CHAPTER 1.

MAASTRICHT CRITERIA AT THE AGE OF 18: ARE THEY EVEN CONVERGING, WHICH PARTY AND TO WHAT END?

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Abstract

Maastricht criteria are well known to be arbitrarily designed. To top it all off, times and again they've been only briefly fulfilled and –worse even- often manipulated with. Among them, fiscal criteria and overall Stability and Growth Pact are perhaps the most controversial of all, as recent problems within the EMU amply demonstrate. Moreover, the epicentre of the EMS, so-called ERM2, and convergence criterion in this regard seem to be much more effective in protecting the interests of those already in the Eurozone, rather than serving as a vehicle for faster and safer euro-accession of the candidates. In addition, since some of the convergence criteria, quite regardless of their dubious effectiveness, leave room for ambiguous interpretations, let alone the often forgotten real convergence criteria earmarked in the Treaty as a carte blanche, existing members of the EMU in times of unprecedented economic hardships may well be tempted to block candidate countries on their way to Euroland. All of these issues raise numerous questions and urge for fundamental reassessment of the Maastricht criteria, as well as point at considering their reform or indeed alternative policy options from the view point of candidate- and acceding countries.

Key words: *EMU, Maastricht (Convergence) criteria, inflation, fiscal profligacy, ERM2, acceding countries*

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INTRODUCTION

EU is and always has been a highly political creature. As such, in fact, it seems to have been driven by notorious discretion more than by (often formally proclaimed) level-playing-field rules, virtually at all times and instances - except when it really didn't make any sense to firmly stick to them. Both retrospect and prospect of European monetary integration have repeatedly illustrated this trait and perhaps most vividly so. In spite of coming to an age this year, convergence criteria -as a set of preconditions for joining the EMU- are by no means exception to that pattern.

Maastricht criteria are well known to be arbitrarily designed.[4] To top it all off, times and again they've been only briefly fulfilled and –worse even- often manipulated with. Among them, fiscal criteria and overall Stability and Growth Pact are probably the most controversial of all, as recent problems within the EMU amply demonstrate. As a matter of fact, global financial meltdown has uncovered alarming dissonance between unprecedented fiscal profligacy in Eurozone countries on one hand and self-inflicting fiscal austerity in candidate and acceding countries on the other [Darvas, 2009]. Moreover, the epicentre of the EMS, so-called ERM2, and convergence criterion in this regard seem to have been much more effective in protecting the interests of those already in the Eurozone, rather than serving as a vehicle for faster and safer euro-accession of the candidates [Fölsz, 2003]. In addition, since some of the convergence criteria, quite regardless of their dubious effectiveness, leave room for ambiguous interpretations, existing members of the EMU in times of unprecedented economic hardships may well be tempted to lock in candidate countries in such a (for members) comfortable status quo: for as long as outsiders pursue national consensus to be promoted into EU/Euroland, their economic policies (and more) remain under control of E(M)U [Lavrač, 2004], [De Grauwe, 2009]. All of these issues raise numerous questions and urge for fundamental reassessment of Maastricht criteria, as well as point at considering their reform or indeed alternative policy options from the view point of acceding countries like Serbia.

The rest of the paper is organised as follows: section 2 gives the overview of convergence criteria and ERM2, section 3 deals with oddity of each and every Maastricht criterion from the perspective of the present moment and potential new entrants, while the section 4 reiterates corrective proposals, counter-weighs principal costs and benefits and eventually concludes.

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[4] For early intellectual critiques, consult Buiter, Corsseti and Roubini (1993) and Wickens (1993).

OVERVIEW OF THE MAASTRICHT CRITERIA

In order to qualify for the Euroland, apart from having to be a member of the EU[5], each candidate country must conform to at least five convergence criteria- defined 18 years ago in the famous Maastricht Treaty, which ushered the timeline and the rules for launching the euro and the EMU as we know them. These criteria tackle either monetary, fiscal or currency stance of a candidate country. In that order of appearance, convergence indicators could be summarized as follows:

1) Applicant's inflation rate for the preceding year must have accounted for no more than 1.5% above the average inflation rate of the three lowest inflation E(M)U members;
2) Long term interest rate (hinting at long run inflation) on applicant's government bonds in the preceding year must have remained no more than 2% above the average long term interest rate of the three lowest-inflation E(M)U members;
3) Budget deficit must not exceed the threshold of 3% of the applicant's GDP ("except in exceptional circumstances");
4) Applicant's public debt must not exceed 60% of the country's GDP ("or must be declining toward that level") and, lastly,
5) Applicant's national currency must stay within its ERM2[6] exchange rate band of ±15% around the central parity for at least two years without outward realignments or unilateral devaluations.

Be that as it may, Maastricht criteria clearly disregarded much of the optimum currency area scientific legacy and introduced set of indicators instead, which scream 'arbitrary' in multiple respects: they are not supported by any other coherent piece of economic theory either, it is unclear why specific numerical targets were chosen (or where it is clear - the reasoning is painfully too linear, to put it mildly), only to culminate with evident (and arguably deliberate) absence of real convergence criteria, calibrated ones at least.[7]

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[5] Moreover, the political set-up of EU enlargement commits accession countries to join the EMU at some stage after the EU accession.

[6] Originally, it used to be just ERM (Exchange Rate Mechanism), a multicurrency parity grid that served as converging hard-core of the EMS. ERM2 came about only with launching of the euro, representing essentially bilateral agreements between euro itself (or EMU if you will) and respectful late comers' currencies which joined or will join the Eurozone subsequently.

[7] We discuss this non-calibrated, and typically less known, additional Maastricht criteria further at the end of this section.

Inflation convergence thresholds, 1) and 2), aim at enforcing the German-style "culture of price stability" in both short and longer run as a top monetary priority in E(M)U. This in turn bears consequence also for criterion 5), to be discussed later. Inflation criterion, nonetheless, is numerically arbitrary beyond reasonable doubt (why exactly 1.5% for short run or 2% above the three best performers' average for the long run inflation). These rules of thumb, even if correspondent to EU's reality once upon a time, nowadays pertain to no more than drastic ego-centrism of the strongest founders and their obsolete arithmetic.

Similarly, fiscal criteria too were arbitrarily designed, often unfulfilled and patently window-dressed. Baldwin and Wyplosz (2009) remind that EMU's budget deficit criterion has been set as equivalent of the usual German golden rule for annual public investment (the only acceptable cause of budget deficit for them at the time) which typically amounted to some 3% of GDP. Cumulative public debt ceiling, again, has been pinpointed at 60% of GDP -according to one school of thought- simply because that was the average EU debt level back in 1991 when Maastricht criteria were being formulated. The other school of thought, first demonstrated by Bini-Smaghi *et al.* (1993), offers more rigorous proof for equally superficial reasoning behind this threshold. Namely, since public debt dynamics stems from current budget deficits as in *(1)*,

$$G(t)-T(t) = PD(t)-PD(t-1) \qquad [1]$$

or in terms of applicant's current GDP,

$$d(t) = p(t)- PD(t-1)/Y(t) \qquad [2]$$

then rearranging the second term on the right hand side yields

$$PD(t-1)/Y(t)= PD(t-1)/(1+g(t)) \qquad [3]$$

where $g(t)$ is an annual economic growth rate. By plugging this result back into *(2)*, we obtain

$$d(t)(1+g(t))-g(t)p(t) =p(t)-p(t-1) \qquad [4]$$

Since fiscal convergence required by Maastricht criteria implies constant debt-to-GDP over time, expression *(4)* collapses to

$$p(t)=d(t)\ (1+g(t))/g(t) \qquad [5]$$

Now, jointly under arbitrary supposition at the time that growth rate amounts to 5% *p.a.* (or 3% in real terms) and under then newly invented rule that budget deficit must not exceed 3%, equation *(5)* gave roughly 60% solution for saddle-

point stable public debt ratio. In any case, upon launching the euro, several initial EMU members had been in breech of the 60% debt rule, notably Belgium, Italy and Greece, but strictly also Sweden, Holland ad Spain, whereas less than 3% budget deficit indicator was honoured only thanks to accounting tricks. Baldwin and Wyplosz (2009) report that France privatised portion of its state-owned telecomm in order to temporarily curb the deficit, Italy collected some tax revenues year in advance, while even Germany contemplated selling monetary gold in order to tune down its public finances.

Finally, the road to the European monetary union goes also through the Exchange Rate Mechanism 2 (ERM2), which regulates the exchange rate relationships between the present Euroland and the future EMU members ("pre-ins") [De Grauwe-Schnabl, 2004]. The ERM2 alone is a mere anteroom which allows the EMU to appraise the pre-in's adjustment potential and financial stability in respect to monetary and exchange rate policy. But more broadly, the ERM2 is the overcoat and temporal yardstick of the entire Maastricht criteria set. There are no explicit regulations as for the timing of the ERM2 entry, but the Maastricht criteria require a minimum waiting period of two years before examination whether one is ready to leave this gym *sui generis* and embrace the euro. Current participants in ERM2 are Denmark's krone, Estonian krone (to vanish as of 1st of January 2011 when Estonia will officially adopt euro), Lithuanian litas and Latvian lats. After deliberately failing to meet some of the convergence criteria in the past, which made it pointless to participate in the ERM, to Sweden has apparently been "let alone" in a position effectively resembling the UK's. All the rest of the bigger EU members still out of Eurozone together with EU candidate countries have problems with choosing the right moment for obligatory ERM2 entry and with meeting macroeconomic consequences of its dire requirements in practice. Couple of things is arbitrary here. Some countries, both EU members and EU candidates, were *de iure* or *de facto* allowed to opt out of the ERM2 and/or euro altogether.[8] In addition, despite officially announced band width of ±15% around central parity, the ECB in reality stubbornly insists on much narrower corridor. Moreover, conversion rate negotiations (*i.e.* determination of central parity) lack in transparency and gain in political discretion on behalf of EMU over more recent euro-applicants. In short, are we witnessing not only the EU enlargement fatigue here, but also the antagonism of macroeconomic interests which may stop the euro's "Drang nach Osten"?

Having said that, it is worth noting that, recently, EMU officials began raising the questions of fulfillment of additional and less known Maastricht criteria, largely

[8] Others, like Italy and Finland, for instance, were admitted in the Euroland following an assessment which took place before the mandatory two years in the ERM had elapsed.

ignored or unaware of thus far even in professional and academic circles, which have to do with the so-called real convergence. While it doesn't explicitly quantify them, the Treaty of Maastricht indeed does mention additional convergence criteria, such as the position and size of the balance of payments disequilibria, developments in unit labour costs and other price indices, (un)employment rates etc. [Lavrač, 2004]. Relevantly enough, Lavrač (2004, pp.4-5) makes the following remark about them, and we quote: "*At this moment it is hard to judge their real weight. They, however, certainly give the EU institutions some additional flexibility and discretion when evaluating readiness of the countries for the EMU which can be activated in the case of need.*" These valuable and meaningful criteria, also related (for a change) to theoretical pillars of the OCA theory, have nevertheless never ever been called upon let alone applied in the case of 'old Europe's' qualification for Eurozone. Enough said, for the time being.

REASSESSMENT OF THE MAASTRICHT CRITERIA AND SOME RECTIFYING PROPOSALS

Before proceeding with more fundamental reassessment of the Maastricht criteria, let us document the output of a quick and somewhat illuminating scientific exercise. Inspired by De Grawe (2009), we ventured to determine how many of the EMU members meet the Maastricht criteria today. Furthermore, logical comparison would enlist the current ERM2 members and other obvious Euroland candidates to see how they fare with the convergence indicators presently and in case they fulfill them to a reasonable extent, what is their macroeconomic performance against the performance of the rest of the European economies without immediate convergence criteria concern.

In a nutshell, apart from Ireland, inflation criterion appears to be by and large met within present EMU too. Quite expectedly, however, relatively larger developing transition countries like Poland, Romania, Serbia and even more developed Turkey are having problems with keeping inflation in check without causing havoc in other aspects/segments of their economies. On the other hand, not a single EMU member (abstracting from tiny Luxembourg) is likely to abide by the budget deficit criterion in 2010. So if Ireland and UK have deficits four times greater than allowed, while France, Italy and Spain have budgetary gaps of roughly double the proscribed Maastricht criterion and rising, how credible is keeping some of the ERM2 and other EU candidates out of integration processes on the grounds of not meeting convergence criteria? In terms of cumulative public debt indicator, matters are even more ironical: in 2010, almost all of the inaugural EMU members are deeply in breech of the 60% GDP ceiling, while virtually all

of ERM2 members as well as others[9] aspiring to join the Euroland or EU (including entire Western Balkans, Turkey, Ukraine, Russia and the rest of the so-called European periphery) demonstrate considerable prudence in regard to the public debt criterion! Nonetheless, it is painfully transparent that most of the newer EU members won't be admitted to Euroland any time soon, whereas if UK, for instance, wanted to swap the pound for euro in spite of its debt-to-GDP of over 80%, it would probably happen literally overnight. Clearly, repeated transgressions of Maastricht criteria in the past and present when it comes to Western European countries coupled with all too easily dismissed leniency in the cases of the new members and acceding countries, suggest that euro entrance criteria have very little to do with economics or rules, and much to do with politics and inconsistent discretion [Jonas, 2004], [De Grauwe, 2009].[10]

Notwithstanding that, explicit results of often preliminary and implicit efforts by candidates for E(M)U to meet the Maastricht criteria seemingly come with steep macroeconomic costs, some of which are genuinely degressive and ultimately avoidable. Reassessment of euro entrance criteria deals with these issues in greater depth.

Inflation criterion, to begin with, would be perhaps more logically defined if extracted among EMU countries inflation rates, rather than entire group of EU members, including those who opted out of the Euroland. By and large, inflation in individual countries of the euro area reflects partly the conduct of monetary policy by the ECB, but partly their specific characteristics like income level, labour costs, taxes and real GDP growth, openness and sensitivity of domestic prices to exchange rate fluctuations etc., which are in no way related to the conduct of the single monetary policy. The more is any given euro area member different from the euro area average, the more can inflation in that particular country reflect its structural specificities, and commensurately less the impact of common monetary policy. In terms of their structural characteristics, particularly income level and growth, the new EU members are akin to the fastest growing/lowest income present euro area members. However, under the existing rule, or, more accurately, under the unchanged approach to the interpretation of the existing rule, these countries would most likely be required to replicate

[9] With noticable exception of Hungary again.

[10] Macroeconomic determinants anyway tend to be of second order importance in both forming and dissolutions of currency unions through time. Currency unions typically dissolve when: a) there are large inflation differentials among member states, b) countries become protectionist (either protectionism or trade flows simply dry up due to exogenous or non trade-barriers driven reasons), c) but mostly and predominantly due to changed political sentiment, drastically altered politics or state status of the member(s) [Nitsch, 2004].

inflation performance of countries that are at the different end of the euro area membership ranked by GDP size [Jonas, 2004]. Moreover, Lavrač (2004) bolsters the argument by asserting that low inflation doesn't have to be always a sign of economic and institutional superiority, but to the contrary - could also be the result of worrisome macroeconomic imbalances. In addition to that, how should we read "three members with the best performance in terms of the price stability" in times of protracted recession causing evaporating inflation rates or indeed deflation in some of the members?! [*Ibidem*] These are just some of the grounds on which several authors, notably Buiter and Sibert (2006) and Darvas (2009), demanded alteration of the price stability criterion so that some kind of euro area average serves as a future reference point, instead of the more extreme ongoing rule the EMU officials stubbornly stick to. The reasoning behind this rectifying proposal being not only that E(M)U has changed to the point it would be unwise to sustain the status quo and ignore the macroeconomic needs of the newcomers and soon-to-be members, but also because pressing constructional weakness of the Maastricht criteria unsustainably specifies a number of nominal convergence criteria that jointly constrain if not redicule the remaining other: for instance, if an applicant economy has to curb current inflation and cuts down long term inflation expectations to the euro area levels, it might cause nominal appreciation of national currency and eventually the breech of narrow exchange rate band established under the auspices of ERM2.

For as long as truly integrated pan-European bond market maintains reasonable real interest rate convergence, the long term interest rate criterion remains the least controversial of the nominal convergence criteria. Nevertheless, until not long ago, the so-called Walters critique (he was a counselor in Thatcher's administration) has ushered the fear of divergence of national long term inflation rates precisely because of honouring the long term interest rate Maastricht criterion. Namely, due to the unified euro area-wide nominal interest rate, countries with higher inflation are to depress their real interest rates, whereas lower inflation economies will expectedly have higher real interest rates, which all in turn corroborate the final corollary: common monetary policy is bound to be more expansionary in higher inflation states and more contractionary in lower inflation member states [Mongelli-Wyplosz, 2008]. That notwithstanding, Mongelli and Wyplosz (2008) dismiss the Walters critique after analyzing the data on Euroland's pre-crisis long term inflation and interest rates time series: since some sort of real covered interest arbitrage flattens out the real interest differential and balance of international competitiveness, under reasonably unified expectations of common currency umbrella, higher inflation and therefore expansionary low real interest rate causes real appreciation (drop of pseudo-real exchange rate) and therefore deterioration of international competitiveness, while conversely, lower inflation rate or deflation tendency implies real depreciation

(rise in real pseudo-exchange rate) which counterbalances the former effect. Alas, if a more serious asymmetric shock, fiscal and/or balance of payments crisis in one or more EMU members alters the rational expectations and (re)introduces uncovered real interest parity into the equation, then markets may start charging fundamentally different nominal interest rates to member state's governments with plagued credibility quite regardless of the ECB's quotations. Recent examples of Greek, Irish or Spanish crisis (although not identical among themselves), call for utmost caution in this regard. In a sense, this long term criterion's destiny depends upon prudent national macroeconomic management and successful reform of other, short-term criteria.

What about reassessment of the fiscal criteria? At the time of Maastricht Treaty preparation, the 3% deficit-to-GDP rule as well as the 60% of GDP debt benchmark, were considered necessary because governments have been tempted to create greater budget deficits in order to mitigate shocks: does that sound strangely familiar by any chance? This could additionally lead and has led to problems of sustainability of deficits and to growing government debts. Other negative effects would include price instability as a country that allows its debt-to-GDP ratio to increase over a period of time would cause its own but gradually also the EU-wide interest rate increase. As a consequence the burden of government debts in other EMU countries would force them to follow more restrictive fiscal polices to stabilize their debt-to-GDP ratios. The above stated considerations contributed to the definition of numerical budgetary rules in the Maastricht Treaty that countries have to satisfy to become members of EMU.

Our assertion is that there must be a level-playing-field correspondence between Euroland members and ERM2 participants in terms of both numerical fiscal requirements and fiscal instruments at their disposal. In other words there should be a tighter compatibility of Maastricht criteria and the so-called Stability and Growth Pact rules.[11] The Stability and Growth Pact's (SGP) main purpose is to ensure that the members maintain budgetary discipline following the introduction of a single currency. It includes a European Council resolution adopted at Amsterdam on 17 June 1997 and two Council Regulations of 7 July 1997. The two regulations were revised in June 2005 and amended after discussions on operation of the SGP. As it is well known (if not consistently deployed), the Stability and Growth Pact opens the way for the Council to penalise any participating member state that fails to take appropriate measures to end an

[11] For instance, thereby it would be inconceivable for euro members to demand from ERM2 participants effectively procyclical fiscal policy in the face of global adversity while they themselves pursue countercyclical policy if not outright fiscal profligacy at the same time.

excessive deficit (the "excessive deficit procedure"). A non-interest-bearing deposit with the ECB would be a form of a penalty. If the excessive deficit is not corrected within two years it could be converted into a non-refundable fine. On the other hand, again, the penalties are subject to assessment of the circumstances by the Council. With regards to the fiscal criteria, based on the Commission report the Council decides weather there is an excess deficit. In most non-member states, fiscal deficits have been above the Maastricht reference value for some time especially due to the government measures undertaken to mitigate the global financial crisis impact. In addition, financial positions in the non-member states have been facing aging-related fiscal shocks. Schadler *et al.* (2005) argue that in the period before euro adoption, the candidate countries should aim at bringing fiscal deficit below 3% of GDP. In the case of a negative shock and assuming that euro qualifiers adopt the euro with the fiscal deficit close to 3%, the negative shock would push the deficit above 3%. Consequently, to reduce the deficit to 3% of GDP would require a restrictive fiscal policy which could be politically difficult provided the adverse effects on the employment and the economy. In the light of the recent shocks that have been caused by the global financial crisis, the authors of this paper suggest that non-member states should reduce the deficits below the 3% of GDP ideally before the entry in ERM2. As a result, a buffer zone would exist to allow shock absorption and prevent the emergence of the currency market nervousness that may impact the euro value. However, how politically feasible that is remains equally controversial issue.

Furthermore, Warin (2005) and Wyplosz (2006) argued that, despite the justification for fiscal rules in an EMU without a centralised budget, EU fiscal rules may hinder economic growth in Europe. The authors consider that those rules reduce the margin of manoeuvre of the member countries when facing asymmetric shocks and are not growth promoting. That is to say that not only current shape of public finances by no means is secure indicator of future growth potential, but even more so that economic costs of lost confidence in institutions and decimated political support may easily overcome extra couple of percent of budget deficit, neglected by the still ruling neoclassical paradigm.

The necessity to combine short-term flexibility and long-run fiscal discipline is a notoriously complex trade off. As shown above with the reference to the statistical data of recent and historical fiscal indicators, the problem of setting the quantitative ceilings is that the rules have been repeatedly broken. A solution to the problem could be the formation of an independent national fiscal body in E(M)U member states, candidate countries and economies with the strategic objective of becoming E(M)U members (such as Serbia). For the sake of the argument, this could be a council consisting of competent experts that are neutral with respect to the ongoing short-sighted political interests and objectives. A

similar approach exists and is implemented in a number of central banks of developed countries in the form of a monetary council. Needless to say, fiscal policy is highly politicised, especially the structure of public revenues as well as the structure of public expenditures. However, what should be excluded from politics with respect to the fiscal policy are the issues of budget deficit and public debt. Setting up medium-term and long-term deficit and public debt targets by an independent fiscal body may bring us a step closer to the objective of achieving the sustainability of budget deficit and public debt based on a more flexible, yet fundamentally prudent, well-balanced and overarching set of conditions, as outlined in reformed and sublimed convergence criteria/SGP.

Finally, we don't see full-fledged fiscal federalism as modality likely to work in the context of EMU, due to stark differences in economic structure and development level among the members (which requires taxing etc. to remain national prerogative in order to preserve the euro) as well as due to historically rooted international and political mistrust within E(M)U, in respect to each other's prudence or intentions even. Nonetheless, ideal reform would institute at least some residual, federally administered funds, which could direct fiscal transfers to most adversely hit or those with the thinnest fiscal base, and -mind you- even before joining the euro, *i.e.* already in the ERM2 stage, just as the ECB, for example, bears responsibility for EMU-applicant's exchange rate zone together with its own national central bank while at common currency anteroom. Alas, from the onset of E(M)U there seems to be no political willingness to instigate such a federal buffer, nor it is obvious where the money might come from [Malović, 1998].

When it comes to the exchange rate criterion and ERM2, apart from increasingly asymmetric impact of one-size-fits-all monetary policy in an ever more diverse EMU[12], the issues that stand out are the following: a) does ERM2 vs. ERM makes a difference and in what respect, b) sustainability of nominal exchange rate target in small open transition economies, and lastly c) timing of ERM2 entry, or indeed, if unilateral euroisation appears more appealing than policy constraints of ERM2, is that an option, for whom and when exactly.

Essentially, there are very few differences between ERM and ERM2. The former was multilateral symmetrical parity grid, but in reality *de facto* DM-zone, the

[12] Therefore, as emphasized many times before, giving up monetary independence may be costly especially for the EMU applicants, when they are hit by asymmetric shocks and cannot efficiently substitute monetary policy with some alternative stabilizing mechanisms [Lättemäe, 2003]. On the other hand, Buiter and Sibert (2006) suggest that asynchronous schocks can be beneficial in currency union with integrated financial markets since they increase the scope for and return on investment diversification.

latter being *de iure* bilateral euro-zone. In both mechanisms countries couldn't unilaterally determine their currency parities,[13] nor were they solely responsible for maintaining them. The main problem with ERM2 is that it was mainly designed to protect those already in the Euroland from potential competitive devaluations/depreciations of the candidate-currencies [Fölsz, 2003]. The straight-forward implication of that being that it's high time for ECB to stop insisting on narrower bands than required by the ERM2 itself, thereby enabling "the outs" to still retain some monetary sovereignty and occasionally deviate from uncovered interest parity without fundamentally endangering the exchange rate criterion.[14] ECB's supporting interventions along those of the respective central bank should be slightly more frequent and more generous, baring in mind that, while in ERM2, EMU applicants are especially vulnerable. Opponents of such a policy contend that wider bands, by abandoning tightly pegged target zones, cannot credibly serve as nominal convergence anchors. The extent to which this assertion is false and all the arguments as well as empirically tested wider currency bands which point to the contrary have been discussed at great length in Malović (2007), *inter alia,* so we won't dwell on it in this treatise.

Even though Harrod-Balassa-Samuelson (HBS hereafter) appreciation effect as a result of transitional catching-up process may be a bit overrated in some instances, it does cause problems to inflation criterion as well as to exchange rate management within ERM2. It is a side-effect of desired but non-quantified real convergence process, yet it may open a conflicting gap in respect to nominal convergence as dictated by the Maastricht criteria [De Grauwe-Schnabl, 2004]. Namely, the currency of fast growing economy appreciates relative to that of the more slowly growing economy, either through nominal appreciation in case of managed floats or through inflation differential channel in case of fixed exchange rate regime. Jonas (2004) underlines that it's almost impossible to peg the exchange rate while at the same time maintaining control over money supply (and thus inflation). Orlowski and Rybinski (2005), however, by extending widely popular flexible inflation targeting framework into *de facto* monetary conditions index, confirm the difficulty of the task, but demonstrate it is not impossible: by assigning interest rate instrument to changes in relative (Polish versus Euro-area) inflation forecast, whereas foreign exchange reserves interventions to exchange rate stabilisation, the framework can work at least for a while and in good times. More serious perils, in our opinion, should be recognized in and during international capital flow reversals, their sudden occurrence made possible by

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[13] Central parities of the ERM2 currencies *vis-a-vis* euro are determined among finance ministers of EU member states, ECB and central banks' governors of ERM2 participants, after taking into consideration Comission's proposal [Fölsz, 2003, p.6].

[14] Letting Slovakia into EMU looks like a long awaited step forward in that respect.

mandatory dismantling of capital controls immediately before entering the EU. At such a fragile point, applicants still could not rely on superior institutional imports, benefits of euro-wide capital market or banking system, but they ought to be able to draw swiftly from ECB's reputation and size through both verbal and open market operations/swaps[15] channel. On their own, national policy makers should strive to avoid sterilisation as well as appreciation, by rapidly repaying foreign debt together with expanding industrial policies and country's export oriented productive capacities.

More often than not, HBS effect alone could be accommodated even within the narrower (±2.25%) version of exchange rate stability criterion, but be that as it may, applicant countries/their currencies should ideally enter ERM2 in peaceful times and at such a level of economic development that forces pressing towards any excess inflation or appreciation are actually modest and/or retreating. In addition, we advise against entering ERM2 if Ricardian equivalence doesn't hold, fiscal policies appear imprudent or if the large-scale administrative price control is still in place. Moreover, for several criteria if not all, some countries may wish to pursue nominal convergence even before formally entering the ERM2, since it seems wise to aim at fulfilling Maastricht criteria at least a year ahead of the planned date of entrance due to lengthy administrating procedures (this being especially advisable to overachievers deliberating speedy entrance) [Lavrač, 2004]. However, struggling history of recent enlargements of Euroland suggests that speedy accessions seldom work out,[16] hence small economies with little industrial production and those having clearly identified interest in hasty adoption of euro, might stand a better chance with outright unilateral eurisation. In this case, the euro would circulate in parallel to the domestic currency, or perhaps replace it altogether. In any event, this action would assume that national authorities fix the value of the domestic currency in terms of the euro, rather than participating in the ERM2 target band arrangement for two years before entering EMU [Meade-Mueller-Plantenberg-Pisani, 2002]. Blessing of dollarisation is by all means always mixed and never completely irrevocable,[17] but for those whom it might

[15] Similar to ones offered by the ECB to Denmark and Sweden, for example.

[16] For instance, Lättemäe (2003) and most strikingly Darvas (2009) describe formidable obstacles, promises to and disappointments of Baltic countries in their attempts to give up their currency board or even dollarisation arrangements in favour of ERM2. Thus, there is a stark contradiction between the huge loans granted from the EU and elsewhere to support Latvia in maintaining its exchange rate peg and the denial of Latvia's euro-area prospects by EU officials [Darvas, 2009]. In presence of tequila effect of global crisis across South and East Europe, this appears yet another example of selfish and dangerous game played out by Brussels and Frankfurt.

[17] Crisis driven exit from dollarisation by Equador constitutes a note-worthy caveat [Darvas, 2009].

serve it is in fact a viable option. Not only that some older members avoided spending entire two years in ERM, but what's more, despite ostentatious verbal threats by the ECB and Commision basically nothing ever happened to economies which eurised without explicit EMU's consent (like Montenegro e.g.). After all, ERM2 is too cumbesome from the outsiders view point, and too defensively designed to serve the interests of those already in. Nevertheless, for countries capable of utilizing non-negligable benefits of autonomous monetary policy making and floating exchange rate, like Poland, Czech Republic, Croatia or Serbia, the choice is probably less easy one and not likely to point in eurisation direction anyway.

CONCLUDING REMARKS

In this paper, we performed reevaluation of the Maastricht (convergence) criteria from the view point of ERM2 members and other acceding countries aiming to join the Euroland in the proximate future. It appears that Maastricht criteria implicate serious flaws and even drawbacks both from the economic theory standpoint and particularly having in mind logical socio-economic priorities of less-developed transitional applicants at the outskirts of Europe. The entire nominal convergence set, but especially inflation, fiscal and exchange rate criteria, seem to be designed primarily to shield the interests of those already in the Eurozone, rather than serving as a vehicle for faster and safer euro-accession of the candidates. Hence, it would be not only analytically easy to show that keeping the same and rather asymmetrically-tackling rules in a vastly expanding E(M)U violates the equal treatment principle, but also that so obsolete convergence criteria arguably aren't in the interest of EMU as a whole either any more. Consequently, at least inflation and long term interest rate criteria could be related to the euro area average rather than three best performing countries. Along the same lines, fundamental reform of fiscal criteria in parallel with SGP reform could establish more flexible albeit credibly prudent fiscal guidelines entrusted to politically independent national fiscal bodies among the applicants, whereas existing EMU members would have to clean up the mess of their own fiscal profligacy and establish the level playing field on the matter. Furthermore, quite independently from dubious effectiveness of several if not all of the nominal convergence criteria, and deliberately left room for ambiguous interpretation by 'insiders' of their fulfillment, previously admitted EMU members could always (and expectedly in crisis times) resort to non-quantified real convergence criteria from the Maastricht Treaty in order to block candidate countries on their way to Euroland. This might happen on economic, financial or clearly nationalistic (political) basis. Nevertheless, once the E(M)U applicants realise that they are knocking on the door of –in many aspects- 'dragged party with lights on and beer

running out', as well as when old E(M)U members on their behalf realise the size of highly skilled imigration injection their economic area and common currency both badly need, there should be common ground for mutually beneficial reform of Maastricht (convergence) criteria.

Otherwise, however, alternatives remaining differ pending on structural, geographic and future strategic traits of economies at hand. Small(er) service based countries may indeed emerge better of by unilaterally adopting the euro, thereby avoiding the most of the messy Maastricht hustle all together. Larger, more heavily populated and more industrial countries, on the other hand, probably must seek either consensual euroisation deal or give it all up (even intentionally postpone) for a longer period. Having said that, too much procrastination on Brussels behalf, surely diminishes the benefits and elongates the costs of common currency adoption for E(M)U applicants according to standard OCA theory and the latest research in this field.[18]

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[18] If we recall the proverbial Mundell's OCA benefits, they are chiefly summarized by: 1) elimination of conversion costs and currency risk (with stable float or unilateral euroisation reasonably achievable even without formally joining the EMU), 2) increased trade (for which in their most recent paper Santos Silva and Tenreyro (2010) econometrically demonstrate it's so negligible that amounts to nothing more than a myth!) and above all 3) reputation and financial potency of union's monetary authority as a body-guard intervener as well as importing well-defined, credible and stable financial rules, laws, disciplined and reliable institutions from 'north' to 'south'. Be that as it may, it strikes us as interesting and indicative, that during both EU and EMU integration, this latter and -chances are- the most beneficial gain the applicants need to wait for the longest time, whichever, formal or unilateral, convergence pattern they choose to follow.

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