5 The ERM and the Maastricht Criteria: Spain

5.1 INTRODUCTION

If the accession of current or new EU members to the ERM is seen as widening, then Chapter 5 deals with an issue in deepening. It considers the transition of a median country to the core group, and thus MU selection, via ERM membership. In order to qualify for MU a country must satisfy the constraints laid out in the Maastricht Treaty, as discussed in Chapter 1. For the current EU member states this requires varying amounts of nominal convergence coupled with fiscal consolidation, as shown in Chapter 2.

The Treaty does not rank the criteria in any order of relative importance, a member must satisfy all (although there is some leeway on the interpretation of the fiscal requirements). What the Treaty does not give a target for is output or unemployment. As long as the criteria are met, a country's unemployment position, for example, does not affect membership.

Eichengreen (1993) and others have argued that the most compelling reason for MU comes from political economy considerations linked to the Single Market process. They argue that large swings in exchange rates during the transition to a Single Market could lead to pressure to abandon the integration process. Following this argument through leads to a logical extension. If the transition to MU is excessively painful or unstable then the commitment to MU may be abandoned, and thus, via Eichengreen's argument, commitment to the Single Market process.

To formalize the argument, one can make the distinction between stabilization policies and convergence policies. Most policy studies attempt to define policy mixes which minimize an objective function. Normally, the objective function is made up of absolute or squared deviations of variables, for example inflation or output, from their base or target values. Positive and negative deviations are equally costly in this framework. The targets can either be exogenous, for example potential output, or derived from some "base" set.

Convergence raises an important question in this context. What are the targets? It would appear obvious that for a converging country the targets would be the Maastricht criteria; however, these do not include output or unemployment. Therefore, policies which target convergence exclusively do
not support direct stabilization of output, whereas stabilization is normally seen as an integral part of policy. Any policy mix put in place in order to achieve convergence must therefore have two characteristics. First the convergence objectives must be attainable and clearly stated, and second, the policy mix should define how to stabilize the economy around its convergence path. On the one hand the policy regime defines how convergence is to be achieved, but on the other it also defines how shocks to the system are to be treated.

Whilst the literature has concentrated on issues such as transitional mechanisms to MUlt, convergence, debt sustainability, and the Maastricht criteria themselves, little has been done to integrate each of these elements into a general equilibrium framework or to combine these issues with stabilization. This chapter remedies this by integrating the Maastricht targets into a dynamic general equilibrium model with a fully specified demand and supply side. Furthermore, the treatment of the ERM regime and its effects on members' monetary policy is carefully constructed to capture the stylized facts. Small theoretical models are incapable of convincingly capturing the multiple targets of government policy attendant on convergence, and whilst large-scale models can do this, the problems discussed in Appendix 1 limit their attractiveness for such policy analysis. The model used in this chapter is both simple enough to be tractable and transparent, whilst offering the ability to convincingly model the ERM and the objectives of the domestic country and Germany.

The widening of the ERM bands to 15% presents an opportunity for ERM members to pursue other targets with monetary policy, or to reduce the weight attached to the exchange rate target, without breaking the exchange rate criteria. This chapter therefore considers two regimes which promote convergence and fiscal consolidation, but which have varying weights attached to stabilization. The first regime is labelled a "narrow band" ERM, corresponding to 2.25% bands, the second a "wide band" ERM, corresponding to 15% bands. For both regimes the tax rate is adjusted to hit the Maastricht criteria debt target.

The questions are: does the wide band ERM compromise convergence, and if not which regime offers the best mix of convergence and stabilization? The two regimes are compared on the basis of their ability to hit the Maastricht criteria. They are also subjected to shocks in order to compare their robustness and ability to stabilize output and inflation. In essence, the regime which minimizes the cost of convergence both with and without shocks is chosen as the dominant regime.

This approach to the issue of convergence gives a better insight into which mix of policy targets is likely to promote successful convergence and thus