How to gate-crash the eurozone

There were howls of protest earlier this year when Lithuania and Estonia were turned away from the eurozone. Georgi Angelov of the Open Society Institute in Sofia, derides the absurdity of the Maastricht criteria, and explains why EU newcomers should unilaterally "euro-ise" their currencies

Joining the eurozone is in principle quite simple – countries need to fulfill a number of criteria, and after that they are welcome to join the common currency. But it's simple in theory and quite complicated in practice. And for some countries it's even impossible – not because of any internal problems these countries may have, but because of intrinsic problems in the entrance criteria themselves.

Once a European country decides that it wishes to join the eurozone, it needs to fulfill the so-called Maastricht criteria:

- Inflation must not exceed by more than 1.5% the average of the three EU members with the greatest price stability
- Budget deficit must be lower than 3% of GDP
- Government debt must be lower than 60% of GDP
- Long-term interest rates must not exceed by more than 2% the average in three EU members with the greatest price stability
- The exchange rate between the applicant country's national currency and the euro must not fluctuate by more than +/-15%

But the Maastricht criteria were designed in the early 1990s when the situation was quite different from today. The European Union was then half its present size, and its member states all had much closer income and price levels, and their economic growth rates were not nearly so diverse. Furthermore the monetary systems of EU member states in the early 1990s didn't show as much variation as now, with currency boards, for instance, unknown in the EU until the Baltic countries joined the Union in 2004.

The situation is now greatly changed, most of all after the "big bang" enlargement of the European Union. As a result, the Maastricht criteria, and especially the inflation criterion, are outdated and inappropriate to the present situation. Nevertheless, these criteria were not changed and the entrance of new member states into the eurozone has become far more complicated.

It is worth analysing the inflation criterion in more detail. At the moment, most of the new lower income members of the EU experience a catch-up process that is associated with higher economic growth and faster increases of wages and prices. This can lead either to appreciation of the exchange rate (for floating exchange rate regimes) or higher inflation rates (for fixed exchange rate regimes). As a result, it is quite probable that many of the countries that achieve high economic growth will breach one of these two criteria.

This situation is further complicated by two additional problems:

- The EU requirement for new member states to "harmonise" (i.e. increase) excise duties is a very strong pro-inflationary factor that can feed the inflation rate exactly in the period when fulfillment of the Maastricht criteria is assessed.
- With 25 (soon 27) members, the probability of having three countries with extremely low (or even negative inflation) is much higher. Therefore, naturally, the limitation for the inflation rate under the inflation criterion is decreasing, even though on paper the rule has not been changed.

The same inflation criterion that was more or less fine for the European Union of the early 1990s is now a major obstacle to eurozone membership for most of the new member states. More than that, the problem does not lie in the new countries themselves, but in the fact that the Maastricht rules were not designed with these countries in mind.

It seems ironic to ask countries with a currency board to control inflation, and

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By **Willem Buiter and Anne Sibert**

A wave of unilateral "euro-isations" would confound the EU's mean-spirited legal nitpickers

Lithuania's eurozone application was rejected last May on the advice of the European Central Bank (ECB) and the European Commission. It was both a mean-spirited and erroneous decision, based on the rigid application of an inconsistent interpretation of a flawed inflation criterion, as Georgi Angelov explains in his article. Estonia was badgered into postponing its application for the same reason.

All three Baltic states are better functioning market economies than France and Germany, and the World Bank ranks both Lithuania and Estonia ahead of Germany and France as regards ease of doing business. As fiscally sound small, open economies, both would benefit greatly from admittance to the eurozone.

In a rational world, the inflation and exchange rate criteria would be modified, scrapped or ignored by the ECB, the Commission and the Council. This, unfortunately, is unlikely. Angelov proposes unilateral euro-isation by would-be eurozone members whose membership of the eurozone is blackballed by Frankfurt and Brussels, and we would support his proposal as the second best solution.

thus to adopt some form of quasi-monetary policy. These are countries that have abolished their monetary policies and irreversibly pegged their currencies to the euro, forming a sort of asymmetric monetary union. There is something bizarrely unreal about requiring currency board countries to relax their commitment to the monetary union in order to enter fully into… the monetary union.

A good demonstration of the problems created by the inflation criterion is given by Ireland – a country that has been developing spectacularly fast in the last 15-20 years, but started from a relatively low level like most of the new member states.

In 2000 and 2001, when the economic growth in Ireland was very impressive, inflation was also higher. If Ireland were to apply for eurozone membership based on its record in 2000 and 2001, it would surely fail the inflation criterion. This means that Ireland, despite the economic miracle that made it the fastest growing economy in the EU, would not pass the inflation criterion.

Plainly, the new EU member states cannot accept such criteria as justified if they discriminate against rapidly developing economies. Being relatively poor, they badly need high economic growth.

In theory, the easiest option for reforming the Maastricht rules is to modify the inflation criterion so as to take into account different initial income and price levels, and higher rates of economic growth in the new EU member states. This is especially needed for countries with a currency board arrangement; because of their strict monetary arrangements, they should have the inflation rule waived altogether.

But it is not so easy to change the Maastricht criteria; the slow pace of EU procedures makes that far from a practical proposition. However, the European Central Bank could be helpful in this respect. It has already somewhat modified the inflation rule by excluding countries with negative inflation from the three countries used for calculating the average for the inflation criterion, justifying this measure with a broad statement that since countries with negative inflation are in some kind of shock, they are not a good benchmark.

There exists, though, another basis for modification by the ECB of the inflation criterion. In the Treaty establishing the European Community and the Protocol on the convergence criteria there are two phrases that are subject to interpretation:

- "The three best-performing member states in terms of price stability" may mean countries with lowest inflation rates, or lowest but positive inflation rates, or inflation rates that are close to price stability, or inflation rates that are close to the ECB's target for price stability (which is a bit less than 2%). This last interpretation could increase the inflation criterion by as much as 1.5%
- "Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions." As far as national definitions are quite different, this too could be useful.

A more radical approach would be to abolish the Maastricht criteria altogether, and to follow a "big bang" policy for enlargement of the eurozone. All new member states could be offered an opportunity to enter immediately. There cannot be any negative implications – the combined GDPs of the new member states is too small a proportion of the EU's total GDP to change the monetary conditions. At the same time, such a move would be very beneficial to new EU member states – it would discipline their fiscal policy and stimulate economic reform. If some countries failed to exercise the necessary fiscal prudence, the market would punish their governments through higher interest rates.

Assuming that the Maastricht criteria will not be changed in the foreseeable future, then new member states have three options. The first is for the new member states to resign themselves to stagnation of their economies – in that case incomes and prices would not catch-up and inflation would be lower. But the idea is totally absurd that a poor country would pursue stagnation just so it can meet a set of totally unjustified rules.

The second option is to use creative accounting to manipulate the statistics (as Greece and Italy have done), or even to disregard the rules altogether (like Germany and France). These are policies that would be harmful in the long run.

Therefore the most sensible option, if the Maastricht criteria are not modified, is for the new member states to "euro-ise"

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While providing many of the benefits of eurozone membership, unilateral euro-isation has three costs compared to eurozone membership. First, the entrant would forego the seignorage revenue a country earns by issuing its own currency – as a member of the eurozone it would get a share of the ECB's profits. But this is in any case likely to be small, perhaps 0.25%-0.5% of GDP per year. Second, the country would not have a seat on the Governing Council of the ECB.

However, the Governing Council is already so large that it cannot function as a meaningful deliberative body, and any candidate's influence would be marginal at best. Third, the country would have no lender of last resort in the event of a financial crisis as it could not print its own euros. For most candidate countries this problem is limited: their banking systems are foreign-owned (mostly by eurozone banks), and their national Treasuries would be able to provide emergency funds limited only by the sovereign's ability to borrow euros.

To get around legal nitpickers in Brussels and Frankfurt, we suggest that countries unilaterally adopting the euro retain their own currencies. The domestic currency and the euro should be joint legal tender, either with a fixed exchange rate or, preferably, with the domestic currency prevented from appreciating vis-à-vis the euro, but free to depreciate.

The government can then take further steps to discourage the use of domestic money such as issuing no new currency, writing its own contracts in terms of euros and making it easier to settle debts with the government unilaterally. If some of them do it the European Commission and the ECB will be forced to recognise the fact – no one can reasonably expect that a country would abandon the euro as its currency so as to fulfill criteria that would allow it to once again adopt the euro. Even if no country resorts to the euro-isation option, it surely offers them a powerful tool against the EU institutions' overly formal and rigid approach to the Maastricht criteria. □

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ADDITIONAL READING

***"The Euro Before the Eu?: An Estimate of the Economic Effects of Euroization in the Western Balkans"**, Altin Ilirjani, May 2006, Globic Press (press.globic.us), ISBN: 0977666212*
***"The Eastern Enlargement of the Eurozone"**, Marek Dabrowski and Jacek Rostowski, January 2006, Springer (www.springer.com), ISBN: 0387257640*
***"Enlarging the Euro Area: External Empowerment and Domestic Transformation in East Central Europe"**, Kenneth Dyson, September 2006, Oxford University Press USA (http://www.oup.com/us), ISBN: 0199277672*

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using euros. Within a few years, the only domestic money would be in the museums of central banks, and the vast majority of all contracts would be denominated in euros. If the countries later wished to join the eurozone, the European Council would determine the "irrevocably fixed conversion rate" between the euro and the domestic currency, but this would have no significance.

The ECB and the EC would not like this solution, but they have no legal grounds for opposing it. They will in any case face the problem of what to do with a non-eurozone country that has the euro as its currency when Montenegro (which adopted the euro as its sole currency when it still was a constituent part of the Republic of Serbia and Montenegro) becomes an EU member and a eurozone candidate.

We recommend that all three Baltic states immediately declare the euro to be joint legal tender and also that Bulgaria adopt it upon becoming an EU member. Furthermore, we would suggest that fiscally sound Visigrad countries consider it as well. □

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