Zdeněk Tůma: Europe's club of nations needs a rule change

Comment by Mr Zdeněk Tůma, Governor of the Czech National Bank, in the published Financial Times (London, England), 4 January 2007.

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The European Union is a pretty big club and it will only get bigger. The rules and institutional framework used by the 27 members to make decisions are, however, much the same as they were when there were six or 15 members. The process of enlargement poses a dilemma: with the number of members growing we need rules respected by everyone more than ever before, but at the same time such rules can be a straitjacket, especially given that the present rules were designed for a very different club.

One example is monetary policy and the process of adopting the euro. Policymakers designed a set of rules 15 years ago that are applied any time a country wants to join the single currency. The country is required to comply with the Maastricht criteria and also to stay for at least two years within the exchange rate mechanism-2 framework. Back then, these rules might have been perfectly legitimate, but today they are outdated and -counter-productive.

The ERM-2 might have made sense in a situation where monetary policies around western Europe were based primarily on fixed exchange rates explicitly or implicitly pegged to the D-mark. Then, the ERM-2 framework worked as a platform for co-operation among countries with interlocked currencies. Today, such a system does not generate any benefits for most EU members. There now exists a wide range of monetary policy frameworks, running from currency boards and hard pegs (used by Denmark and the Baltic states) to inflation-targeting economies with floating exchange rates (the UK, Sweden, the Czech Republic, Poland), with other countries lying somewhere in between.

Countries with currency boards have been allowed to pursue their original policy within the ERM-2, meaning that fulfilling the condition of staying inside this system is a formality.

But what is the sense in asking countries that already use inflation targets and floating rates to enter the ERM-2? The step is simply counter-productive. It implies switching from a regime that is perfectly compatible with the European Central Bank framework to a semi-fixed exchange rate, which is incompatible. We certainly do not need any exchange rate band to assess whether a currency is stable as determined by the market - we can just take a look at the prevailing market exchange rate.

Similarly, the budget deficit threshold of less than 3 per cent of gross domestic product has been modified by the stability and growth pact, which sets stricter criteria for keeping the fiscal house in order. All EU members are expected to comply with the pact, so that staying under the Maastricht 3 per cent limit is again purely a formality. This Maastricht criterion could be abolished without any harm being done.

What about inflation? Over the past three or four years we have had many discussions on this issue with the ECB and the European Commission. We have repeatedly pointed out that setting the inflation criterion in relative terms - against the three best performers in the EU - was an appropriate option 10 years ago. But today we have another firm anchor: the single currency and the definition of price stability applied by the ECB. The purpose is for an applicant to converge with the euro area. So the benchmark should be the price stability benchmark used by the ECB and not the countries that happen to have the lowest inflation, quite often because of one-off shocks.

Even more important, the growing number of EU members increases the probability of extremes: by definition the distribution of inflation rates is wider. Therefore the benchmark currently being used is systematically lower than it was during the second half of the 1990s. This means that the favourite argument of equal treatment does not hold: the same rule leads to stricter treatment because there is a different and much larger sample.

All these examples illustrate a more general European dilemma. We need a stable legal framework, but all legal systems in history have evolved as the world has changed. Rules such as constitutions are - and should be - difficult to change. Others, however, have to be more flexible. There is little doubt that rules supporting policymakers' decisions belong to the latter group.

We are caught between two poles. We need rules for policymaking, yet we must also retain some discretion. The response to the economic arguments should certainly not be: "The legal department has decided that the treaty says . . . ".