

# Time to loosen the criteria for joining the euro

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The European Commission recently promised to interpret the rules on budget deficits pragmatically, to help European Union member countries cope with the economic crisis.

It did not, however, promise to be equally pragmatic about the Maastricht criteria for entering the euro, designed in the early 1990s when eastern enlargement was only a fanciful idea and financial markets were far less developed. Today the criteria make little economic sense for eurozone candidate countries in central and eastern Europe. The crisis has made reform of these rules even more urgent.

Two of the five criteria – on inflation and membership of ERM2, the latest form of the European exchange rate mechanism – are particularly flawed. If the inflation criterion were reformed and ERM2 scrapped, the Czech Republic and Poland could enter the eurozone within a year or two.

Other new EU member states would regain motivation to comply with the rules. From central and eastern Europe only Slovenia has joined, with Slovakia due to become the 16th eurozone country on January 1. A fast track to eurozone membership would help prevent the financial and economic crisis from deepening in the region.

The inflation criterion says inflation must be no more than 1.5 percentage points above the average rate of the three EU member states with the lowest inflation over the previous year. The first flaw is that it is hard to explain why eurozone candidate countries should be judged on the basis of inflation in non-eurozone countries such as the UK. Second, it is unclear why the criterion is not simply based on average eurozone inflation: this is what the European Central Bank tries to control and what eurozone candidate countries import. There is also no reason to base the average on countries with unhealthily low inflation, below the ECB's 2 per cent target. Third, the one-year period for assessing compliance is too short. It motivates candidate countries to slow down growth and pursue sub-optimal policies such as administrative control of prices, just to meet the inflation criterion.

The requirement to stay at least two years in the ERM2, limiting currency fluctuations against the euro to plus or minus 15 per cent, is also outdated. First, exchange rate fluctuations can hardly be a test of a country's quality of macroeconomic policies. Exchange rates are no longer driven by current account deficits or interest rate disparities but by global speculation. Second, in today's world it is impossible for any country to ensure stability of its exchange rate, except by rigidly pegging it to another currency (and even then stability is not assured, as evinced by Argentina before and Ukraine now).

The euro exchange rate is the best example: the euro itself would not pass the stability test if it had entered a hypothetical ERM2 with the US dollar in July this year. It would be irrational to expect the ECB to intervene successfully in foreign exchange markets that trade thousands of billions of euros daily. If the ECB could not do it, why demand it from eurozone candidates?

Finally, ERM2 requires the impossible: to control inflation and exchange rates simultaneously. If euro candidate countries were forced to intervene in the exchange rate, the resulting money expansion would put the inflation criterion in danger.

Eurozone accession for all new EU member states would not complicate eurozone monetary policy, given that their combined gross domestic product is less than 10 per cent of the eurozone's GDP. If inflation in all these countries were 1.5 percentage points above euro area inflation, it would add only 0.1 points to

overall inflation. Postponing euro adoption until greater real and nominal convergence has been achieved, as some argue, is tantamount to saying that euro adoption cannot help in a crisis and that it is not important for growth. Is this really what the architects of the euro had in mind?

The European Commission and ECB have shown they can be pragmatic in fighting the crisis. The Commission agreed to be flexible in applying state aid rules to bank recapitalisations in western Europe and in interpreting budget deficit limits enshrined in the stability and growth pact. The ECB relaxed its lending rules to prevent eurozone financial markets from freezing. The same pragmatism should also apply to euro entry criteria. Rules should not be the enemy of what makes economic sense.

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