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CRITERIA IN CRISIS

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In killing off the stability and growth pact of the European Union by refusing to enforce fines against France and Germany for persistent breaches of its fiscal rules, the large countries of the Union also mortally wounded the four convergence criteria agreed at Maastricht in 1991, which will be used to judge the eligibility of the new Central European EU members to join the eurozone.

Many considered the fiscal rules of the stability pact to be misconceived, but no one doubted the need for criteria for entry into the eurozone. Unfortunately, the prohibition of fiscal deficits of over 3% of GDP, which has been swept aside is exactly the same as the fiscal criterion of the Maastricht Treaty. It is also the most important of the four Maastricht criteria, and the hardest for central European countries to satisfy. How legitimate would a decision to reject a central European candidate to the eurozone exclusively on the basis of this criterion now be?

The second convergence criterion covers the exchange rate. Countries are supposed to remain inside the European exchange rate mechanism for 2 years. The purpose is to ensure the "right" exchange rate for conversion of the national currency into euros. But Germany satisfied the criterion with ease during 1996-8, even though on most measures the mark has joined the euro at a rate that was about 20% overvalued compared to the franc and many other eurozone currencies, causing severe damage to the German economy and generating a serious drag on growth in the eurozone as a whole.

Paradoxically, the European Commission has spent the last three years trying to tighten the exchange rate criterion, which would turn it into an insurmountable obstacle for the central Europeans. Although the criterion requires only that countries remain within the normal fluctuation bands of the ERM, 15% either side of the central parity, the Commission has said that it will base recommendations on whether countries should be accepted into the eurozone on whether the exchange rate remains within 2.25% either side of the central parity.

The final two criteria (inflation and interest rates) have also become a mess. The inflation criterion states that a candidate for the eurozone must have inflation which is not more than 1.5% above the average of the three best performing member states of the European Union for one year. The joke here is that the three can easily be countries that are *outside* the eurozone. Indeed, in September inflation rates across the present Union and the new members that will join in May 2004, were such that the three "reference" countries would have been Lithuania, Poland and the Czech Republic, had they already been members. Next May they will be members, and may well constitute the "reference group". Also, the inflation criterion fails to allow for higher inflation in services and construction in faster growing countries. Such inflation is a natural adjustment of

relative prices resulting from faster growth. It harms no one, and should not be penalised.

Finally, the interest rate criterion requires that rates on 10 year government bonds not exceed 2% above the rates in the three countries performing best *in terms of inflation*. Again, these could easily prove to be three new members outside the eurozone.

These examples show where the root cause of the problem lies. The criteria were devised when the eurozone did not exist. Four large countries and a number of small ones had to be brought into nominal convergence, to ensure that the anchor of a common currency did not rip their economies apart.

Today a large and stable eurozone exists. The very small countries wishing to join it need to achieve convergence with the eurozone in their own interests, but there is no danger that they could impose measurable damage on existing members if they got it wrong, let alone anything like the damage caused by Germany joining the eurozone with a highly overvalued currency.

The act of political and economic vandalism carried out by the EU "big four" in smashing the SPG, means that a new fiscal framework has to be developed for the eurozone, but that means that new convergence criteria for eurozone entry are also needed.

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