidate countries (except the UK and Denmark). At present, this entry condition could introduce the inflation performance of one or several MS that are not currently members of the euro area as a reference, which would make little sense. Compared with 1998, when EU only had fifteen MS, we have now twelve more EU MS with a more diverse range of inflation rates (see Annex). As Gros (2004) has recently pointed out, an extended sample of EU MS increases the likelihood of extreme inflation values, and hence the likelihood of establishing a too restrictive reference value to assess the candidate's inflation performance.

Secondly, the Maastricht price stability condition sets a maximum of 1.5% above the unweighted inflation of the three MS with the lowest inflation rate. It would be advisable **to set the 1.5% margin over the average of the whole of Eurozone**. A strong argument in favour of this change is that the reformed criterion would offset differential *Ricardo-Balassa-Samuelson effects* when a monetary zone comprises countries with different productivity growth rates (See Gros 2004).

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[40] Following the HICP could lead to wrong analysis of price developments, with unwanted effects both in assessing candidate's price performance and conducting monetary policy in the euro area, due to two technical operational flaws in the definition of price stability as a convergence criterion which merits a closer look and the proper reform. On the one hand, candidate inflation is evaluated according to the registered inflation record; and, on the other, this evaluation is made in terms of the performance of defective price index.

In assessing price performance, expected inflation is as important as registered inflation The Commission "de facto" incorporates this forward-looking perspective in making the convergence reports (see European Commission 2007 for Cyprus and Malta evaluation reports). By construction, HICP is a partial price index which only takes into account a selected basket of goods and services, which corresponds to the representative consumption patterns of a "representative agent". But, this is not a measure of the purchasing power of money. To get it, a non partial price index would be required, such as the GDP deflator used in the US: which, by definition, is calculated considering the prices of all the goods and services produced in the economy. Moreover, the HICP is not the proper index to reflect changes in the productivity of the economy: it is a partial, time-delayed and asymmetrical price index (see Cechetti and Groshen 2001). The impact (if any) of a productivity gain in a particular sector in this index will vary depending on two elements: whether that sector is considered by the index and, if so, the distance of that sector with the final consumption prices. As a result, there could be productivity gains in the economy with no effects in the HICP or, in the best case, with a time-delayed effect.

According to the Balassa-Samuelson model, first formulated in a more acceptable monetarist version by David Ricardo,[41] the country with a higher productivity growth will also show a higher inflation rate because of the monetary effect of the surplus exports of cheaper goods. [The effect is equivalent to that of an inflow of gold into the more productive country.] If the new countries' exchange rates were fully flexible, there would be a real revaluation of the currency through a strengthening of the *nominal* exchange rate. But under the EMS quasi-fixed exchange rate regime obtaining in the candidate countries, the exchange rate can barely move. But as the nominal exchange rate is for all purposes fixed, exported goods and services will have to become more expensive by an increase in their cost. Prices and wages will rise with the higher productivity of labour in the sectors exporting to the rest of the EU: the larger those sectors and the higher the productivity, the more markedly higher the price and wage level will be there. This is equivalent to a rise in the *real* exchange rate. As a result of all this, economies with higher *productivity level* will also be placed on a *price level* higher than that of lower productivity economies. And countries with a higher *productivity growth* will show quicker *price growth*, i.e., a *higher inflation rate.* If on top of this, the labour market is unionised and oligopolistic, wages will also rise in the non-tradable goods sector and price indices may for a time show additional inflationary effects.

The central and eastern European countries ready to join the euro area have registered significant economic growth, well above the average of the enlarged EU, and thus euro area countries (see the Annex and the statistics section of last *ECB Monthly Bulletin*). On average, those countries have grown by more than 7.5% in 2006, which more than doubles EU growth (3%) and euro area growth (2.8%). So, following the *Ricardo-Balassa-Samuelson* model, their price levels should be rising faster than those of the Eurozone countries. As expected, they show higher inflation rates, on average (4.5%), double the HICP of the EU and the euro area (both 2.2%). Daniel Gros (2004) reports that the Bundesbank has estimated that the *Balassa-Samuelson* effect in Europe as between 1.9% and 2.6%.

This virtual monetary effect of productivity growth on prices in open economies has unfortunately been reinforced by the reduction in interest rates due to their expected adoption of the euro. Coming from quite high levels, official interest rates have increasingly converged to the much lower ECB rate levels (See Krenussz, 2006 and Annex). As it happened with some southern Europe countries in the 1998 first accession process, these new and loosen financial conditions have favoured the needed public finance adjustment, as well as much higher liquidity growth in these countries. In the central and eastern Europe candidate countries money growth has been fast – more than double than that required to maintain price stability much higher.[42]

These results would justify using a 1.5% margin of excess above the Eurozone average as a criterion for joining, not that same margin above the three EU countries with the lowest inflation, since the Eurozone inflation average will be higher.

[41] Ricardo (1817), when he deals with the distribution of the precious metals in the world in chapter VII on foreign trade.

[42] *According to the* Quantity Equation *(M+V=P+Yr, in rates of growth), to maintain price (P) stability (inflation below 2% in terms of current ECB definition), liquidity growth (M) should be just enough to finance the real growth of the economy (Yr) at stable prices (that is, inflation bellow 2%). Assuming a decline of money velocity between 1-2% annually, the resulting money growth in a country like Bulgaria in 2005 should have been around 9-10% (M=P+Yr-V = 2%+6,2%+(1 or 2%) but was in fact close to 24%. The Czech Republic, Poland and Slovakia are the exceptions: with a lower money growth, they are the best performing candidates countries in terms of price stability.*

2. Regarding fiscal discipline, the Maastricht fiscal criterion defines sound public finance as "*sustainability of the government fiscal position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive*". According to the Treaty, fulfilment of this general principle involves two conditions:

- The ratio of the government' deficit to GDP cannot be higher than 3%.
- And, the ratio of the government's debt to GDP cannot exceed 60%.

However, in case of a deficit over the 3% limit, this criterion is also evaluated considering the evolution of the deficit in recent years. Accordingly, fulfilment of this criterion may be achieved by. Finally, there is another exception clause in: Also, a temporarily excessive deficit may be accepted, if the deficit remains still close to the limit.

The rationale of this fiscal criterion is plainly valid for future euro area enlargements. Since there is a single monetary policy which sets a common official interest rates for all euro members, non-sustainable fiscal policies at a national level will have an impact in the conduct of the common monetary policy; which imposes a financial cost also on well-run countries. In particular, a growing deficit in a member country will increase its demand of credit and hence, in the absence of a credit or monetary expansion, higher interest rates in all the euro area. This increase in the price of credit would be precisely the costs of an ill-run public finance by a member country. To avoid free-rider behaviour and spill-over effects, fiscal discipline must be imposed as an entry condition to access the euro area.

As in the original *Stability and Growth Pact* (SGP), **candidates should be required to achieve fiscal balance or surplus as a medium term fiscal target**. This would ensure a sustainable fiscal position in times of a reduction of the current economic growth stance. However, this strict criterion has been watered down by considering it fulfilled when a significant and continuous decline of the deficit is achieved bringing it eventually close to that limit.

This criterion could be bettered if the budget deficit were analysed together with the performance of public investment in line with the reform of the UK fiscal strategy. In 1998, the so-called *golden rule* of public finance was instituted in the UK. This rule sets the need to preserve fiscal balance in current terms over the cycle; that is, current outlays must be fully financed by current revenues one year with another (see British Treasury 1998). Hence, public debt is an exceptional tool only used to finance public investment. As a result, public debt ratio should be lower than 60%, since it would be used only for specific purposes and not as a permanent way to finance current income shortfalls. In our view and contrary to the UK strategy, the *golden rule* should not be evaluated over the cycle but annually, in order to avoid measurement errors and higher volatility in conducting fiscal policy (Castañeda 2006).

If the *golden rule* was adopted as a fiscal criterion, for accession, candidates should aim at a year on year zero deficit in current terms, as well as a lower debt ratio.

However, in order to maintain the coherence inside the current fiscal EU strategy, those proposals should not only affect candidate countries but all members of the EU; which would require a reform of the SGP.

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ANNEX: EU STATISTICS

Table 1: GDP real growth

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
EU (27 countries)	2.7	2.9	3.0	3.9	2.0	1.2	1.3	2.5	1.8	3.0	2.9 (f)	2.7 (f)
EU (25 countries)	2.7	3.0	3.1	3.9	2.0	1.2	1.3	2.4	1.8	3.0	2.8 (f)	2.6 (f)
EU (15 countries)	2.6	2.9	3.0	3.8	1.9	1.1	1.1	2.3	1.6	2.8	2.7 (f)	2.5 (f)
Euro area	2.5	2.8	3.0	3.8	1.9	0.9	0.8	2.0	1.5	2.8	2.6 (f)	2.5 (f)
Euro area (13 countries)	2.6	2.8	3.0	3.8	1.9	0.9	0.8	2.0	1.5	2.8	2.6 (f)	2.5 (f)
Euro area (12 countries)	2.6	2.8	3.0	3.8	1.9	0.9	0.8	2.0	1.5	2.8	2.6 (f)	2.4 (f)
Belgium	3.5	1.7	3.4	3.7	0.8	1.5	1.0	3.0	1.1	3.2	2.3 (f)	2.2 (f)
Bulgaria	-5.6	4.0	2.3	5.4	4.1	4.5	5.0	6.6	6.2	6.1	6.1 (f)	6.2 (f)
Czech Republic	-0.7	-0.8	1.3	3.6	2.5	1.9	3.6	4.6	6.5	6.1 (f)	4.9 (f)	4.9 (f)
Denmark	3.2	2.2	2.6	3.5	0.7	0.5	0.4	2.1	3.1	3.5	2.3 (f)	2.0 (f)
Germany	1.8	2.0	2.0	3.2	1.2	0.0	-0.2	1.1	0.8	2.9	2.5 (f)	2.4 (f)
Estonia	11.1	4.4	0.3	10.8	7.7	8.0	7.1	8.1	10.5	11.4	8.7 (f)	8.2 (f)
Ireland	11.7	8.5	10.7	9.4	5.8	6.0	4.3	4.3	5.5	6.0 (f)	5.0 (f)	4.0 (f)
Greece	3.6	3.4	3.4	4.5	5.1	3.8	4.8	4.7	3.7	4.3	3.7 (f)	3.7 (f)
Spain	3.9	4.5	4.7	5.0	3.6	2.7	3.1	3.3	3.6	3.9	3.7 (f)	3.4 (f)
France	2.2	3.5	3.3	3.9	1.9	1.0	1.1	2.5	1.7	2.0	2.4 (f)	2.3 (f)
Italy	1.9	1.4	1.9	3.6	1.8	0.3	0.0	1.2	0.1	1.9	1.9 (f)	1.7 (f)
Cyprus	2.3	5.0	4.8	5.0	4.0	2.0	1.8	4.2	3.9	3.8	3.8 (f)	3.9 (f)
Latvia	8.4	4.7	3.3	6.9	8.0	6.5	7.2	8.7	10.6	11.9	9.6 (f)	7.9 (f)
Lithuania	8.5	7.5	-1.5	4.1	6.6	6.9	10.3	7.3	7.6	7.5	7.3 (f)	6.3 (f)
Luxembourg	5.9	6.5	8.4	8.4	2.5	3.8	1.3	3.6	4.0	6.2	5.0 (f)	4.7 (f)
Hungary	4.6	4.9	4.2	5.2	4.1	4.4	4.2	4.8	4.1	3.9	2.4 (f)	2.6 (f)
Malta	:	:	:	:	-1.6	2.6	-0.3	0.1	3.1	3.2	3.0 (f)	2.8 (f)
Netherlands	4.3	3.9	4.7	3.9	1.9	0.1	0.3	2.2	1.5	3.0	2.8 (f)	2.6 (f)
Austria	1.8	3.6	3.3	3.4	0.8	0.9	1.2	2.3	2.0	3.3	2.9 (f)	2.5 (f)
Poland	7.1	5.0	4.5	4.3	1.2	1.4	3.9	5.3	3.6	6.1	6.1 (f)	5.5 (f)
Portugal	4.2	4.8	3.9	3.9	2.0	0.8	-0.7	1.5	0.5	1.3	1.8 (f)	2.0 (f)
Romania	:	:	-1.2	2.1	5.7	5.1	5.2	8.5	4.1	7.7	6.7 (f)	6.3 (f)
Slovenia	4.8	3.9	5.4	4.1	2.7	3.5	2.7	4.4	4.0	5.2	4.3 (f)	4.0 (f)
Slovakia	5.7	3.7	0.3	0.7	3.2	4.1	4.2	5.4	6.0	8.3	8.5 (f)	6.5 (f)
Finland	6.1	5.2	3.9	5.0	2.6	1.6	1.8	3.7	2.9	5.5	3.1 (f)	2.7 (f)
Sweden	2.3	3.7	4.5	4.3	1.1	2.0	1.7	4.1	2.9	4.2	3.8 (f)	3.3 (f)
United Kingdom	3.1	3.4	3.0	3.8	2.4	2.1	2.8	3.3	1.8	2.8	2.8 (f)	2.5 (f)

(:) Not available
(f) Forecast
Source: Eurostat (from Eurostat website)

Table 2: HICP

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
European Union	1.7 (ei)	1.3 (ei)	1.2 (ei)	1.9 (i)	2.2 (i)	2.1 (i)	2.0 (i)	2.0 (i)	2.2 (i)	2.2
Euro area	1.6 (e)	1.1	1.1	2.1	2.3	2.2	2.1	2.1	2.2	2.2
Belgium	1.5	0.9	1.1	2.7	2.4	1.6	1.5	1.9	2.5	2.3
Bulgaria	:	18.7	2.6	10.3	7.4	5.8	2.3	6.1	6.0	7.4
Czech Republic	8.0	9.7	1.8	3.9	4.5	1.4	-0.1	2.6	1.6	2.1
Denmark	2.0	1.3	2.1	2.7	2.3	2.4	2.0	0.9	1.7	1.9
Germany	1.5	0.6	0.6	1.4	1.9	1.4	1.0	1.8	1.9	1.8
Estonia	9.3	8.8	3.1	3.9	5.6	3.6	1.4	3.0	4.1	4.4
Ireland	1.3 (e)	2.1	2.5	5.3	4.0	4.7	4.0	2.3	2.2	2.7
Greece	5.4	4.5	2.1	2.9	3.7	3.9	3.4	3.0	3.5	3.3
Spain	1.9	1.8	2.2	3.5	2.8	3.6	3.1	3.1	3.4	3.6
France	1.3	0.7	0.6	1.8	1.8	1.9	2.2	2.3	1.9	1.9
Italy	1.9	2.0	1.7	2.6	2.3	2.6	2.8	2.3	2.2	2.2
Cyprus	3.3	2.3	1.1	4.9	2.0	2.8	4.0	1.9	2.0	2.2
Latvia	8.1	4.3	2.1	2.6	2.5	2.0	2.9	6.2	6.9	6.6
Lithuania	10.3	5.4	1.5	1.1	1.6	0.3	-1.1	1.2	2.7	3.8
Luxembourg	1.4	1.0	1.0	3.8	2.4	2.1	2.5	3.2	3.8	3.0
Hungary	18.5 (i)	14.2 (i)	10.0 (i)	10.0 (i)	9.1 (i)	5.2	4.7	6.8	3.5	4.0
Malta	3.9	3.7	2.3	3.0	2.5	2.6	1.9	2.7	2.5	2.6
Netherlands	1.9	1.8	2.0	2.3	5.1	3.9	2.2	1.4	1.5	1.7
Austria	1.2	0.8	0.5	2.0	2.3	1.7	1.3	2.0	2.1	1.7
Poland	15.0 (ei)	11.8 (ei)	7.2 (ei)	10.1	5.3	1.9	0.7	3.6	2.2	1.3
Portugal	1.9	2.2	2.2	2.8	4.4	3.7	3.3	2.5	2.1	3.0
Romania	154.8 (i)	59.1 (i)	45.8 (i)	45.7 (i)	34.5 (i)	22.5 (i)	15.3 (i)	11.9 (i)	9.1 (i)	6.6
Slovenia	8.3	7.9	6.1	8.9	8.6	7.5	5.7	3.7	2.5	2.5
Slovakia	6.0	6.7	10.4	12.2	7.2	3.5	8.4	7.5	2.8	4.3
Finland	1.2	1.3	1.3	2.9	2.7	2.0	1.3	0.1	0.8	1.3
Sweden	1.8	1.0	0.5	1.3	2.7	1.9	2.3	1.0	0.8	1.5
United Kingdom	1.8	1.6	1.3	0.8	1.2	1.3	1.4	1.3	2.1	2.3

(:) Not available
(e) Estimated value
(i) See explanatory text

Source: Eurostat (from Eurostat website)

Table 3: Public Finance

Net borrowing/lending of consolidated general government sector as a percentage of GDP
EU definition: net borrowing (+)/net lending (-) of general government is the difference between the revenue and the expenditure of the general government sector. The general government sector comprises the following subsectors: central government, state government, local government, and social security funds. GDP used as a denominator is the gross domestic product at current market prices.

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
EU (27 countries)	:	:	:	:	:	:	:	:	-3.1	-2.7	-2.4	-1.7
EU (25 countries)	:	:	:	:	:	0.4	-1.3	-2.3	-3.1	-2.7	-2.4	-1.7
EU (15 countries)	-5.3	-4.1	-2.5	-1.7	-0.8	0.5	-1.1	-2.2	-2.9	-2.7	-2.3	-1.6
Euro area	:	:	:	:	:	:	:	-2.5	-3.0	-2.8	-2.5	-1.6
Euro area (13 countries)	:	:	:	:	:	:	:	:	-3.0	-2.8	-2.5	-1.6
Euro area (12 countries)	-5.3	-4.2	-2.6	-2.2	-1.3	0.0	-1.8	-2.5	-3.0	-2.8	-2.5	-1.6
Belgium	-4.2	-3.7	-2.1	-0.8	-0.5	0.1	0.6	0.0	0.1	0.0	-2.3	0.2
Bulgaria	:	:	:	1.7	0.4	-0.5	1.9	0.1	-0.9	2.2	1.9	3.3
Czech Republic	-13.4	-3.3	-3.8	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-2.9	-3.5	-2.9
Denmark	-2.9	-1.9	-0.5	0.0	1.3	2.3	1.4	1.2	0.0	2.0	4.7	4.2
Germany	-3.2	-3.3	-2.6	-2.2	-1.5	1.3	-2.8	-3.7	-4.0	-3.7	-3.2	-1.7
Estonia	:	:	:	:	:	-0.2	-0.3	0.4	2.0	2.3	2.3	3.8
Ireland	-2.0	0.0	1.2	2.4	2.7	4.6	0.8	-0.4	0.4	1.4	1.0	2.9
Greece	-9.0	-6.7	-6.0	-4.2	-3.3	-4.0	-4.9	-5.2	-6.2	-7.9	-5.5	-2.6
Spain	-6.3	-4.7	-3.3	-3.1	-1.3	-0.9	-0.5	-0.3	0.0	-0.2	1.1	1.8
France	-5.5	-4.0	-3.0	-2.6	-1.7	-1.5	-1.5	-3.2	-4.1	-3.6	-3.0	-2.5
Italy	-8.2	-7.0	-2.7	-2.8	-1.7	-0.8	-3.1	-2.9	-3.5	-3.5	-4.2	-4.4
Cyprus	:	:	:	-4.2	-4.4	-2.4	-2.3	-4.4	-6.3	-4.1	-2.3	-1.5
Latvia	-2.0	-0.5	1.5	-0.6	-5.3	-2.8	-2.1	-2.3	-1.6	-1.0	-0.2	0.4
Lithuania	-1.6	-3.3	-11.9	-3.1	-2.8	-3.2	-2.1	-1.5	-1.3	-1.5	-0.5	-0.3
Luxembourg	2.3	1.2	3.7	3.4	3.4	6.0	6.1	2.1	0.4	-1.2	-0.3	0.1
Hungary	:	:	-5.9	-8.0	-5.5	-2.9	-3.4	-8.2	-7.2	-6.5	-7.8	-9.2
Malta	:	:	:	-9.7	-7.6	-6.1	-6.4	-5.5	-10.0	-5.0	-3.1	-2.6
Netherlands	-8.8	-1.8	-1.3	-0.9	0.4	2.0	-0.2	-2.0	-3.1	-1.8	-0.3	0.6
Austria	-5.4	-3.8	-1.7	-2.3	-2.2	-1.5	0.0	-0.5	-1.6	-1.2	-1.6	-1.1
Poland	-4.4	-4.9	-4.6	-4.3	-1.8	-1.5	-3.7	-3.2	-6.3	-5.7	-4.3	-3.9
Portugal	-5.1	-4.4	-3.4	-3.0	-2.7	-2.9	-4.3	-2.9	-2.9	-3.3	-6.1	-3.9
Romania	:	:	:	-3.2	-4.5	-4.6	-3.3	-2.0	-1.5	-1.5	-1.4	-1.9
Slovenia	:	:	:	:	:	-3.8	-4.1	-2.5	-2.8	-2.3	-1.5	-1.4
Slovakia	-1.8	-8.6	-6.7	-4.8	-6.4	-11.8	-6.5	-7.7	-2.7	-2.4	-2.8	-3.4
Finland	-5.9	-3.5	-1.2	1.7	1.6	6.9	5.0	4.1	2.5	2.3	2.7	3.9
Sweden	-7.0	-2.7	-0.9	1.8	2.5	5.0	2.5	-0.2	-0.9	0.8	2.1	2.2
United Kingdom	-5.8	-4.1	-2.1	0.1	1.2	1.7	1.0	-1.7	-3.2	-3.1	-3.1	-2.8

(:) Not available

Source: Eurostat, OECD (from Eurostat website)

Table 4: General government consolidated gross debt as a percentage of GDP

EU definition: the general government sector comprises the subsectors of central government, state government, local government and social security funds. GDP used as a denominator is the gross domestic product at current market prices. Debt is valued at nominal (face) value, and foreign currency debt is converted into national currency using end-year market exchange rates (though special rules apply to contracts). The national data for the general government sector are consolidated between the sub-sectors. Basic data are expressed in national currency, converted into euro using end-year exchange rates for the euro provided by the European Central Bank.

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
EU (27 countries)	:	:	:	:	:	:	:	:	61.8	62.2	62.9	61.7
EU (25 countries)	:	:	:	67.5	66.7	62.9	62.0	60.4	62.1	62.5	63.3	62.2
EU (15 countries)	70.8	72.6	71.0	68.9	67.9	64.1	63.1	61.5	63.1	63.3	64.4	63.3
Euro area	:	:	:	:	:	:	:	68.2	69.3	69.8	70.6	69.1
Euro area (13 countries)	:	:	:	:	:	:	:	:	69.2	69.7	70.5	69.0
Euro area (12 countries)	73.6	75.2	74.9	74.2	72.7	70.4	69.3	68.2	69.3	69.8	70.6	69.1
Belgium	134.0	130.2	124.8	119.6	114.8	109.1	108.0	103.3	98.6	94.3	93.2	89.1
Bulgaria	:	:	105.1	79.6	79.3	73.6	66.2	54.0	45.9	37.9	29.2	22.8
Czech Republic	:	:	12.2	12.9	13.4	18.2	26.3	28.5	30.1	30.7	30.4	30.4
Denmark	73.2	69.7	65.7	61.2	57.7	52.3	48.0	46.8	45.8	44.0	36.3	30.2
Germany	57.0	59.8	61.0	60.9	61.2	60.2	59.6	60.3	63.9	65.7	67.9	67.9
Estonia	:	:	6.4	5.6	6.0	4.7	4.7	5.6	5.7	5.2	4.4	4.1
Ireland	81.8	73.3	64.5	53.8	48.6	38.3	35.9	32.2	31.2	29.7	27.4	24.9
Greece	108.7	111.3	108.2	105.8	105.2	114.0	114.4	110.7	107.8	108.5	107.5	104.6
Spain	63.9	68.1	66.6	64.6	63.1	61.1	56.3	52.5	48.8	46.2	43.2	39.9
France	54.6	57.1	59.3	59.5	58.5	56.8	56.8	58.2	62.4	64.3	66.2	63.9
Italy	124.3	123.1	120.5	116.7	115.5	111.2	110.9	105.6	104.3	103.8	106.2	106.8
Cyprus	:	:	:	61.6	62.0	61.6	61.9	64.7	69.1	70.3	69.2	65.3
Latvia	:	:	:	9.8	12.6	12.9	15.0	13.5	14.4	14.5	12.0	10.0
Lithuania	:	:	15.2	16.5	23.0	23.8	22.9	22.2	21.2	19.4	18.6	18.2
Luxembourg	6.7	7.2	6.8	6.3	5.9	5.5	6.7	6.5	6.3	6.6	6.1	6.8
Hungary	:	:	64.2	61.9	61.2	55.4	52.2	54.0	58.0	59.4	61.7	66.0
Malta	:	:	51.5	64.9	56.8	56.4	63.5	60.1	70.4	73.9	72.4	66.5
Netherlands	77.2	75.2	69.9	66.8	63.1	55.9	51.5	50.5	52.0	52.6	52.7	48.7
Austria	67.9	67.6	63.8	64.2	66.5	67.0	67.0	65.8	64.6	63.9	63.5	62.2
Poland	:	:	44.0	39.1	40.3	36.8	36.7	39.8	47.1	45.7	47.1	47.8
Portugal	64.3	62.9	59.1	55.0	54.3	53.3	53.6	55.5	56.8	58.2	63.6	64.7
Romania	:	:	16.5	17.8	24.2	22.7	:	23.8	21.5	18.8	15.8	12.4
Slovenia	:	:	:	23.6	24.9	27.4	28.4	29.1	28.6	28.9	28.4	27.8
Slovakia	:	30.6	33.1	34.0	47.2	49.9	49.2	43.3	42.4	41.5	34.5	30.7
Finland	57.1	57.1	54.1	48.6	47.0	44.6	43.6	41.3	44.3	44.1	41.4	39.1
Sweden	73.7	73.5	70.6	68.1	62.7	52.8	54.3	52.0	53.5	52.4	52.2	46.9
United Kingdom	51.8	52.3	50.8	47.7	45.1	42.0	38.7	37.5	38.8	40.3	42.2	43.5

(:) Not available

Source: Eurostat, OECD (from Eurostat website)

Table 5: Broad monetary aggregate growth (M3, annual change, %)

	2000	2001	2002	2003	2004	2005	2006
Euro Area (EA11-2000, EA12-2006, EA13)	4.3	10.9	6.6	6.4	6.3	8.4	9.4
Bulgaria	30.8	25.8	11.7	19.5	23.1	23.9	:
Czech Republic	-	-	-	6.6	7.4	:	:
Estonia	25.4	24.5	12.1	8.8	16.7	:	:
Latvia	26.8	20.2	18.1	21.1	26.7	:	:
Lithuania	16.1	21.9	17.0	20.1	27.5	:	:
Hungary	18.0	17.1	9.3	12.0	11.6	:	:
Poland	11.9	9.2	-2.0	5.6	8.6	:	:
Romania	-	-	-	-	-	36.5	28.1
Slovakia	-	-	-	-	15.0	:	:

Source: From Eurostat website

CRITERIA FOR MONETARY UNION ACCESSION

Briefing paper for the Economic and Monetary Committee of the EU Parliament

October 2007

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Executive Summary

The Maastricht entry criteria were probably originally designed to ensure that entrants into monetary union possessed the political will to support a policy of low inflation. Countries are more likely to have such will if their tax systems are efficient and their labour markets are flexible. As fundamental reforms of tax systems and labour markets are difficult to quantify, the criteria are targets for more easily measured variables.

There are numerous problems with the fiscal criteria but an application of them would make a reasonable distinction between countries that are ready for monetary union and countries that are not.

The monetary criteria are unreasonable. It is not sensible to require countries to meet both an inflation and an exchange rate target. Moreover, the inflation target is too severe.

A major problem with the criteria has been their implementation; countries that have failed to undertake necessary fundamental reforms have been held to far lower standards than countries which have reformed.

Introduction

Upon joining the European Union, new members must accept the *acquis*, that is, the rules of the founding treaties of the Union. As part of this, all new members are required to adopt the euro eventually. Therefore, they are expected to satisfy the criteria described in the Maastricht treaty which are a requirement for membership in the monetary union. These entrance criteria are of two types. First, there are two fiscal criteria: both a candidate country's deficit-to-GDP ratio and its debt-to-GDP ratio are to be below specified ceilings. However, an allowance is made for a deficit that exceeds the ceiling if the excess-deficit country's deficits have declined steadily and substantially and their deficits are near the ceiling or if the excessive deficit is an exceptional and temporary increase above the ceiling. An allowance is also made for a debt that exceeds the ceiling if the debt is declining toward the ceiling at a fast enough rate. Second, there are three monetary criteria: the country is expected to participate in an exchange rate mechanism with the union and both its interest rates and inflation are to be below specified target levels.

The original reason for these Maastricht entry criteria was probably to ensure that candidate entrant countries possessed the political will to support a union-wide policy of low inflation. If some entrant countries possess tax systems that are less efficient than the average EU tax system, then these countries may have an optimal inflation rate that is higher than the optimal rate for the union as a whole. Even if an entrant country's optimal tax rate does not differ from that of the EU average, if the country has distorted and inflexible labour markets or an inefficient tax system it will have an incentive to create unanticipated inflation.

As a consequence, it is likely that EU policy makers wanted countries to undertake fundamental reforms of their tax systems and their labour markets prior to joining monetary union. In practice however, it was probably perceived to be impractical to specify entrance criteria in terms of these fundamental reforms: it is too difficult to describe and quantify labour market and tax system reform. Probably for this reason, the Maastricht criteria are targets for more easily measured variables such as inflation and exchange rates. The framers of the Maastricht treaty may have believed that countries would undertake the desired fundamental reforms to ensure that they would be able to satisfy the Maastricht criteria.

In this note I specify how I believe the criteria for monetary union accession should be changed. I first discuss the fiscal criteria and then the monetary criteria.

Fiscal Criteria

An inability or unwillingness of some member states to commit themselves to a sustainable fiscal policy is viewed as a potential cost of their membership in the Eurozone to the other member states. It is frequently believed that a country's actual or threatened insolvency might jeopardise the entire Eurozone financial system or destabilise the common currency by forcing the European Central Bank into a bail out. The ECB is prohibited from rescuing an insolvent government by buying its government debt in the primary market. However, it is indirectly able to rescue a government by purchasing its debt in the secondary market or by reducing interest rates. Thus, a monetary union has an interest in excluding countries on the verge of insolvency or countries whose fiscal and political systems are such that they might risk insolvency in the future.

Perhaps the most obvious way that a country would become insolvent is that it experiences an unfavourable economic shock and begins to run unsustainable fiscal deficits. As the situation continues the likelihood of insolvency rises and tax increases or spending cuts are required. If a country has a large cash-intensive informal sector that makes direct taxation distortionary, if

tax administration is inefficient or if complicated procedures make tax compliance difficult then such painful measures will be especially tough to implement.

The size of the informal sector, the competency of the tax administrators and the complexity of the tax code are all hard to measure. As a substitute, imposing ceilings on permissible debt and deficits for candidate members of the monetary union is not an unreasonable way to lower the risk of admitting a country that is likely to present a threat to monetary union because of its fiscal policy. It should be noted, however, that none of the current accession countries is large enough to present a systemic risk to the eurozone, except perhaps through contagion.

Another way that a country's fiscal policy can present problems for monetary union is if the country relies heavily on an inflation tax prior to joining the monetary union. Due to different abilities to collect taxes and differences in the size of the informal sector, different countries may have different optimal inflation rates. If a government is relatively poor at collecting taxes or if its taxes are particularly distortionary, then it may find it optimal to collect a significant inflation tax, either through seigniorage (revenues from base money issued by the central bank) or an erosion of the real value of domestic-currency fixed interest debt at a rate of inflation higher than was anticipated when the debt was issued. Thus, it may prefer an inflation rate which is higher than the one which is optimal for the eurozone on average. The solution to this problem is reform of the tax system. Again, as it is difficult to quantify reform, a ceiling on allowed deficits is not unreasonable.

The numbers chosen for the deficit as a percentage of GDP and debt as a percentage of GDP ceilings are three and sixty percent, respectively. The choice of these numbers may have been based on an assumption of five percent nominal GDP growth. In this case, if debt is sixty percent of GDP, then the increase in the debt-to-GDP ratio brought about by a three percent deficit is approximately offset by the decrease in the debt-to-GDP ratio brought about by a five percent increase in GDP. Nominal GDP growth in the new member states, however, is considerably higher than five percent.

There are numerous problems with implementing a test of whether a country has met the existing numerical criteria. The existence of off-budget and contingent assets and liabilities presents accounting problems. Collecting budgetary statistics is difficult. Nevertheless, an application of these criteria at present would make a reasonable division of the countries who are ready for money union and those who are not. Most accession countries would easily pass both fiscal criteria.

Only one country is in flagrant violation: Hungary with debt equal to 66 percent of GDP and a deficit of over nine percent of GDP in 2006. Poland and Slovakia satisfy the debt criterion but have 2006 deficits of 3.9 and 3.4 percent, respectively.

The major problem with the fiscal criteria is that current union members are supposed to satisfy them as part of their adherence to the Stability and Growth Pact but many do not and never have. Debt as a percentage of GDP is 89.1 percent in Belgium, 67.9 percent in Germany, 104.6 percent in Greece, 63.9 percent in France, 106.8 percent in Italy, 62.2 percent in Austria and 64.7 percent in Portugal. Germany, Greece, France and Italy frequently exceed the three-percent deficit limit. Moreover, current members Italy, Greece and Germany were allowed to join without satisfying the debt criterion. For member countries to so extravagantly flout the rules and then deny eurozone membership to Lithuania because it failed to meet the inflation criterion by a hair's breadth makes a mockery of the process.

Monetary Criteria

Suppose a potential entrant to a monetary union has either a distorted labour market or a tax system that is costly to administer and comply with. The former problem causes employment to be below the socially optimal rate and the latter causes the government to want to collect an inflation tax. Fixed nominal wages ensure that employment is increasing in unexpected inflation and fixed nominal interest rates ensure that the value of the government's domestic-currency debt is decreasing in unexpected inflation. Thus, even if the government does not like actual inflation it has an incentive to generate unexpected inflation. Rational expectations ensure that on average there is no unexpected inflation. If the marginal benefit of unexpected inflation exceeds the marginal costs of actual inflation when inflation is at its socially optimal rate, the result is excessive actual inflation on average, with no unexpected inflation and, thus, no corresponding social benefit.

If current members of a monetary union do not want future members who have such an incentive to create inflation opportunistically, then they would want the new members to reform their tax systems and labour markets. However, as such reforms are difficult to assess, it is likely that the current monetary criteria were seen as a reasonable substitute for evidence of fundamental reforms. These three monetary criteria are: (1) an interest rate criterion; long-term (ten-year) nominal interest rates on government debt are to be within two percent of the average in the three countries with the best (lowest) inflation record; (2) an inflation criterion; the annual inflation rate cannot exceed the average of the three best performing (lowest inflation) countries by more than 1.5 percent during the year prior to the formal assessment of whether a candidate has met the EMU membership criteria; (3) the exchange rate criterion; the exchange rate has to respect the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the formal assessment. In particular, the Member State shall not have devalued its currency on its own initiative for the same period. The ECB and the European Commission have interpreted normal fluctuations to be within a 15 percent bands around a fixed central parity against the euro. There is also the requirement that the central bank of the candidate country must be independent.

The major theoretical objection to the monetary criteria is that it is only possible for a central bank with a single policy instrument to target a single nominal variable. Sensibly, neither the ECB nor the Bank of England attempt to do more than control their inflation rates. In practice this has caused difficulties for Estonia and Lithuania who operate remarkably successful currency boards. In pegging their exchange rates, they have given up control over inflation and it is only by chance that they can satisfy the tough inflation criterion. To have satisfied both the inflation and exchange rate criterion in January 2007 (the interest rate target was lax enough that it did not present a problem) they would have had to have either abandoned their currency boards and adopted a flexible exchange rate system – the 15 percent exchange rate bands offer more leeway than the rigorous inflation target – or they could have used fiscal policy to engineer a recession, lowering inflation in the process. Existing members were less enthusiastic about applying the monetary criteria to themselves: recognizing the economic damage attempting to satisfy both criteria might cause, Finland, Italy and Greece were not required to satisfy the exchange rate criterion.

Another problem with the monetary criteria is the severity of the inflation target. The target is unreasonably restrictive for three reasons. First, the Balassa-Samuelson effect implies that as the accession countries catch up with Euro area countries their real exchange rates will appreciate. For currency-board countries such as Estonia and Lithuania with a fixed nominal exchange rate this implies that their inflation will be higher than in Euro area countries.

Short data sets and cyclical factors make it difficult to assess the size of the inflation increase due to the Balassa-Samuelson effect on the accession countries, but estimates are in the range of 1.5 percent to 2.5 percent.[43] As the Maastricht Treaty only allows for inflation to be 1.5 percent above benchmark, this creates a serious problem for Estonia and Lithuania.

Second, benchmark inflation is that of the three best-performing countries. While "best-performing" is not defined in the Treaty, the ECB and European Commission have operationalised this as being the *lowest* non-negative inflation countries. This is at odds with the ECB's own target. Recognizing that measured inflation exceeds actual inflation and that the costs of deflation probably exceed the costs of inflation, the ECB has defined price stability for itself to be inflation close to but below two percent. When challenged about this, the ECB and European Commission did not defend their methodology. Instead, they made the extraordinary argument that it should be used because it had been used in the past.

Finally, the Treaty calls for benchmark inflation to be that of the three best-performing EU member countries, not the three best-performing eurozone countries! Indeed, two of the countries used in constructing the benchmark for Cyprus and Malta were Poland and Sweden. This has the bizarre consequence that an accession country with inflation close to that of the eurozone average could be kept out because three non-eurozone countries followed excessively restrictive monetary policies.

Suggestions for Improving the Criteria

Perhaps the major problem with the criteria is the insistence that countries must join the exchange rate mechanism and satisfy an inflation target. It would be more sensible to allow countries to pick one or the other. As the optimal exchange rate system for a small accession country is probably either a currency board or a float, the fifteen percent fluctuation bands in the exchange rate mechanism are generous for a country that pegs its exchange rate. The inflation target is too tight, however, and should be replaced with a less restrictive one. Adding 1.5 percentage points to allow for the Balassa-Samuelson effect onto the ECB inflation target of about two percent gives a more reasonable 3.5 percent.

Just as bad as the specification of the criteria has been the implementation. Countries such as Italy and Greece, with their profligate fiscal policies and their heavily distorted markets have been exempted from the rigours of satisfying the fiscal and exchange rate criteria. Lithuania, with its disciplined fiscal policy, admirable monetary policy and flexible markets was rejected because it had inflation of 2.7 percent when the benchmark was 2.6.

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[43]A discussion of this is found in Willem Buiter, "To Purgatory and Beyond: When and How should the Accession Countries from Central Europe Become Full Members of the EMU," 2004.

THE MAASTRICHT CRITERIA

Briefing paper for the Economic and Monetary Committee of the EU Parliament

October 2007

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Executive Summary

The Maastricht criteria are largely an accident of history. They were adopted more than 15 years ago to deal with countries that were quite similar but some of which had not displayed much attention to sound monetary policies and were large enough to disturb the whole euro area.

The need for entry criteria has been challenged even before they were adopted. Many analysts had claimed that the creation of the single currency was bound to profoundly transform wage and price setting behaviour provided the ECB is independent and given a clear mandate of price stability. The experience so far has shown that this view was, and remains, correct, while recent events have shown that two decades of low inflation have not eliminated influential resistance to sound ECB policies.

It is regrettable that only three countries will have adopted the euro by next January, four years after enlargement. It is distressing that the Maastricht criteria prevent the three Baltic States, which conduct high quality macroeconomic and structural policies, from being invited to adopt the euro for reasons that are beyond their control, and largely reflect their successful growth performance.

So far, the old euro area members, which control the Commission and the ECB, have refused to recognize the hardships that the Maastricht criteria impose on the new EU members. They do so for a range of reasons – a legalistic reading of the criteria, a misleading application of the equal treatment principle and unfounded fears that the euro area is at risk – that are not convincing.

The best, if most radical, approach would be to eliminate the Maastricht criteria. A more likely approach would be to apply them with flexibility, replacing a mechanical reading with considered judgment.

1. The weight of history

The Maastricht criteria were negotiated in 1990-91 when the idea of a single currency was still considered as an extremely bold step, potentially dangerous. Importantly, at that time, some countries like Germany had a long record of price stability while others, like France and Italy, were either fresh converts or still prone to periods of inflation. Because inflation is an unmitigated bad, it stood to reason that the single currency should be strong and based on price stability.

The debate, then, was whether pre-conditions were required. One argument, most popular with German policymakers, was countries should only admitted after they had demonstrated their attachment to "a culture of price stability". This was the pre-condition school. The opposite argument was popular among academics, call it the institutions school. It stated that, once it has joined the monetary union and relinquished its ability to run an independent monetary policy, a country's past will be irrelevant; what mattered was that the central bank be independent and given a clear mandate of price stability. The first argument won, which has led to the Maastricht criteria.

Strikingly, the President of the ECB recently appeared to endorse the view of the institutions school (without rejecting the pre-condition school views) when he stated:

> "Recent ECB research [...] identifies the launch of EMU and the establishment of a clearly defined nominal anchor as the defining event that changed the very nature of the inflationary process in the euro area. This institutional break has eradicated the "intrinsic" component of the inflation formation mechanism, namely the extent to which economic agents – in re-setting prices or negotiating wages – look at the past history of inflation, rather than into the eyes of the central bank. To be sure, this phenomenon is not confined to the euro area."[44]

Fifteen years down the road, the debate is still with us. It is impossible, of course, to know what would have happened without the criteria. We only know that some countries "managed" their numbers and we can see that the very principles of central bank independence and price stability are being challenged by (at least) one euro area member countries. What matters now is the way we deal with the new EU members. By January 2008, three of them will have passed the criteria and joined the monetary union: the glass is half full in the sense that the union keeps expanding, and it is half empty in the sense that several countries are likely to stay out for many more years.

2. The economic reasoning

The Maastricht criteria rest on some solid principles. The first one is that lasting inflation is always the consequence of lax monetary policy. The second principle is that, central banks adopt inflationary policies under political pressure, hence the need for independence. But, third, independence has its limits; in particular large and growing budget deficits can create the conditions for a central bank to cave in to political expediency. In the end, and this is the fourth principle, the independence of a central bank ultimately rests on broad public opinion support for price stability.

This reasoning finds its counterpart in the Maastricht criteria. Public opinion support of price stability is to be gained by sustained experience with price stability: low inflation, of course, but also low long-term interest rates, which incorporate inflation expectations and a stable exchange rate, which reflects both past and future price stability. The risk of political pressure is contained by the criteria that limit the deficits and the size of the debt.

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[44] Presentation at the Ninth ECB Watchers Conference, Frankfurt, September 7, 2007. http://www.ifk-cfs.de/fileadmin/downloads/events/ecbwatchers/20070907ecb_trichet.pdf

The criteria, however, suffer from a number of weaknesses. To start with, what matters is behaviour within the monetary union. As entry conditions, the criteria do not provide any guarantee that, once admitted, member countries will behave as they are expected to. This criticism was anticipated in two ways. First, good monetary policy would enforce price stability and low interest rates while the irreversible conversion of parities would eliminate all risk of exchange rate instability. Second, the Excessive Deficit Procedure, which eventually led to the Stability and Growth Pact, makes permanent the two remaining criteria.

Another objection to the Maastricht criteria is that they are based on arbitrary rules. This is clearly the case about the 3% deficit and 60% public debt criteria. These numbers have no solid basis. More importantly, they fail to recognize the special circumstances that may characterize particular countries at a particular point in time, as the 2003 failure of the Stability and Growth Pact amply demonstrated. While they could be seen as adapted to the countries that were EU members in the early 1990s, they are particularly ill-suited to several of the recent members, as is explained below.

Finally, any arbitrary rule invites perverse efforts at circumvention. It is well known, by now, that the budgetary and inflation numbers of some countries were suitably doctored to pass the entry conditions. The EU statistical apparatus has considerably improved over the last decade, if only to help enforce the Stability and Growth Pact, but it would be illusory to imagine that all loopholes have been closed.

3. The case of the new EU members

Virtually all new EU member countries are significantly poorer than the older members. As the following table shows, with the exception of Cyprus and marginally Slovenia, income per capita is everywhere less than half of the average in the older member countries. This characteristic matters in a number of ways.

One of the key benefits from EU membership is that the new members are catching up. A particular aspect of the catch-up process is that wages and prices, which are lower, are rising to reach the levels in the rest of the EU. This implies that, when measured in euros, prices must rise faster than in the euro area member countries.[45] Since one of the Maastricht criteria is Exchange Rate Membership (ERM) membership, with an exchange rate fixed to the euro inflation must be higher in the new member countries. For example, if the price level is half that in the euro area and if the catch-up will last 10 years, inflation must be 3% higher. If the catch-up lasts 20 years, inflation must be 1.5% higher, and it must be 1% higher for a 30 year catch-up. Since the catch-up is faster early on, the inflation rate too must be higher. This makes it harder, in some cases nearly impossible, to satisfy simultaneously the inflation and ERM membership criteria.

[45] This is precisely happened in Ireland, euro area's fastest growing country.

Table 1. GDP per capita as % of EU15 average

(Corrected for purchasing power parity)

Cyprus	67.2
Czech Republic	41.2
Estonia	39.6
Hungary	35.6
Latvia	29.5
Lithuania	27.3
Malta	43.5
Poland	26.9
Romania	19.2
Slovakia	34.9
Slovenia	54.7

Source: Ameco data base, European Commission

There new members are poorer in part because they are less well equipped with infrastructures. Catch-up requires heavy public spending in public infrastructures. Should all such spending be paid by current taxes? A very general principle is that productive investments can be safely financed by borrowing. It follows that governments should borrow to carry out spending that will generate faster growth. This means that budget deficits early on in the catch-up period are not only acceptable, but desirable if they are indeed used to finance growth-raising public investments.

Finally, the requirement that currencies be tied to each other via ERM was decided while most countries were still operating capital degrees to various degrees. A basic principle, known as the "impossible trinity" is that the three following characteristics are incompatible: 1) fixed exchange rates; 2) full capital mobility; 3) autonomous monetary policy. When the restrictions to capital movement were lifted – as part of the Single Market Act – a wave of speculative attacks followed in 1993 and the fluctuation bands were raised from ± 2.25% to ± 15%.

These wider bands and a virtual abandonment to autonomous monetary policy – the ERM became known as the DM area – made it possible to complete the five remaining years to the launch of the euro without further crisis. The new member countries were required to fully liberalize the capital movements upon joining the EU, which would require that they either let their exchange rate float or that they forego monetary policy independence.

The problem is that ERM membership is also required by the accession agreements, which means that new members are required to surrender monetary policy autonomy. The wide bands offer some flexibility and, therefore, some limited policy autonomy. The situation is uncomfortable but manageable for a limited amount of time, as shown by the earlier experience of the initial members of the euro area. It may be more delicate for the new members because their political-economic situation is perhaps less stabilized.

Quite reasonably, therefore, those countries that aimed at promptly adopting the euro have joined the ERM: this is the case of Cyprus, Estonia, Latvia, Lithuania, Malta, Slovakia and Slovenia. The three largest countries, the Czech Republic, Hungary and Poland, however have not. One possible reason is that they face less stable political conditions, which partly translates into large budget deficits.

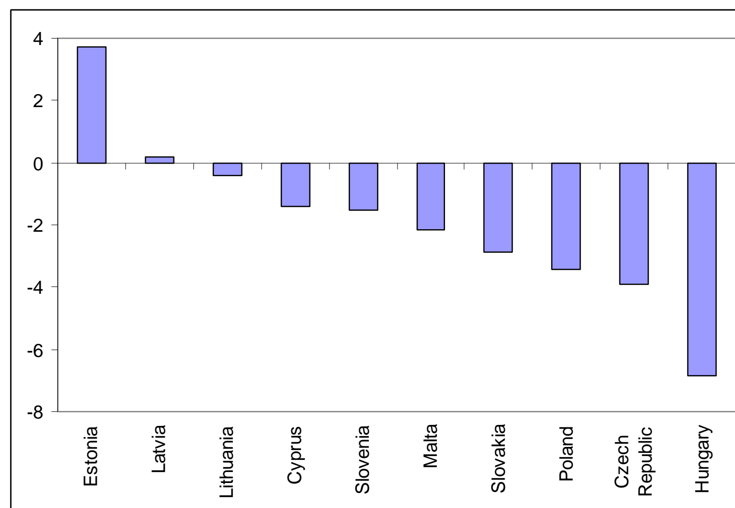
4. The situation

The good news is that three countries have been admitted to the euro area. Slovakia might follow in the near future. The three Baltic States are in a difficult position because the Maastricht criteria are ill-suited and the three larger countries keep postponing the entry target dates because the criteria are out of reach.

Figure 1 shows EU Commission forecasts of budget balances in 2007. The three Baltic countries have budget in balance or surplus. They are also members of the ERM, so the remaining key criterion is inflation. As can be seen from

Figure 2 they have high inflation rates. Yet, there is nothing that they can do about it. As ERM members, they are subject to the impossible trinity, which means little monetary policy autonomy. In fact, Estonia and Lithuania operate a currency board, which completely removes any policy autonomy. This means that the inflation rate is beyond national control. High inflation in these countries reflects rapid catch-up – Estonia has been growing at more than 10% per year. Their remarkable growth performance, the result of wise structural policies, turns out to be a curse as far as the Maastricht criteria are concerned. It is difficult to find a better proof that the criteria are ill-adapted to the new EU member countries.

Figure 1. Budget balances – 2007 (% of GDP)



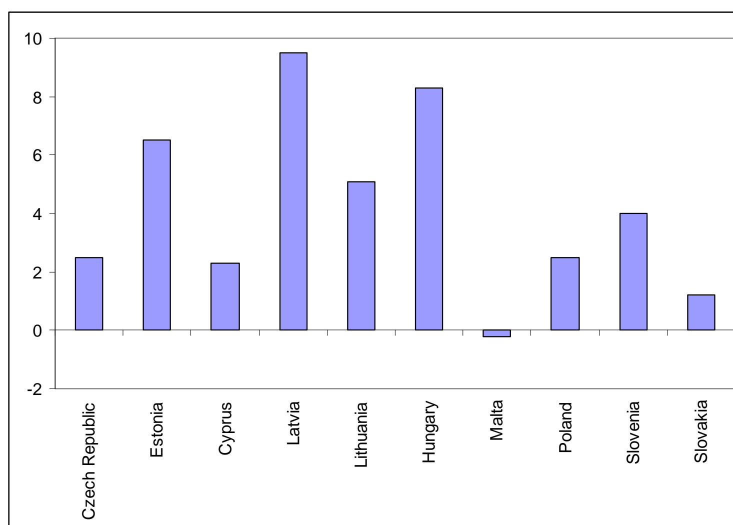
Source: AMECO database, EU Commission.

The case of the three largest countries is different. From

Figure 2, we can see that the Czech Republic and Poland satisfy the Maastricht criteria, but Hungary does not. From Figure 1, it is clear that the budget deficits are excessive in Hungary and the Czech Republic and close to the limit in Poland. The question is whether these deficits reflect reckless behaviour or wise spending on much needed public investments. Unfortunately, this question is not asked.

Figure 2. Consumer price indices (HICP) . July 2007

(Change from previous year)



5. Should the criteria be changed?

That the Maastricht criteria do not fit the new EU member countries is well established. Should they be changed? So far, the Commission and the ECB have strongly opposed any change, on the basis of three arguments.

The first one is purely legal. The Maastricht criteria have been accepted by all new members on their Accession Treaty. This is true, but Treaties can be changed. The ICG that led to the failed constitution refused to deal with the issue. The one currently under way could repair this mistake.

The second argument is based on the “equal treatment” clause of the Copenhagen declaration. It boils down to the view that, since the old EU members had to meet the criteria, so should the new ones. It is hard to see any justification to what looks like an initiation rite approach to fairness: “I did something painful to get there, so must you”.

Of course, there might be some merit to enduring pain. This takes us back to the need of acquiring a culture of price stability and to the debate between advocates of a long process of nominal convergence to best monetary policy practice and those who argue that this process is useless because the ECB is independent and dedicated to price stability. Thus the third and final argument is that a country may always misbehave after joining the euro area, and will do so unless it has recognized, from direct experience, the merits of price stability. Even if the ECB is independent and dedicated to low inflation, misbehaviour by one member may hurt the whole area. This was indeed a key fear of the 1990s, especially since some large countries had not established convincing credentials in the fight against inflation. To create any serious disruption, however, a country must be large enough.

Table 2 shows that even the largest economy is small relative to the EU and to the euro area.

	Share EU27	Share EU12		Share EU27	Share EU12
Czech Republic	1.0	1.4	Germany	19.8	27.3
Estonia	0.1	0.2	Spain	8.6	11.8
Cyprus	0.1	0.2	France	15.3	21.0
Latvia	0.2	0.2	Italy	12.6	17.4
Lithuania	0.2	0.3			
Hungary	0.9	1.2			
Malta	0.0	0.1			
Poland	2.4	3.4			
Slovenia	0.3	0.4			
Slovakia	0.4	0.6			

Table 2. GDP as a share of the EU and the euro area (2007)
Source: AMECO data base, EU Commission

Each of the three arguments has some merit, of course, but these merits must be weighed against the consequences of keeping out countries that wish – or used to wish – to adopt the euro. If the common currency is providing important benefits, which it does, non-membership implies that these benefits are lost. More worrisome is that ERM membership along with full capital mobility can create a volatile situation for countries that need some monetary policy autonomy. Equally worrisome is public opinion disenchantment with a Union that does not recognize the needs and desires of their countries. Finally, it is puzzling that the old members, who control the Commission and the ECB, ignore the pleas of small countries which, like the Baltic States, wish to join the euro and are conducting sensible macroeconomic and structural policies.

6. Alternative approaches

There are many ways in which admission conditions to the euro area could be adapted the new EU member countries. The most radical one would be to simply ignore the Maastricht criteria. As noted earlier, these criteria have always been seen as controversial and the alternative view, that euro area membership does not require nominal convergence, just proper institutions, is finally (almost) recognized by the President of the ECB himself. Given the small economic size of the new member countries (see Table 2) immediate admission would not represent any threat to the euro area as a whole and would bring immediate benefits, including a good monetary policy, to the new members.

A less radical approach would be to recognize the specificities of the new member countries in interpreting the Maastricht criteria. Thus the inflation criteria could be ignored for the Baltic States. The reason is that they operate fixed exchange regimes that prevent them from controlling their own inflation rates, which are high simply because standards of leaving are fast rising. In other countries, the budget deficits should not be judged bluntly as a single number but attention should be devoted to the quality of public expenditures. The interest rate criterion is self-fulfilling: if a country is believed to join soon the euro area, its long term rate will automatic converge to the euro area level.