Eurozone: ‘a club of rich countries with slow growth–dynamic poor countries, please keep out’?
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Lessons from the European Commission decision on Lithuania’s EMU membership

Béla Galgóczi and Gintare Kemekliene

Recent developments – the decision

In accordance with the provisions of the Maastricht Treaty, all new members of the EU are eligible to join the euro; indeed participation in the euro area is an obligation for the member states that joined the EU in 2004. The issue of their entry to the Eurozone is therefore one of timing, and most of them are preparing to join it in 2008-2010.

Estonia, Lithuania and Slovenia have pursued a strategy for early adoption of the euro starting from January 2007. These countries were the first new EU MS to join the ERM II at the end of June 2004. However, as recent developments show, the only new EU member state whose application was accepted and which is set to adopt the euro in January 2007 is Slovenia. Estonia has decided to put off joining the Eurozone for one year, until 1 January 2008, citing higher than expected inflation figures. Lithuania’s bid to join the Eurozone in 2007 was turned down by the EU Commission on the grounds that its inflation rate (2.7% on average in the 12 months to March 2006) is marginally above the 2.6% benchmark.

Lastly, the benefits and drawbacks of a fast-track EMU accession with the current criteria for the NMS will be briefly presented and the implications for future enlargements of the Eurozone outlined.

Background to the decision – Maastricht criteria

There are five Maastricht criteria for full membership of EMU:

- to qualify for membership, annual inflation in a candidate country cannot exceed the average of the three ‘best performing’ EU member countries in terms of price stability by more than 1.5% in the year prior to examination;
- the annual government deficit must not exceed 3% of GDP;
- total public debt must be below 60% of GDP;
- the long-term interest rate should not exceed the reference value – which is defined by the average long-term interest rates of the three EU MS with the lowest inflation – by more than 2%;
- finally the exchange rate should remain within the normal fluctuation margins provided for by the ERM of the European Monetary System without severe tensions for at least the last 2 years before the formal assessment.

As the below table shows, Slovenia met all the criteria in the reference period, and was accepted. Lithuania also easily met all convergence criteria for adoption of the euro, except for the one on inflation during the period April 2005 – March 2006. The budget deficit, public debt and long-term interest rates were well below the reference values. The national currency Litas has remained stable in line with the requirements. It should also be noted that the application of the currency board with a peg of the euro (Litas has been pegged to the euro since February 2002) is tantamount to participation in the Eurozone, albeit with the theoretical possibility of altering the exchange rate of the national currency.

The ruling in Lithuania’s case has invoked considerable debate and questions about the interpretation of the Eurozone entry criteria, their application and economic sense. This debate, with specific reference to the decision on Lithuania, will be presented in this paper. Secondly, the usefulness of Maastricht criteria and their interpretation in a more fundamental sense will be discussed.

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Table 1: Maastricht convergence criteria  
(%, average of observations through April 2005 – March 2006)

<table>
<thead>
<tr>
<th></th>
<th>Reference value</th>
<th>Slovenia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government gross debt</td>
<td>60%</td>
<td>29.9%</td>
<td>18.9%</td>
</tr>
<tr>
<td>General government deficit</td>
<td>-3.0%</td>
<td>-1.9%</td>
<td>-0.6%</td>
</tr>
<tr>
<td>HICP inflation</td>
<td>2.6%</td>
<td>2.3%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Exchange rate stability</td>
<td>Max upward deviation 0.1%; Max downward deviation 0.2%</td>
<td>Max upward deviation 0.0%; Max downward deviation 0.0%</td>
<td></td>
</tr>
<tr>
<td>Long term interest rate</td>
<td>5.9%</td>
<td>3.8%</td>
<td>3.7%</td>
</tr>
</tbody>
</table>

Source: European Commission, 2006

Interpretation of the decision

Flawed inflation criterion

The application of the inflation criterion has become particularly controversial for Lithuania. As noted above, the European Commission issued a recommendation not to include Lithuania in the euro zone in January of 2007 due to the fact that it violated one of the five Maastricht criteria – the price stability criterion. Recorded inflation in Lithuania for March 2006 stood at 2.72 percent, just missing the criterion of 2.63 percent. In its decision, the Commission also emphasised the negative outlook due to upward wage pressure resulting from high growth and productivity improvements, thereby questioning the sustainability of the current inflation level.

The second consideration relates to the fact that the inflation criterion is based on the EU ‘best performers’ inflation rather than Eurozone. In the current case, two out of the three lowest inflation-recording countries – Poland, Finland and Sweden – are outside the Eurozone. The criterion based on the inflation of the three EU Member States was set, and made sense, when there was no Eurozone, but it is difficult to see now how the inflation performance of EU members outside EMU is relevant to whether or not Lithuania is allowed to join EMU. Moreover, with an increasing number of members in the EU it will become increasingly likely that the three ‘best performers’ will be outliers and could be well below the Eurozone average. Therefore, retaining the inflation criterion unchanged would in reality mean making it much stricter.

Moreover, it is highly questionable whether countries with the lowest inflation should be used as a reference for the fast-growing catch-up economies (the inflation rate in Sweden was 0.9%). Here it is important to note that in the Convergence Report 2004, the ECB did not include the lowest inflation country in their calculation of the benchmark – and that country was Lithuania, with deflation of -0.2%.

In addition, defining "best performing" as having the lowest (positive) inflation rate is ambiguous, if we regard the European Central
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Bank’s own formulation of price stability for the Eurozone. The inflation criterion is based on the prices levels of the ‘best performing’ countries. However, inflation of 0.9% could be regarded as irresponsibly low. This is why the ECB revised its definition of price stability in 2003 as ‘below but close to’ 2 per cent.

Graph 1: Inflation rates in Lithuania and Slovenia, 1999-2006

Finally there is an issue with the reference period. As Graph 1 shows, Lithuania sustained very low inflation levels as from 2000, while the average inflation rate in Slovenia was falling but remained well above the inflation rate in Lithuania through most of the period. It is rather ironical that Lithuania, which had met the Maastricht inflation criterion in the past five years and failed to do so in the last year, was refused entry to the Eurozone, whereas, Slovenia, which had exceeded the inflation criteria ever since the Eurozone came into existence (except for the last few months), received a green light. In addition, one day after the ECB published its Convergence Report Eurostat issued new inflation figures showing that the reference value for April 2007 had risen to 2.7% and was thus equal to the inflation value in Lithuania. This emphasized, once again, the arbitrary nature of the assessment process.

Why the Commission is so “tough” in the case of Lithuania?

One of the Commission’s main arguments against Lithuania’s accession to the Eurozone was that it would not be able to sustain its inflation rate within the established limits in the short to mid-term (according to the Commission, inflation is forecast to rise to 3.5% in 2006). Commissioner Almunia, at a hearing in the European Parliament, justified the Commission’s decision using the sustainability argument: ‘the current inflation figure is one thing and the prospects and the sustainability are the other. As catching-up economy Lithuania shows high productivity growth, which pushes wages and inflation up…’ (Napi 2006). Several members of the European Parliament interpreted Almunia’s response as the Commission’s distinction between member states according to their economic development status. If this means that the Eurozone is reserved for developed (rich) countries and GDP/capita level is an ‘implicit’ criterion of the EMU accession, then this contradicts the basic principles of the Treaty. If catching up is interpreted as a disqualifying factor in relation to the EMU, then something must surely be wrong.

It is hard to see, however, how Lithuania, considering the size of its economy and a
hundredth-of-a-per-cent higher inflation rate, could cause consumer prices to rise across the euro area. Even if one takes all NMS (roughly the size of the Netherlands in economic terms) no special risk on the Eurozone would have emerged. In fact, it seems that the Commission’s purpose is to set a lesson for the other new member states that will be applying for the euro in the near future, as bending the criteria for Lithuania could cause problems when larger countries such as Poland or Hungary apply.

The Commission insists that rules of the Eurozone be rigorously enforced. However, old EU Member States like Belgium and Italy joined the Eurozone with the government debts higher than 100% of GDP. The decision was justified by the fact that total borrowing was falling significantly and quickly approaching the 60% target. However, today both countries still have debts of over 100%. When Greece joined in 2001, its debt was too high, as was its budget deficit, and it published false data about its finances to support its membership. These examples provide a precedent to argue that the Maastricht criteria have been violated in the past, so that the decision to respect them on strictly technical grounds in the particular case of Lithuania comes to appear questionable. Besides, application of a very strict interpretation of convergence criteria to candidate countries, when a number of current Eurozone members breach the criteria, provokes claims that double standards are being applied.²

Direct implications for Lithuania

The delay in the introduction of the euro is not expected to have a significant impact on the Lithuanian economy. Nor did the news that Lithuania will not join the Eurozone in January 2007 cause major disappointment among the population. According to the latest Eurobarometer survey, only 33% of respondents in Lithuania said they were happy about the euro replacing the national currency Litas and 56% were rather or very unhappy about the changeover (European Commission, 2006). It is possible, however, that the delay in accession to the Eurozone may impose something of a burden on the real estate market, insofar as speculative behaviour is related to the eventual official changeover to the euro. Any such impact on the real estate market will also depend on how long introduction of the euro is delayed.

Adoption of the euro remains the key objective of Lithuania. The new target date is expected to be set by the new government. However, it is hard to make any projections about when Lithuania could join the Eurozone. While not impossible, it seems that it will be hard to keep inflation low, especially in the short-term. In the next year, global oil prices are expected to stay high and gas providers are planning further price increases, while wages will continue to rise. In fact, all Baltic countries are expected to have higher inflation levels, but this is an equilibrium phenomenon (see below). Furthermore, inflation forecasts show that the three lowest-inflation-recording countries in March 2006 will have slightly rising but low inflation levels in 2007, thus keeping the inflation reference value low (OECD, 2006).

Broader context of the decision

Do the Maastricht criteria fit the NMSs?

Setting aside the formal controversies surrounding the decision and related comments, we should also consider whether, in a more fundamental sense, the Maastricht criteria can be regarded as appropriate for application to the CEE new member states. The Maastricht criteria were tailored to the specifics of the EU12 countries at the beginning of the 1990s (for more on the background see Thygesen 2002). Apart from the government deficit criterion, the current inflation criterion – the precise subject of the current decision – can be regarded as controversial in case of

² It is worth mentioning here that Estonia, which withdrew its application to the EMU (having had inflation slightly over 3%), has a total government debt roughly the same, as a percentage of GDP, as Germany’s one-year deficit.
fast growing, catching-up economies. The different macroeconomic profiles of the NMS compared with the current Eurozone countries can be summed up as follows:

- Their different macroeconomic profiles, characterised by substantially lower GDP levels, with more dynamism (close to 10% nominal growth rates, high but uneven productivity growth), ongoing transformation and convergence (catch-up process).
- Higher social risks in the form of a ‘welfare deficit’ accumulated during the transformation, with severe labour market tensions (low employment and/or high unemployment) and an increase in poverty and inequalities requiring special attention, especially if the European Social Model is taken as reference (for more on this see Keune and Rhodes 2005).
- Economic backwardness, implying a need for greater investment. Public investments in infrastructure, health care, education, research and development and environmental protection are badly needed for these countries in order to induce convergence with their more developed EU counterparts and to comply with their commitments related to adoption of the acquis communautaire.
- Prices in the new Member States are significantly below the EU25 level, ranging between 76.4% in Slovenia and 54.7% in Lithuania (see Graph 2).

Graph 2: Price levels in the EU25

![Graph 2: Price levels in the EU25](image)

Source: Eurostat (2006)

As a result, applying the same nominal criteria to the NMS means de facto applying stricter criteria in real terms. Nominal growth rates in the new Member States fluctuate between 7% and 11%. Assuming that a sustainable fiscal situation is based on a GDP/debt ratio not exceeding 60%, the maximum tolerable fiscal deficit that would enable CEE countries to maintain stable debt levels would be around 4–5% of GDP (Surányi 2005).

A number of crucial issues arise due to the combination of the inflation and exchange rate criteria. The Balassa–Samuelson effect (Balassa 1964; Samuelson 1964) may be considered crucial in determining suitable exchange rate policies for the accession countries before joining EMU (Szapari 2004). In a developing economy catching up with income levels in more economically advanced countries, productivity in tradable goods sectors will tend to rise faster than in non-tradable sectors (United Nations 2001). Since wage increases tend to be more or less the same in all sectors, relatively faster productivity growth in the tradable sector of
accession countries will convert into a higher inflation rate if the exchange rate remains constant (Buiter and Grafe 2002). The Balassa–Samuelson effect means on average that, in the case of fixed exchange rates, the equilibrium level of inflation is 1 to 3 percentage points higher in the CEE new Member States than in the EU15 (de Grauwe and Schnabl 2004). Simulation results show that the effects could be quite different in individual countries (Egert 2002). The findings show that in the Czech Republic, Slovakia and Slovenia the impact of productivity growth on the inflation differential relative to Germany ranged from 0.9% to 1.3%, while in Poland and Hungary the range would be higher, up to 3.5%. Doyle et al. (2001) estimate the size of the Balassa–Samuelson effect to be on average 1% to 3% a year.

We can point out on basis of the above that in the spirit of the Maastricht criteria, sustainable inflation in the case of the NMS would be 1 to 3 percentage points higher than in the EU15, while a sustainable government deficit would be between 4 and 5% of GDP.

Benefits and drawbacks of a fast-track EMU accession with the current criteria for the NMS

Most politicians on national level, the Commission, the IMF and the majority of experts took the positive impacts of a fast-track Eurozone accession for the NMS for granted, while the negative impacts were mostly not addressed or were seen as temporary adjustment problems. In general it was assumed in all CEE EMU applicant countries that the earlier the accession, the better it would be for their economic and social prospects (for more detail, see: Galgoczi 2005).

Expected positive impact (mainstream view)

It is expected that EMU accession will result in an increase in growth rates, thus boosting real convergence of GDP with the EU average. Estimates foresee temporary drops in growth rates of between 0.3 and 0.8 percentage points, followed by gains of 0.2 to 0.4 percentage points in the coming years (European Policy Centre 2004). According to the IMF (IMF 2004), ‘over the long term, euro adoption could raise GDP by an additional 20–25 percent in most Central European countries’. This would be a result of the following factors:

- Lower interest rates, leading to higher investment accompanied by lower costs of public debt servicing.
- Elimination of exchange rate risks and lower foreign trade transaction costs (Oblath 2003).
- Better environment for FDI due to increased credibility and a trade generation impact.
- Possible stimulus for structural reforms through the disciplining impact of ERM II participation on domestic policies.
- Increased macroeconomic stability and further convergence of business cycles.
- Once inside EMU, the option of influencing the monetary policy of the ECB to a greater extent than these countries’ relative economic weight might otherwise allow.

Expected negative impacts

Given that the ‘straitjacket’ of the current Maastricht rules ill fits the specifics of these countries (they are stricter on real terms), growth, employment and real convergence would seem to be in genuine danger. Governments pursuing such criteria will place economic and social convergence of their countries at serious risk. The points argued earlier in this paper also have an economic and a social dimension.

From an economic point of view, pushing inflation below the equilibrium level hampers growth, productivity gains, wage convergence and real convergence. As a secondary effect, it would also have a
negative impact on employment. Under the stricter fiscal criteria (on real terms) EMU accession countries need to tighten up their fiscal policies more than is really necessary with the result that there will be insufficient resources for infrastructure development projects and other vital public investments, constituting yet another negative impulse to growth and convergence.

From a social point of view, we have to address the welfare risks attached to the application of inappropriate criteria. Most transformation countries are afflicted by a ‘welfare deficit’ and are in desperate need of stepping up welfare and employment policies. In this regard, the stricter than necessary fiscal tightening has a clearly negative impact here also.

If the principles of the European Social Model and the Lisbon agenda are borne in mind, it becomes evident that there is a manifest contradiction between the objectives of the Lisbon agenda and the current Maastricht criteria in relation to the CEE new Member States. The relation between the Maastricht criteria and the principles of the European Social Model can also be seen as ‘ambiguous’. While on the one hand the EU15 countries are becoming increasingly concerned about what they call ‘social dumping’ from the East, rigid application of the Maastricht criteria imposes serious constraints on CEE countries, preserving distortions in price and cost structures, and disproportionalities between wage and productivity levels.

The above arguments may apply to individual CEE countries to varying extents and degrees. First of all countries with a currency board (Estonia, Lithuania) and Latvia with a conventional hard peg have already given up the tool of independent monetary policy. Their currencies are pegged to the euro. In case of a currency board arrangement tight fiscal policy was a necessary precondition for maintaining this regime. These countries can clearly benefit from an early EMU accession, because remaining outside would not offer them any additional benefits. The fact that these countries have the highest social risk in the region (beside Poland) and also the lowest levels of social spending does not affect their EMU prospects but poses a challenge for the future.

For the Visegrad 4 countries (CZ, HU, PL, SK) the weight of each of the advantages and disadvantages of fast-track EMU accession depends on their actual macroeconomic status and national development priorities.

Conclusions
The experience of existing euro-area members indicates that pre-entry inflation convergence – to comply with Maastricht Treaty convergence criteria – was followed by post-entry divergence. Given the relatively low economic weight of the accession states, a divergence in their inflation rates would have limited impact on ECB monetary policy and would not endanger the stability of the Eurozone. On the other hand, the Eurozone could well benefit from integrating high-growth, dynamic new Member States.

It is therefore appropriate to consider the potential indirect impacts of the decision taken in this case, e.g. to set an example for others – both other EMU candidates and existing EMU members. It may be asked whether this was the appropriate opportunity, the right occasion and the proper manner for a demonstration of strength.

The examples of Germany and France with their notorious government deficits, and the divergence of inflation rates between Ireland and Spain, on the one hand, and Germany on the other, indicate that divergence within the EMU is a genuine problem and one that needs to be tackled. This does not justify, however, delivering a lesson to the cost of example of Lithuania on the basis of dubious arguments.
The recent tough decision on Lithuania would not help to prevent any future divergence within the EMU. If the concern is that new entrants may not be able to sustain the performance level they achieved at the time of the entry, then whatever toughness or rigidity was applied at entry would not help. What is wrong with this decision is precisely the fact that the alleged justification relating to non-performance of the entry criterion is actually disguising the real reason: the Commission believes that a transformation country such as Lithuania would be unable to stick to the criteria in the future. But were future projections declared part of the entry criteria and were they applied to other countries in the past? Such a stance looks very like discrimination among countries and also displays some confusion between entry criteria and the management of divergence within the EMU. Instead, it would be more appropriate to consider by what measures divergence within the Eurozone could be tackled.

As far as potential EMU candidates are concerned, the message of the decision was clearly negative and heralds uncertainty for their future strategies. On the basis of the above considerations it may be stated with ample justification that the decision on Lithuania has delivered a wrong message. This rejection of a country that made all the necessary adjustments in a convincing manner and fulfilled the requisite, albeit inappropriate, criteria will represent a disincentive for other candidates in stepping up their efforts (e.g. Hungary with its previous ‘sabotage’ of the deficit criterion and its having itself recently embarked on a fast-correction path).

The decision also creates the impression that the EMU zone does not welcome fast-growing catching-up countries. The argument that increased inflationary pressure resulting from high growth and catching up is seen as a destabilising factor conveys an especially negative message. In fact, the growth of 7.5% in 2005 in Lithuania, while keeping inflation at a reasonable level, should be viewed as a fine achievement and seen as a real success of enlargement and convergence.

Considering this, the decision was a clear blow to EMU candidates, not only because their specifics had not been acknowledged, but also because ‘zero tolerance’ had been shown in application of the criteria which had been imposed, moreover, with reference to forecasts about possible future trends (and precisely with reference to the controversial inflation criterion). The Commission has never really paid attention to the Balassa-Samuelson effect – it has tended, rather, to downplay its impact and did not want to acknowledge the specificity of the NMS, preferring to promote instead the fast-track EMU accession, based on the original criteria.

Something is wrong here. Do we want convergence of the new member states to be promoted, or rather to hinder it? Wage convergence is a crucial factor here, especially in the case of the Baltic states that are lagging behind the wage levels of even the Visegrad-4 countries. If Europe does not want to become competitive on the basis of low wages, wage convergence is an important issue and not a risk factor and a development that might be expected to be promoted in accordance with the spirit and principles of the Lisbon strategy (knowledge-based economy), the European Social Model and the Treaty.

It would be more helpful if the Commission were to take the specifics of the NMS into account. The application of the same criteria that were used when forming the euro as a new currency between big economies becomes problematic with the current and future enlargements. More discussion is needed about what might be an economically meaningful interpretation of the Maastricht criteria in keeping with the new situation.

Even if this does not seem to be a politically realistic perspective at the present moment, a minimum level of tolerance would have greatly helped to gain confidence for the euro
area. As it is, the decision has merely served to emphasise once more the controversial nature of the Maastricht criteria for the NMS. It has also shed light upon the inappropriate foundations of the EMU in general.

What lesson individual EMU candidates draw from this decision will depend on their own macroeconomic situation and national priorities. They will undoubtedly set about revaluing the benefits and risks of EMU accession.

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