The Maastricht inflation criterion: lessons to learn

As part of the process toward monetary union in Europe, countries were required to fulfill three criteria, set out in the Treaty of Maastricht. One of them required countries to achieve an inflation rate for one year of no more than 1½ percent above the average of the three European Union (EU) member states with the most stable prices. The purpose of this criterion was to bring high-inflation EU countries in line with low-inflation countries before the euro was introduced. According to a new IMF Working Paper, the criterion has achieved its aim of narrowing the inflation gap between EU countries. But it has also encouraged countries to adopt short-run, fiat measures to reduce inflation rather than structural reforms with longer-term economic benefits. The study examines what implications this may have for the 10 new EU member countries, all of which are hoping to join the monetary union in the near future.

From a purely numerical perspective, the Maastricht inflation criterion was a great success: the inflation differential between low- and high-inflation countries, which was in the double digits from the mid-1970s to the early 1980s, started to narrow in the early 1990s, declining to 2–3 percentage points by 1997. But from a policy perspective, it had some unintended consequences. To meet the criterion, EU member countries were faced with two choices: adopt credible monetary policy and market-oriented reforms that reduced inflation on a more permanent basis or opt for short-term measures, such as changes in regulated prices and indirect taxes, and other measures that reduced demand and forced wage moderation.

Which of these two disinflation strategies works best? For rapid entry into the euro zone with maximum political support, the best choice proved to be the short-term strategy. Trying to achieve low inflation through structural reforms can be a protracted process and it might have delayed membership in the monetary union. But countries opting for the longer-term strategy would have entered with a healthier economy.

In the late 1990s, in their rush to adopt the euro, all EU members relied at least partly on short-term measures, leaving their goods and factor markets unreformed. Once the effect of these measures faded, however, inflation accelerated again in highly regulated countries (see chart). While the strategy of "low inflation now, reforms later" may have modest short-term costs, the long-term costs are high. The monetary policy transmission mechanism is likely to be less efficient, and economic agents continue to base their decisions on expectations of higher inflation. This makes future disinflation more costly. In contrast, countries that implemented more long-term structural reforms now benefit from flexible markets and expectations of low inflation going forward.

What does the experience of the old EU member countries imply for the new members (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia, and Slovakia)? The authors' simulation shows that countries with unreformed economies are likely to face much steeper costs when they try to bring down inflation in the future. This result holds for both the current euro zone members and new member countries. The latter would benefit from an inflation criterion that makes the choice of a short-term disinflation strategy less appealing. At present, the short, 12-month testing period of the Maastricht inflation criterion may encourage use of the fiat strategy. A longer testing period, perhaps covering the full business cycle, might be preferable. The tightness of the inflation criterion also provides a further incentive for one-off measures. These incentives could be alleviated by excluding countries with negative output gaps from the calculation of the criterion. ■

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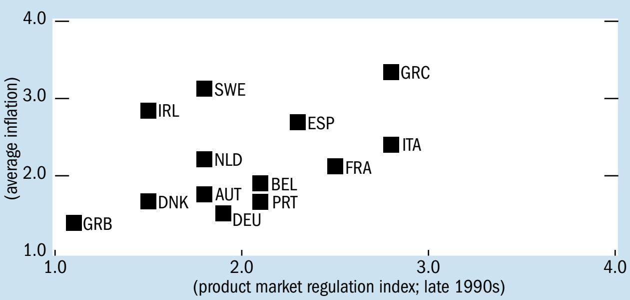
Cost of regulation

European Union countries with more regulated markets have higher inflation.



Note: AUT=Austria, BEL=Belgium, DEU=Germany, DNK=Denmark, ESP=Spain, FRA=France, GBR=United Kingdom, GRC=Greece, IRL=Ireland, ITA=Italy, NLD=Netherlands, PRT=Portugal, SWE=Sweden. The index captures competitiveness in countries' product markets; the lower the number, the more competitive the market.

Data: IMF, *World Economic Outlook;* Paul Conway, Véronique Janod, and Giuseppe Nicoletti, "Product Market Regulation in OECD Countries: 1998 to 2003," OECD Economics Department Working Paper WKP(2005)6 (Paris: Organization for Economic Cooperation and Development, 2005); and authors' calculations.

This article is based on IMF Working Paper No. 06/154, "The Maastricht Inflation Criterion: How Unpleasant Is Purgatory?" Copies are available for $15.00 each from IMF Publication Services. See page 308 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).