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The Launch of the Euro and Economic Performance

2.1 Introduction

We start by examining the formation of the Economic and Monetary Union (EMU), considering the ‘convergence criteria’ which in principle determine whether a European Union (EU) country could and should join the euro. These ‘convergence criteria’ continue to be applicable to potential members of EMU, though our focus here is on the application of those criteria to the initial membership of EMU. It is argued that there were some notable omissions from the criteria applied, and those omissions in effect stored up problems for the euro area, which came to prominence in the years after the financial crisis of the late 2000s. This is followed by an overview of the macroeconomic performance in the euro area, which it is argued could be labelled lacklustre in the period preceding the financial crisis. In this overview we also point to the differences between the countries of the EMU, particularly with regard to inflation, competitiveness and the current account position, and indicate how those differences contributed significantly to the euro crisis.

The rest of this chapter proceeds as follows. After this short introduction, we discuss in section 2.2 the EMU convergence criteria and the Stability and Growth Pact (SGP). Section 2.3 assesses the economic performance of the euro area since its creation. Section 2.4 turns to the recent euro area crisis before some final comments are provided in section 2.5.

2.2 Convergence criteria and the Stability and Growth Pact

The Maastricht Treaty laid down criteria that should be met by those seeking to join the euro, and indeed countries meeting the criteria
were obliged to join, though some countries secured opt-outs from that obligation. The convergence criteria are set in nominal terms (relating to inflation and interest rates, for example) with no mention of real convergence (in terms of, for example, output per head or unemployment rates) or even of the convergence of business cycles across countries. The criteria include a budget deficit and a government debt limit designed to establish ‘fiscal responsibility’ in the eyes of the financial markets but no underlying rationale was provided for the limits set down. The independence of the national central banks on an operational and political level was also on the list of these criteria. In terms of countries meeting the criteria, it must be said that with the exception of the inflation rate and the interest rate, they were not met as comfortably as it might have appeared initially. In fact a great deal of ‘fudging’ took place. In the event, 11 countries out of the then 15 member countries of the EU were deemed to have met both these criteria and joined the EMU (Greece was not included initially, but in January 2001 was deemed to have met the criteria and became a member of the EMU).\(^2\) Denmark and the UK secured ‘opt-outs’ such that even when they satisfy the convergence criteria they are not obligated to join. Sweden voted against joining the euro in a referendum in 2003; and at the time of writing it does not satisfy the convergence criteria with regard to the independence of its central bank and membership of exchange rate mechanism.\(^3\)

The convergence criteria to be applied to a country for membership of the EMU under the Maastricht Treaty are:

1. Average exchange rate not to deviate by more than 2.25 per cent from its central rate for the two years prior to membership;
2. Inflation rate not to exceed the average rate of inflation of the three community nations with the lowest inflation rate by 1.5 per cent;
3. Long-term interest rates not to exceed the average interest rate of the three countries with the lowest inflation rate by 2 per cent;
4. Government budget deficit not to exceed 3 per cent of its GDP;
5. Overall government debt not to exceed 60 per cent of its GDP.

It is also required that a country has adopted an ‘independent central bank’ – that is, a central bank with operational independence from the national government under which the central bank would adhere to the ECB’s decisions on interest rates in pursuit of mainly the price stability objective; each national central bank adopts the interest rate as set by the ECB. The national central banks do, though, retain responsibility for the regulation of their domestic financial sector.